IASB PUBLISHES EXPOSURE DRAFT *PROVISIONS – TARGETED IMPROVEMENTS (PROPOSED AMENDMENTS TO IAS 37)*

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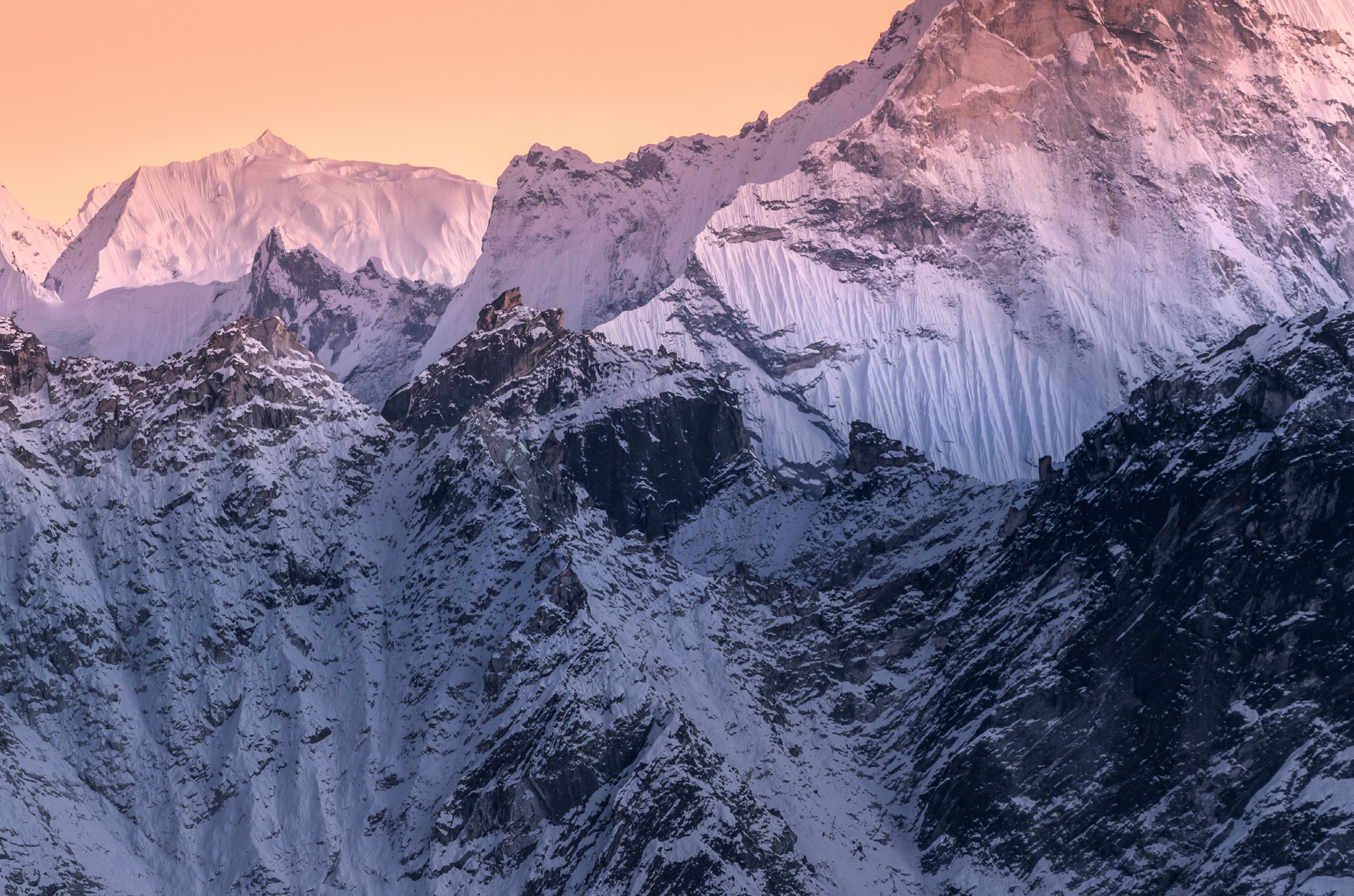

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BACKGROUND

The International Accounting Standards Board (IASB) published Exposure Draft *Provisions – Targeted Improvements (Proposed Amendments to IAS 37)* (the Exposure Draft) on 12 November 2024.

