IFRS Accounting

Staff paper

Agenda reference: AP3

Joint CMAC-GPF meeting
June 2023

Provisions—Present obligation recognition criterion

Background

- The IASB is undertaking a project to make three targeted improvements to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- One of these improvements would affect a criterion for including ('recognising') a provision in the financial statements—specifically, the requirement for an entity to have a present obligation as a result of a past event.
- The IASB is considering amending the requirements supporting that recognition criterion, with the aim of:
  - clarifying the requirements—making them easier to apply, promoting consistent application; and
  - changing the timing of recognition of some provisions—specifically provisions for costs (often levies) that are triggered only if the entity takes both (or all) of two (or more) actions.
- The IASB has already developed concepts on which to base new requirements—it added those concepts to its *Conceptual Framework* in 2018. The amendments to IAS 37 would involve importing the concepts into IAS 37 (to replace existing requirements), withdrawing IFRIC 21 *Levies* and updating some of the illustrative examples accompanying IAS 37.

Purpose of this session

This session has two aims:

1. To start familiarising you with the possible amendments, which are still at an early stage of development.

> The staff will present an overview of the possible amendments and their implications for a selection of illustrative examples, by talking through slides 4–21.

2. To hear your initial reactions to the possible amendments, and seek your views on two specific questions the IASB will be considering as it develops the amendments:
   a) whether to add application requirements specifying when to recognise provisions for charges triggered if a measure of the entity's activity (for example its revenue or carbon emissions) exceeds a threshold; and
   b) what guidance, if any, to add on the meaning of 'no practical ability to avoid'—and specifically on whether to amend or clarify a statement in IAS 37 that, for a legal obligation, it is necessary that the obligation 'can be enforced by law'.

> You will be invited to discuss these questions in breakout groups by reference to illustrative examples. The breakout group questions and examples are set out in slides 22–29.

Staff presentation

An introduction to the possible amendments

Current status of amendments and IASB plans

IASB discussed possible amendments at April 2023 meeting[1]—no decisions

IASB now consulting stakeholders

- Tentative decisions at future meeting
- Any proposed amendments would be exposed for comment

1 Agenda Paper 22 *Liability definition and 'present obligation' recognition criterion*
Agenda Paper 22 (Appendix A) *Initial staff suggestions for amendments to IAS 37*
Agenda Paper 22 (Appendix B) *Initial staff suggestions for amendments to illustrative examples accompanying IAS 37*

IAS 37 criteria for including ('recognising') a provision in financial statements

➊ The entity has a present obligation as a result of a past event,

➋ outflows are probable, and

➌ the amount can be reliably estimated.

Possible amendments would affect this criterion

Applying the 'present obligation' criterion—problems with existing requirements

Existing requirements

1. IAS 37—Entity has:
   - obligation that exists independently of its future actions
   - no realistic alternative to settling obligation.
2. IFRIC 21 *Levies*—if an entity pays a levy only if it takes both (or all) of two (or more) specified actions, entity has a present obligation only when it has taken the last action.

Problems

1. Requirements unclear—does an entity have an obligation if it can avoid expenditure through future actions but taking those actions is not a realistic alternative?

   → inconsistent application and frequent requests for clarification submitted to IFRS Interpretations Committee.
2. IFRIC 21 → late and point-in-time recognition of annual levies. Criticised for:
   - misrepresenting the entity's financial position
   - being inconsistent with other IFRS Standards.

Applying the ‘present obligation’ criterion—possible new requirements

Apply concepts added to IASB’s *Conceptual Framework* in 2018:

- Disentangle and separately explain three conditions for identifying a liability:
  1. entity has an obligation–defined as a responsibility it has no practical ability to avoid (see slide 9)
  2. obligation is to transfer an economic resource (see slide 10)
  3. obligation is a *present* obligation that exists as a result of *past events* (see slide 11).
- Redefine ‘as a result of past events’ and withdraw IFRIC 21.

Potential advantages

Easier application—clearer requirements and enables step-by-step process for assessing whether criterion is met—promoting consistent application.

Earlier and progressive recognition of some levies.