The Exposure Draft proposes targeted improvements to three aspects of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, one related to recognition and two related to measurement:

1. Recognition:

   The Exposure Draft proposes to amend the recognition criterion related to whether a present obligation exists, which must be met in order to recognise a provision.

2. Measurement:

   - The Exposure Draft proposes to amend the requirements related to the costs an entity includes in estimating the future expenditure required to settle its present obligation.
   - The Exposure Draft proposes that the discount rate used for determining the present value of provisions does not reflect non-performance risk i.e. the risk that the entity will not settle the obligation.

STATUS

Exposure draft

ACCOUNTING IMPACT

The proposed amendments may significantly affect entities that currently apply IFRIC 21 in situations where levies are charged if an entity takes two or more specific actions. The proposed amendments also affect the costs to be included in the measurement of provisions and the discount rate to be used for determining the present value of provisions.

The IASB has also proposed amendments to the *Guidance on Implementing IAS 37* (the Implementation Guidance). These proposals include proposed amendments to the existing examples to align them with the proposed requirements and addition of several new examples.

The Exposure Draft, the Basis for Conclusions and the Guidance on implementing may be accessed on the Provisions – Targeted Improvements project page on the IFRS Foundation website.

Comments on the Exposure Draft are due by 12 March 2025.

ENTITIES AFFECTED BY THE PROPOSED REQUIREMENTS

The proposed amendments would significantly affect entities that apply IFRIC® Interpretation 21 Levies (IFRIC 21) in situations where levies are charged if an entity takes two or more specific actions. The recognition of provision may occur earlier in these situations, as a result of the proposed amendments.

The proposed amendments to measurement requirements related to costs to be included in measuring a liability and the discount rate to be used may result in an increase in the amount of provisions depending on the accounting policies that the entities are currently following.

PROPOSALS RELATED TO DEFINITIONS AND PRESENT OBLIGATION RECOGNITION CRITERION

What is the issue?

There were mainly three reasons for proposing these amendments:

A

Difficulties in differentiating two distinct conditions within the present obligation recognition criterion.

B

Stakeholder dissatisfaction with IFRIC 21, Levies, which interprets the present obligation recognition criterion.

C

Difficulties in applying the requirements to laws and regulations with novel mechanisms or settlement options.

A. Difficulties in differentiating two distinct conditions within the present obligation recognition criterion:

IAS 37.10 defines a liability as a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

The first criterion for recognising a provision is that an entity has a present obligation (legal or constructive) as a result of a past event (IAS 37.14). There are essentially two conditions within the present obligation recognition criterion:

- An obligation condition: This is a requirement for a mechanism, for example, a law or a published policy of the entity that imposes responsibilities on the entity and leaves the entity with no realistic alternative to discharging those responsibilities if a specific event occurs.
- A past-event condition: This is a requirement that the specific event has occurred and consequently the obligation is a present obligation.

As the above two distinct conditions are combined in one condition, application issues arise because it can be unclear which condition an explanation refers to. For example, paragraph 19 of IAS 37 refers to an entity having no present obligation if it can avoid future expenditure through its future actions. It is unclear whether this reference applies to actions the entity could take to avoid creating a present obligation (the past-event condition) or to actions it could take to avoid settling the obligation (the obligation condition).

B. Stakeholder dissatisfaction with IFRIC 21 Levies:

In some cases, levies are charged if an entity takes two or more specific actions. In such circumstances, IFRIC 21 requires the entity to recognise the liability only when it takes the last of those actions, triggering the charge. This requirement results in entities recognising some recurring periodic levies as expenses at a single point in time late in the period for which they are charged, or even after the end of that period. This has led to some stakeholders' concerns around usefulness of the information provided.