Applying the present obligation criterion—**Step 1**

Does the entity have an obligation (condition 1)?

Does a specified action (or combination of actions) of the entity give it a responsibility it has no practical ability to avoid?

No → No liability—no provision recognised

Yes ↓

Step 2

Responsibility could be:

- **legal**—ie derive from legislation, a contract or other operation of law; or
- **constructive**—ie derive from entity's past practice, published policies or sufficiently specific current statement.

Applying the present obligation criterion—**Step 2**

Is the obligation to transfer an economic resource (condition 2)?

Does it have the **potential** to require the entity to transfer an economic resource?

No → No liability—no provision recognised

Yes ↓

Step 3

An obligation to **exchange** economic resources is not an obligation to transfer an economic resource unless the exchange is unfavourable, eg an onerous contract.

Applying the present obligation criterion—**Step 3**

Does a present obligation exist as a result of a past event (condition 3)?

Has entity taken the specified action?

If the obligation arises from a combination of actions, has entity:

a) taken any of the actions; and
b) no practical ability to avoid the remaining actions?

No → No liability—no provision recognised

Yes ↓

✓ **Present obligation criterion met** Provision recognised if two other recognition criteria are also met.

✓ Outflows are probable
✓ Amount can be reliably estimated

Applying the 3 steps: Example 1—Levy

A government enacts legislation requiring all entities operating in a market on 1 January 20X1 to pay a levy.

Each entity must pay 1% of the revenue it generated in 20X0.

An entity has generated revenue in 20X0 and is preparing financial statements for the year ended 31 December 20X0.

Is the 'present obligation' criterion satisfied at 31 December 20X0?

✓

Applying the 3 steps: Example 2—Net zero commitment

In 20X0, a manufacturer publicly announces its commitment to become ‘net zero’ by 20X5.

It announces it will:

a) immediately start changing its processes with the aim of reducing its greenhouse gas emissions by at least 60% by 20X5; and

b) in 20X5 and thereafter, offset any remaining emissions by paying the forestry commissions of specified countries to plant trees.

Is the present obligation criterion satisfied at 31 December 20X0?

Applying the 3 steps: Example 3—Restructuring plan

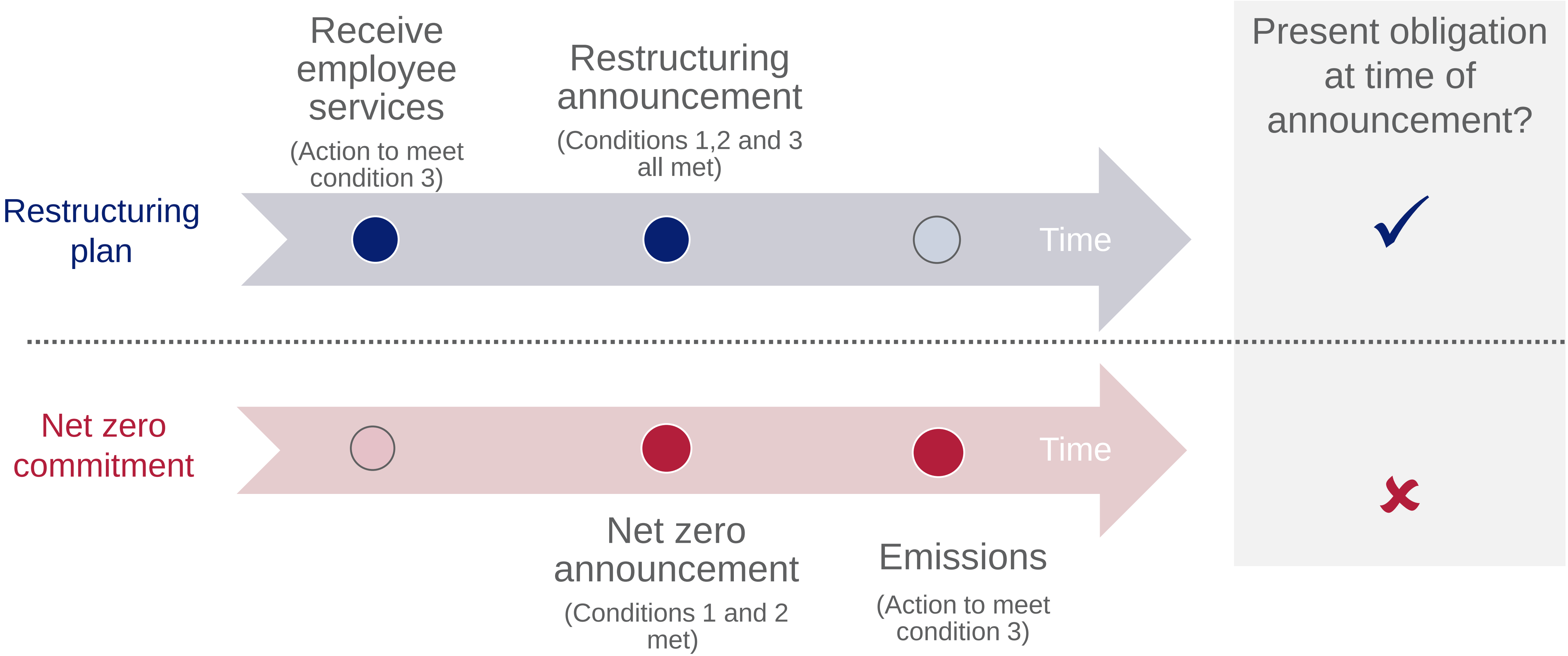
Employees of an entity are contractually entitled to compensation if the entity terminates their employment contracts. The amount depends on their length of service.