C. Difficulties in applying the requirements to laws and regulations with novel mechanisms or settlement options:

Recently, certain new laws and regulations have been introduced with features that differ from those of conventional laws. For example, the obligations arising under some climate-related regulations are not conventionally enforceable; or an entity might be able to settle its obligations in a novel way - for example, by changing its future operations instead of by paying penalties.

In view of these features, the IASB felt that there was a need for a clear distinction between the obligation and past-event conditions within the present obligation recognition criterion and for clearer application guidance on the factors to consider in assessing whether an entity has a realistic alternative to settling an obligation.

What do the proposals require?

IAS 37.14 currently provides three criteria that need to be met in order for a provision to be recognised:

(a) an entity has a present obligation (legal or constructive) as a result of a past event;

(b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

(c) a reliable estimate can be made of the amount of the obligation.

The ED proposes to amend the first criterion i.e. the present obligation recognition criterion. No amendments are proposed to the second and third criteria.

The proposed amendments consist of the following:

I.
- Updating the definition of a liability

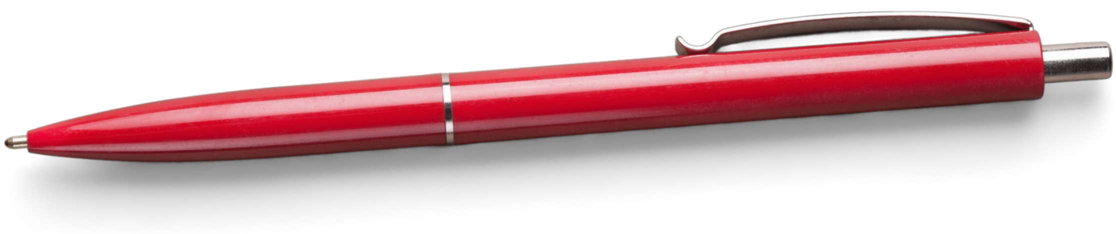
II.
- Aligning the wording of the present obligation recognition criterion with the updated definition of a liability

III.
- Removing the term 'obligating event'
- Adding three conditions within the present obligation recognition criterion

IV.
- Redefining a past event

V.
- Threshold-triggered costs

VI.
- Restructuring costs - improved wording



I. Updating the definition of a liability:

The ED proposes to amend the definition of a liability to align it with the definition in the Conceptual Framework.

The proposed definition of a liability is as below (new text is underlined and deleted text is struck out):

> *A liability is a present obligation of the entity to transfer an economic resource as a result of ~~arising from~~ past events~~, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits~~.*

II. Aligning the wording of the present obligation recognition criterion with the updated definition of a liability

The present obligation recognition criterion in IAS 37.14(a) is proposed to be amended as below to align it with the updated definition of a liability (new text is underlined):

> *an entity has a present obligation (legal or constructive) to transfer an economic resource as a result of a past event (paragraphs 14A–16)*

III. Three conditions within the present obligation recognition criterion, instead of the 'obligating event'

Currently, IAS 37.17 provides the requirements relating to 'obligating event'. The ED proposes to remove these requirements and replace them with a requirement to meet three distinct conditions - obligation, transfer and past-event conditions.

OBLIGATION CONDITION	TRANSFER CONDITION	PAST-EVENT CONDITION
The entity has an obligation.	The nature of the entity's obligation is to transfer an economic resource.	The entity's obligation is a present obligation that exists as a result of a past event.

These proposals would fundamentally change how the present obligation recognition criterion is applied to assess whether a provision is required to be recognised.

1. Obligation condition

The ED proposes that an entity has an obligation if all three of the following criteria are met:

Existence of a mechanism imposing a responsibility on the entity if it obtains specific economic benefits or takes a specific action

- Such mechanism can be legal or constructive.

The entity owes that responsibility to another party

- The entity need not know the identity of the party to whom the responsibility is owed.
- The other party could be a person(s) or another entity(ies) or society at large.

The entity has no practical ability to avoid discharging the responsibility if it obtains the specific economic benefits or takes specific action

- Legal obligation: The other party has a right to act against the entity if the entity fails to discharge the responsibility and as a result of that right, the economic consequences for the entity of not discharging the responsibility are expected to be significantly worse than the costs of discharging it.
- Constructive obligation: The entity's pattern of past practice, published policy or sufficiently specific current statement creates valid expectations in other parties that the entity will discharge the responsibility.

The following examples illustrate when the three criteria for the obligation condition would be met or not met:

CRITERION	CRITERION MET	CRITERION NOT MET
Mechanism imposing responsibility	An airline is required by law to overhaul its aircraft once every three years. ***This is a legal requirement. Therefore, there is a legal mechanism imposing a responsibility on the entity.*** *(Based on Example 11B from the proposed Implementation Guidance)*	An airline needs to overhaul its aircraft once every three years for technical reasons. There is no legal requirement for the overhaul. ***There is no legal or constructive mechanism imposing a responsibility on the entity.***
Responsibility owed to another party	An entity operates an offshore oilfield where the law requires it to remove the oil rig at the end of production and restore the seabed. ***The entity owes the responsibility to the government, which acts on behalf of society at large.***	An entity has a furnace that needs its lining replaced every five years. ***The responsibility is not owed to any other party. The entity replaces the furnace lining for its own benefit.*** *(Based on Example 11A from the proposed Implementation Guidance)*
No practical ability to avoid discharging the responsibility	An entity operates in the chemical industry. The entity's jurisdiction does not require it to treat the contaminated water used in the production process before discharging it. However, the entity has a published policy by which the entity treats the water contaminated in the production process. The entity has been known to adhere to this policy in the past. ***The entity has a pattern of past practice that creates a valid expectation in society at large that the water contaminated in its production process would be treated by the entity before discharge. Therefore, the entity does not have a practical ability to avoid discharging the responsibility.***	A private entity operates in the chemical industry. It has production facilities in multiple jurisdictions. The entity has a practice of treating contaminated water when there is a legal requirement in a particular jurisdiction to do so. At the beginning of December 20X1, the entity's Board of Directors decides to adopt a policy to treat contaminated water in all facilities irrespective of whether there is a legal requirement for it. This decision is not published or communicated internally or externally by 31 December 20X1. ***The entity does not have a pattern of past practice, published policy or sufficiently specific current statement that would create valid expectations in other parties that the entity would treat contaminated water in all facilities irrespective of***

CRITERION	CRITERION MET	CRITERION NOT MET
		the existence of legal requirements. Therefore, the entity cannot be said to not have practical ability to avoid discharging the responsibility.

2. Transfer condition:

For the transfer condition to be met, the obligation must have the potential to require the entity to transfer an economic resource to another party. The condition requires such potential to exist. It does not need to be certain or even likely that the entity will be required to transfer an economic resource.

BDO Comment

Does the proposed amendment mean that the probability of a transfer does not affect whether a provision is recognised?

The probability of a transfer does not affect whether the 'transfer condition' of the present obligation recognition criterion is met. However, IAS 37.14(b) requires transfer of economic resources to settle the obligation to be probable. This recognition criterion is not proposed to be amended, except for some amendments to the wording of the criterion to align it with the updated definition of liability.

What about executory contracts?

An executory contract is a contract, or a portion of a contract, that is equally unperformed. For example, Entity A enters into a contract with Entity B to purchase goods in exchange for an agreed consideration, which is required to be paid 3 months after the goods are delivered. Until the goods are delivered, neither party has performed under the contract and the contract is executory. Once the goods are delivered but the consideration is yet to be paid, Entity B will have performed under the contract, but Entity A will not. At this stage, the contract will not be executory.

A question arises whether an entity makes a provision for its responsibilities under executory contracts, i.e. in the above example, after the contract is entered into, whether Entity A should make a provision for the goods to be purchased under the contract.

The ED proposes to clarify that an obligation to exchange economic resources with another party is not an obligation to transfer an economic resource to that party unless the terms of the exchange are unfavourable to the entity. Therefore, obligations arising under executory contracts are not obligations to transfer an economic resource ***unless the contract is onerous***.

The following example illustrates when a transfer condition is met or not met:

New legislation requires an entity to make modifications to its production process to reduce green-house gas emissions. The modifications would involve purchase of energy-efficient machinery, purchase of electricity from renewable sources etc. Non-compliance with the requirement would lead to heavy penalties.