Before the end of its reporting period, the entity has:

- prepared a detailed formal plan for closing a division and terminating the contracts of that division's employees; and
- announced the main features of the plan to the employees and others affected by the closure.

Is the 'present obligation' criterion met at the end of the reporting period? ✓

Comparison: net zero commitment (Example 2) versus restructuring plan (Example 3)



Open questions

Seeking your views on two topics

Open questions

The IASB will have several questions to consider as it develops the possible amendments. Two questions it has already identified for further research and discussion are:

a) whether to add specific application requirements specifying when to recognise provisions for charges triggered when a measure of the entity's activity (for example its revenue or carbon emissions) exceeds a threshold—see slides 18–19.

b) what guidance, if any, to add on the meaning of 'no practical ability to avoid'—see slides 20–21.

Application requirements for charges triggered by exceeding a threshold

Examples of charges

- Sector levies on entities with revenues exceeding a specified annual amount.
- Penalties for greenhouse gas emissions above a specified target.

Thresholds could be cumulative or average measures.

Factors to consider in assessing the need for application requirements

- Prevalence—are such obligations widespread in practice?
- Are the amounts large enough for information about the obligations to be material?
- Are specific requirements necessary to avoid diversity in practice (might different views be reached on the answers to the questions on slides 9–11)?

Application requirements for obligations triggered by exceeding a threshold

Possible views on when condition 3 is met

1. The 'specified action' is activity above the threshold—no present obligation exists until the entity's activity has exceeded the threshold **or**

→ Provision recognised later

2. The 'specified action' is the activity to which the charge applies—a present obligation starts to accumulate as soon as the entity starts to perform the activity:

   A. if it has no practical ability to avoid exceeding the threshold **or**

   B. irrespective its ability to avoid exceeding the threshold—exceeding the threshold is not a separate activity.

→ Provision recognised earlier

Expectations about the extent to which the entity will exceed the threshold could affect the measurement of the provision.*

* Perhaps analogous to situations in which different income tax rates apply to different levels of taxable income? IAS 12 *Income Taxes* requires deferred tax to be measured at average rate expected to apply.

Application guidance on meaning of ‘no practical ability to avoid’

IAS 37

Existing guidance

= no practical ability to avoid

Entity has no realistic alternative to settling a **legal** obligation only if settlement of the obligation can be enforced by law.