OBLIGATION TO PURCHASE ENERGY-EFFICIENT MACHINERY, ELECTRICITY FROM RENEWABLE SOURCES ETC.	OBLIGATION TO PAY FINES
Transfer condition not met: The obligation to purchase energy-efficient machinery and electricity from renewable sources is an obligation to exchange economic resources, not an obligation to transfer an economic resource. The entity will pay cash and receive property, plant and equipment and electricity in exchange.	***Transfer condition met:*** The obligation to pay fines is an obligation that has the potential to require the entity to pay cash. The entity will not receive any economic resource in exchange.

3. Past-event condition:

The ED proposes that an entity's obligation becomes a present obligation that exists as a result of a past event when the entity:

- has obtained specific economic benefits or taken a specific action; and
- as a consequence of having obtained those benefits or taken that action, will or may have to transfer an economic resource it would not otherwise have had to transfer.

The following example (based on example 6 in the proposed Implementation Guidance) illustrates when a past-event condition is met or not met:

New legislation requires an entity to fit smoke filters in its factories if it produces smoke in its operations by 30 June 20X1. Non-compliance with the requirement would lead to heavy penalties. The entity produces smoke in its operations, but has not fitted smoke filters in the factories by 31 December 20X1. Is the past-event condition met for the obligation to pay fines on 31 December 20X0 and 31 December 20X1?

30 DECEMBER 20X0	30 DECEMBER 20X1
Past-event condition not met: The entity has not yet taken the action, therefore a past event did not occur (producing smoke after 30 June 20X1) as a consequence of which it will have to fit smoke filters or may have to pay fines it would not otherwise have had to pay.	***Past-event condition met:*** The entity has taken the action (producing smoke after 30 June 20X1) and as a consequence of which it will have to fit smoke filters and may have to pay fines it would not otherwise have had to pay.

Summary of the recognition criteria:

The following diagram summarises the criteria that need to be met for recognising a provision under the proposed amendments:

Present obligation recognition criterion (IAS 37.14(a))	**Transfer of economic resources probable (IAS 37.14(b))**	**Reliable estimate (IAS 37.14(c))**
Obligation condition: ▶ Mechanism imposing responsibility ▶ Responsibility owed to another party ▶ No practical ability to avoid discharging the responsibility.	No amendments proposed, except some changes in wording.	No amendments proposed.
Transfer condition		
Past-event condition		

IV. Redefining a past event

The proposed amendments to the past event condition aim to address the criticism of IFRIC 21. As discussed in point (III.) above, in some cases, levies are charged if an entity takes two or more specific actions. In such circumstances, IFRIC 21 requires the entity to recognise the liability only when it takes the last of those actions, triggering the charge.

The ED proposes to clarify that in such situations, the past-event condition is met when the entity has taken the first action (or any of the actions) and has no practical ability to avoid taking the second action (or all the remaining actions).

BDO Comment

The above proposal may have a significant effect on recognition of provision for levies in situations where the levy is triggered by the entity taking two or more specific actions. Currently, a provision is recognised when an entity takes the last of the required actions.

Under the proposed amendments, the recognition of the provision would be accelerated to when the entity takes the first action (or any of the actions) and has no practical ability to avoid taking the second action (or all of the remaining actions).

Example (Based on Example 13B in the proposed Implementation Guidance)

Fact pattern:

A government charges a levy on banks. Any entity that is operating as a bank on the last day of its annual reporting period is within the scope of the levy. The amount of the levy is calculated by reference to the amounts in an entity's statement of financial position at the end of that reporting period. If the reporting period is longer or shorter than 12 months, the levy is increased or reduced proportionately—for example, if an entity has a nine-month reporting period, the levy is 9/12ths of the initial amount calculated. An entity receives no economic resources in exchange for paying the levy.

At the start of an entity's current annual reporting period, the entity is operating as a bank.

Analysis under the proposed requirements:

Management:

- Assesses all the terms of the legislation and concludes that the requirement to pay the levy is a consequence of the entity taking two separate actions:
  - operating in its current annual reporting period and
  - operating as a bank on the last day of that period.

  Both actions are required for the levy to be payable.
- Judges that the entity has no practical ability to avoid paying the levy if it takes the two actions.
- Judges that the entity has no practical ability to avoid the second action because the economic consequences for the entity of ceasing banking activities before the end of the annual reporting period would be significantly more adverse than the cost of paying the levy charged for that period.

The entity starts to take the first action from the start of the current annual reporting period and has no practical ability to avoid the second action. Therefore, the past-event condition is met at the start of the annual reporting period.

The amount of the levy depends on the length of the reporting period. Therefore, the present obligation accumulates over the annual reporting period.

Therefore, the liability is recognised over the annual reporting period.

Analysis under IFRIC 21 (Based on Example 3 from illustrative examples in IFRIC 21):

The obligating event, as identified by the legislation, is the entity operating as a bank at the end of the annual reporting period. Before that point, the entity has no present obligation to pay a levy, even if it is economically compelled to continue to operate as a bank in the future. Assuming the current annual reporting period ends on 31 December 20X1, the activity that triggers the payment of the levy, as identified by the legislation, is the entity operating as a bank at the end of the annual reporting period, which does not occur until 31 December 20X1.

The fact that the amount of the levy depends on the length of the reporting period does not change the conclusion.

Therefore, the liability is recognised in full on 31 December 20X1.

V. Threshold-triggered costs

In some situations, an entity has an obligation to transfer an economic resource only if a measure of its activity in a period (the assessment period) exceeds a specific threshold. For example, the entity is required to pay certain penalty, if its greenhouse gas emissions exceed a specified limit in a specific assessment period.

In its assessment, the IASB concluded that the action that satisfies the past-event condition is all activity that contributes to the total activity on which the cost is assessed, both activity below the threshold and activity above the threshold. Therefore, the past event condition begins to be met as soon as an entity starts carrying out the activity that contributes to the total being assessed.

Therefore, at any date within the assessment period, the present obligation is a portion attributable to the activity carried out to date.

VI. Restructuring costs - improved wording

IAS 37.70-83 set out recognition requirements for restructuring provisions. Those paragraphs currently require an entity to recognise a restructuring provision when it has a 'constructive obligation to restructure'. However, the IASB noted that IAS 37 should not refer to a 'constructive obligation to restructure' on account of the following reasons:

- restructuring is an activity implemented for the benefit of the entity, not an obligation owed to another party.
- the obligations arising from a restructuring are not necessarily constructive.
- the obligations are present obligations only if the requirement to pay the restructuring costs is a consequence of the entity having obtained specific economic benefits or taken a specific action in the past and having no practical ability to avoid a second specific action required to trigger the payments.

Therefore, the IASB decided to amend the wording related to the requirements for restructuring costs without changing the substance of the requirements.

Instead of a 'constructive obligation to restructure', the ED proposes to amend the wording to a 'present obligation for the costs of the restructuring' in IAS 37.72. The ED proposes similar wording changes in other paragraphs related to restructuring costs.

PROPOSALS RELATED TO EXPENDITURE REQUIRED TO SETTLE AN OBLIGATION

What is the issue?

IAS 37.68A specifies the costs that an entity is required to include when assessing whether a contract is onerous. These costs are the costs that relate directly to the contract i.e. the incremental costs of fulfilling the contract and an allocation of other costs that relate directly to fulfilling contracts.

An application question arose in this respect of which costs an entity includes in measuring an onerous contract provision and, more broadly, any provision within the scope of IAS 37.

What does the Exposure Draft propose?

The Exposure Draft proposes to clarify that the expenditure required to settle an obligation comprises the costs that relate directly to the obligation. Similar to the requirement for assessing whether a contract is onerous, the costs that relate directly to an obligation consist of both:

- the incremental costs of settling that obligation; and
- an allocation of other costs that relate directly to settling obligations of that type.

BDO Comment

Entities may not currently include an allocation of other costs that relate directly to settling the obligations in the measurement of a provision. Under the proposed requirements, entities would be required to include such costs in the measurement of the provision. Therefore, there would be an increase in the amount of the provisions measured in accordance with IAS 37.