Possible reason for clarifying or amending this guidance

- Some recent (often climate-related) laws cannot be enforced in conventional ways, ie by asking the courts to enforce compliance
- Instead, governments have a legal right to provide economic incentives for compliance or impose economic sanctions (eg, restrictions on future market access) for non-compliance
- Questions arise—is the ‘can be enforced by law’ requirement satisfied.

Application guidance on meaning of ‘no practical ability to avoid’

Possible solutions

Clarify ‘can be enforced by law’ or replace it with new application guidance on the meaning of no practical ability to avoid.

What the IASB’s *Conceptual Framework* says

- factors used to assess whether an entity has the practical ability to avoid transferring an economic resource may depend on the nature of the entity’s responsibility
- eg, in some cases, entity may have no practical ability to avoid a transfer if any action that it could take to avoid the transfer would have economic consequences significantly more adverse than the transfer itself. [1]

[1] Paragraph 4.34 of the *Conceptual Framework*

Breakout group discussions

Topic 1—Charges triggered by exceeding a threshold

Breakout topic 1—Charges triggered by exceeding a threshold

Questions for discussion

An entity might incur a charge (for example, to pay a levy or purchase carbon credits) if a measure of its activity (for example, its revenue or gas emissions) exceeds a specified threshold.

Please refer to the information on slides 9–11 and 18–19 and discuss:

1. for the fact pattern described on slide 24:
    a. when you think the company has a present obligation arising from a past event; and
    b. which aspects of the general requirements set out in slides 9–11 you are applying in reaching that view.
2. whether IAS 37 needs application requirements for charges triggered by exceeding a threshold.

Breakout topic 1—Charges triggered by exceeding a threshold

Fact pattern

In accordance with legislation, a levy is triggered if a company generates revenue exceeding 50 million currency units (CU50 million) in 20X1. The levy rate is 0 per cent revenue below CU50 million and 2 per cent of revenue above CU50 million.

An entity has an annual reporting period that ends on 31 December. In 20X1, its revenue reaches the revenue threshold of CU50 million on 17 July 20X1.

This fact pattern reflects the fact pattern of Illustrative Example 4 accompanying IFRIC 21 *Levies*. However, the conclusions reached applying concepts in the *Conceptual Framework* may be different from those reached applying the consensus in IFRIC 21.

Breakout group discussions

Topic 2—Application guidance on meaning of ‘no practical ability to avoid’

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Breakout topic 2—Application guidance on meaning of 'no practical ability to avoid'

Questions for discussion

As explained on slides 8-9, the IASB is considering amendments to IAS 37 that would result in entities recognising provisions for obligations that they have 'no practical ability to avoid'.

Please refer to the information slides 20–21 and discuss:

1. whether in the fact pattern described on slide 27, you think the entity has an obligation it has no practical ability to avoid.
2. whether IAS 37 needs application guidance on the meaning of 'no practical ability to avoid' and if so, what that guidance should be. Should it refer to economic compulsion and if so, what should it say?
3. whether the guidance should clarify or replace the existing requirement that a legal obligation 'can be enforced by law'.

Breakout topic 2—Application guidance on meaning of ‘no practical ability to avoid’

Fact pattern

A government enacts legislation to encourage the sale of low-emission cars in its market. Under the legislation, car manufacturers receive *positive* credits for producing cars with average emissions *lower* than a target, and *negative* credits for producing cars with average emissions *higher* than the target.

Under the legislation, manufacturers with negative credits are required to offset them by obtaining and surrendering positive credits. The government does not have the right to force manufacturers to comply with this requirement, but it does have the right to restrict a non-compliant manufacturer’s access to its car market in the future.

A manufacturer has produced cars whose average emissions exceed the government target. For that manufacturer, the likely economic consequences of the government’s right to restrict its market access are significantly more adverse than the cost of obtaining positive credits.

This fact pattern reflects one discussed by the IFRS Interpretations Committee. The Committee published its conclusions in Agenda Decision Negative Low Emission Vehicle Credits in July 2022

Breakout group discussions

Topic 3—Other comments

Breakout topic 3—Other comments

Questions for discussion

Having listened to the staff presentation, are there any other matters that you think it is important for the IASB to consider as it continues its discussions on this topic?

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