PROPOSALS RELATED TO DISCOUNT RATES

For the purpose of discounting, IAS 37.47 currently requires an entity to use a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability, to the extent these risks are not reflected in the cash flows.

The IASB proposes to clarify that the current market assessments of the time value of money are represented by a risk-free rate.

Instead of 'risks specific to the liability', the IASB proposes that the discount rate would reflect risks surrounding the amount or timing of the expenditure required to settle the obligation if those risks are not reflected in the estimates of the future cash flows.

Therefore, under the proposed requirements, the discount rate would be a pre-tax rate, reflecting the following:

Current market assessments of the time value of money, represented by a risk-free rate.	+	Risks surrounding the amount or timing of the expenditure required to settle the obligation if those risks are not reflected in the estimates of the future cash flows.

Non-performance risk:

'Risks specific to the liability' that IAS 37.47 currently requires to be reflected in the discount rate include the uncertainty in the amount or timing of the expenditure required to settle the liability. But IAS 37 does not currently specify whether risks specific to the liability also include non-performance risk, i.e. the risk that the entity will not settle the liability.

The IASB proposes to clarify that the discount rate does not reflect non-performance risk.

The IASB considered the following factors while reaching the above conclusion:

- Provisions within the scope of IAS 37 such as asset decommissioning obligations typically do not include an obligation for an entity to pay the counterparty compensation for accepting non-performance risk.
- There was a preference among stakeholders for a rate that can be determined objectively by reference to an observable market rate. The non-performance risk associated with a provision is not observable and can differ from the non-performance risk associated with an entity's other liabilities. Therefore, adjustments for non-performance risks can be highly subjective.
- Measuring a provision at an amount that reflects the entity's own credit standing can be counter-intuitive, as an entity with a weak credit standing would measure a liability at a lower amount than an entity with a stronger credit standing.

OTHER PROPOSALS

Disclosure requirements

The ED proposes a new requirement to disclose the discount rate (or rates) used in measuring the provision and the approach used to determine that rate (or those rates).

Implementation guidance

The ED proposes to add a three-part decision tree that summarises the process of applying the three criteria for recognising a provision.

The ED also proposes four new examples in the Implementation Guidance to assist users to apply the proposed requirements related to recognition of a provision. The existing examples are proposed to be amended to align them with the proposed requirements. All the examples illustrate how the three conditions of present obligation recognition criterion (obligation condition, transfer condition and past-event condition) may be assessed for the given fact patterns.

PROPOSED TRANSITION REQUIREMENTS

The amendments are proposed to be applicable retrospectively in accordance with IAS 8 *Accounting Policies*, *Changes in Accounting Estimates and Errors*. To apply the amendments retrospectively, an entity would be required to identify, recognise and measure provisions and re-measure the carrying amount of related assets as if the entity had always applied the amendments. Any resulting net difference would be recognised in retained earnings or other component of equity, as appropriate.

Mandatory exception to retrospective application:

The ED proposes one mandatory exception to retrospective application of the amendments, for costs included in the measurement of a provision.

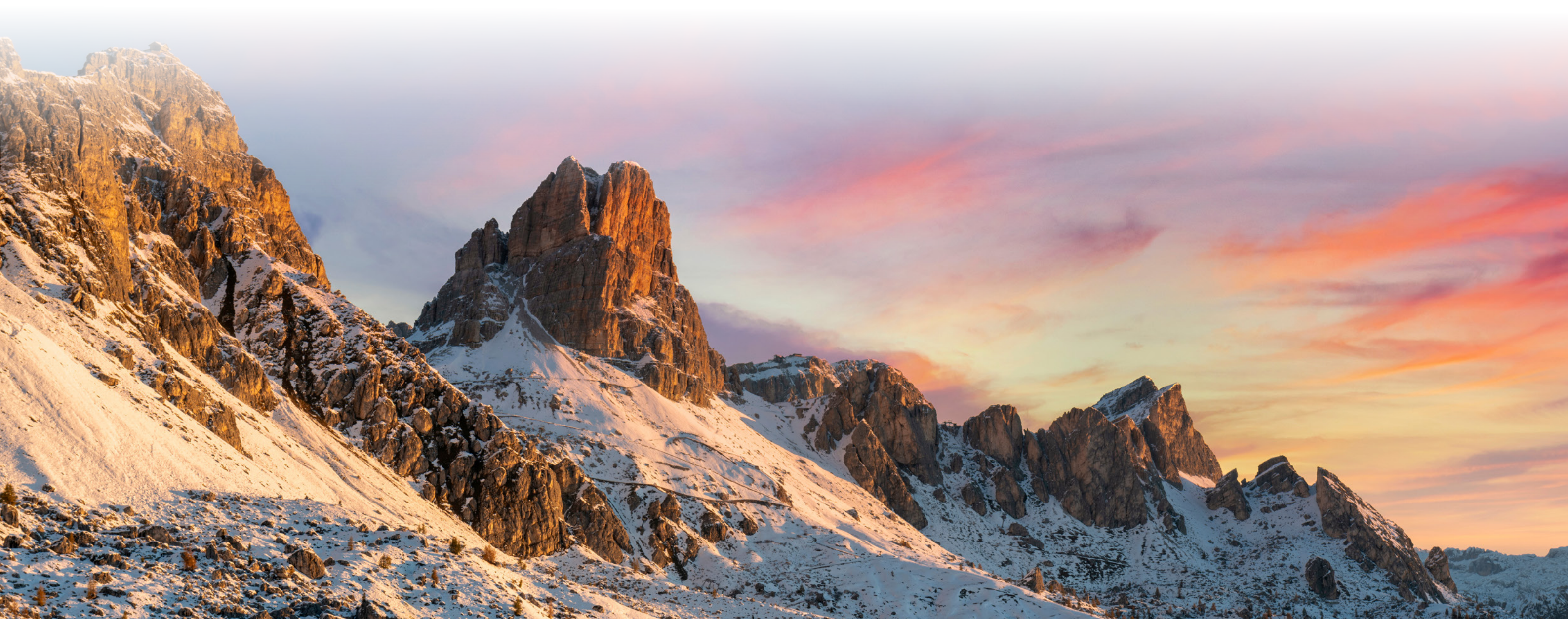
This exception would apply if an entity changed its accounting policy for the costs it includes in the measure of a provision to comply with the proposed requirements. The entity would be required to apply such a change only to obligations the entity has not yet settled at the date of initial application and without restating comparative information. The cumulative effect of initially applying the amendments would be recognised as an adjustment to the opening balance of a related asset (if any), retained earnings or other component of equity, as appropriate, at the date of initial application.

Optional exemption from retrospective application:

The Exposure Draft also proposes an exemption from retrospective application that an entity may choose to apply. This exemption applies if an entity changes its accounting policy for determining discount rates to comply with the proposed amendments. The exemption permits an entity to not apply the requirements of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* for changes in the measurement of a provision that occurred before the transition date, if the entity changes its accounting policy for determining discount rates to comply with the proposed requirements. The entity electing to use this exemption would apply the amended requirements to restate the provision at the transition date and apportion the amount by which it adjusts the provision at the transition date between the related asset and retained earnings:

- assuming the current discount rate(s) and estimates of cash flows used in measuring the provision have not changed since the provision was first recognised; and
- using current estimates of the useful life of the related asset.

This exemption is proposed because of the requirements in IFRIC 1 related to fluctuations in the amount of provisions for asset decommissioning or restoration liabilities. IAS 37 requires an entity to measure a provision using current estimates of the expenditure required to settle the present obligation and a current market assessment of the time value of money. As a result, the amount of provision for asset decommissioning or restoration liabilities fluctuates between reporting dates. IFRIC 1 requires such fluctuations to be added to or deducted from the cost of the related asset and are recognised prospectively in the statement of profit or loss with depreciation or impairment. To comply with the requirements of IFRIC 1 on retrospective application of the proposed amendments, an entity would be required to construct a historical record of every change to the asset's cost and accumulated depreciation, which could be onerous. Therefore, the IASB has proposed the above exemption to the transition requirements.



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