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Staff paper

Agenda reference: 3

Emerging Economies Group meeting

Date	**May 2024**
Project	**Provisions—Targeted Improvements to IAS 37**
Topic	**Climate-related matters**
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Session overview

In this session, we'll explore how climate-related matters are influencing the IASB's current work on IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

AQ

Application question to the IFRS Interpretations Committee

Climate-related Commitments

MP

IASB Maintenance Project

Provisions—Targeted Improvements

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AQ

Application question

Climate-related commitments

Climate-related commitments

Fact pattern

In 20X0, an entity publicly states its commitment to be ‘net zero’ from 20X9. It commits:

20X9

by 20X9

to **reduce** by 60% its annual greenhouse gas emissions, by modifying its manufacturing methods

from 20X9

to **offset** its remaining emissions by buying and retiring carbon credits

Climate-related Commitments

Clarification requested

How does IAS 37 apply to these net zero commitments?

1. Does the public statement **create a constructive obligation** to fulfil the commitments?
2. If so, does the entity **recognise a provision** for that obligation?

Climate-related Commitments

Interpretations Committee analysis—constructive obligation

Definition of constructive obligation

Entity’s past practice, published policies or sufficiently specific current statement:

- indicates to other parties that entity will accept certain responsibilities; and
- creates valid expectation that entity will discharge those responsibilities.

Analysis—Whether statement of net zero commitment creates constructive obligation will depend on facts and circumstances

Climate-related Commitments

Interpretations Committee analysis—provision

Analysis

No constructive obligation → No provision

Constructive obligation → Consider whether obligation meets IAS 37 criteria for recognising provision

Climate-related Commitments

Interpretations Committee analysis—provision

Recognition criteria

Present obligation as a result of a past event	Probable outflow of resources	Reliable estimate

Analysis

Obligation to **reduce** emissions is **not** a present obligation—costs to modify manufacturing methods are costs of operating in the future

Obligation to **offset** emissions becomes a present obligation only when entity has emitted gases it has committed to offset—ie in 20X9 onwards

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Climate-related Commitments

Interpretations Committee conclusions and decision

Conclusions

- Whether statement of net zero commitment creates constructive obligation depends on facts and circumstances
- In fact pattern considered, constructive obligation (if any) becomes present obligation only when entity has emitted gases it committed to offset. Provision recognised then if other recognition criteria are met.
- **Entity's transition plan might affect amounts at which entity measures other assets and liabilities, and information it discloses about them**

Decision

IAS 37 requirements provide an adequate basis to determine whether to recognise a provision, so no project added to work plan

Agenda Decision *Climate-related Commitments* published April 2024

Question for EEG members

Does this Agenda Decision give you the guidance you need to apply IAS 37 to the net zero commitments you see in practice?

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Maintenance project

Provisions—Targeted Improvements

Project overview

Objectives—targeted improvements to IAS 37

1. Criteria for recognising a provision—amendments to 'present obligation' criterion (IAS 37.14(a))
   - Clarifications—easier application, fewer questions to the IFRS Interpretations Committee
   - Changes—earlier and progressive recognition of some annual levies—more useful information
2. Measurement—tighter discount rate requirements (IAS 37.47)
   - less diversity in practice

Stage

IASB currently developing proposals

Exposure draft expected H2 2024

How climate-related matters are influencing the project

Non-traditional features of climate-related regulations highlight need for clarifications

- non-traditional enforcement mechanisms
  - market-based incentives instead of enforcement through courts
- novel settlement methods
  - opportunities to settle obligations by changing future operations

As discussed in
Agenda Decision *Negative Low Emission Vehicle credits*

Climate-related regulations reinforce need for changes to requirements affecting levies

Climate-related regulations may impose costs with levy-like features

- for example, costs triggered when greenhouse gas emissions exceed a specified threshold

A closer look at ‘present obligation’ proposals

1. Present obligation recognition criterion—clarifications
2. Meaning of ‘obligation’—clarifications
3. Meaning of ‘present obligation’—changes
4. New application guidance—threshold-triggered costs
5. Additional illustrative examples

1 Present obligation recognition criterion—clarifications

	IAS 37 now	Likely proposal (per *Conceptual Framework*)
Liability definition	Present obligation arising from past events, expected to result in outflow of resources embodying economic benefits	Present obligation to transfer an economic resource as a result of past events
Present obligation recognition criterion	Present obligation (legal or constructive) as a result of a past event	Present obligation (legal or constructive) to transfer an economic resource as a result of a past event

1 Present obligation recognition criterion—clarifications

Clearer supporting requirements

IAS 37 now	Likely proposal		
Obligating event event that creates obligation entity has no realistic alternative to settling	**Responsibility condition** Entity has an obligation	**Transfer condition** Obligation is to transfer economic resource	**Timing condition** Obligation is a **present obligation**—a result of a past event
	Mechanism exists that (a) imposes responsibility on entity, and (b) is strong enough in effect that entity has **no practical ability to avoid** responsibility	Exchange ≠ transfer (unless unfavourable)	

Mixes responsibility + timing conditions

Three distinct conditions explained separately

2 Meaning of ‘obligation’—clarifications

Meaning of ‘no practical ability to avoid’

	IAS 37 now		Likely proposal
Legal obligation	Settlement can be enforced by law	→	1. Other party has legal right to take action against entity if entity fails to settle obligation, and 2. as a result, economic consequences of not settling are significantly more adverse than those of settling
Constructive obligation	Entity’s past practice, policy or statement creates valid expectation in other parties that entity will settle obligation	=	(No change)

3 Meaning of 'present obligation'—changes

IAS 37 now	Likely proposal
Paragraph 19 in IAS 37 Obligation exists independently of entity's future actions + **IFRIC 21 *Levies*** Obligating event is event that triggers payment of levy	▪ Present obligation arises when: ○ entity has obtained economic benefits or taken an action, and ○ as a consequence, will or may have to transfer an economic resource it would not otherwise have had to transfer ▪ If transfer will be required only if entity takes two (or more) separate actions, present obligation arises when entity takes first action if it has no practical ability to avoid taking other action (or actions)

Earlier and progressive recognition of some levies

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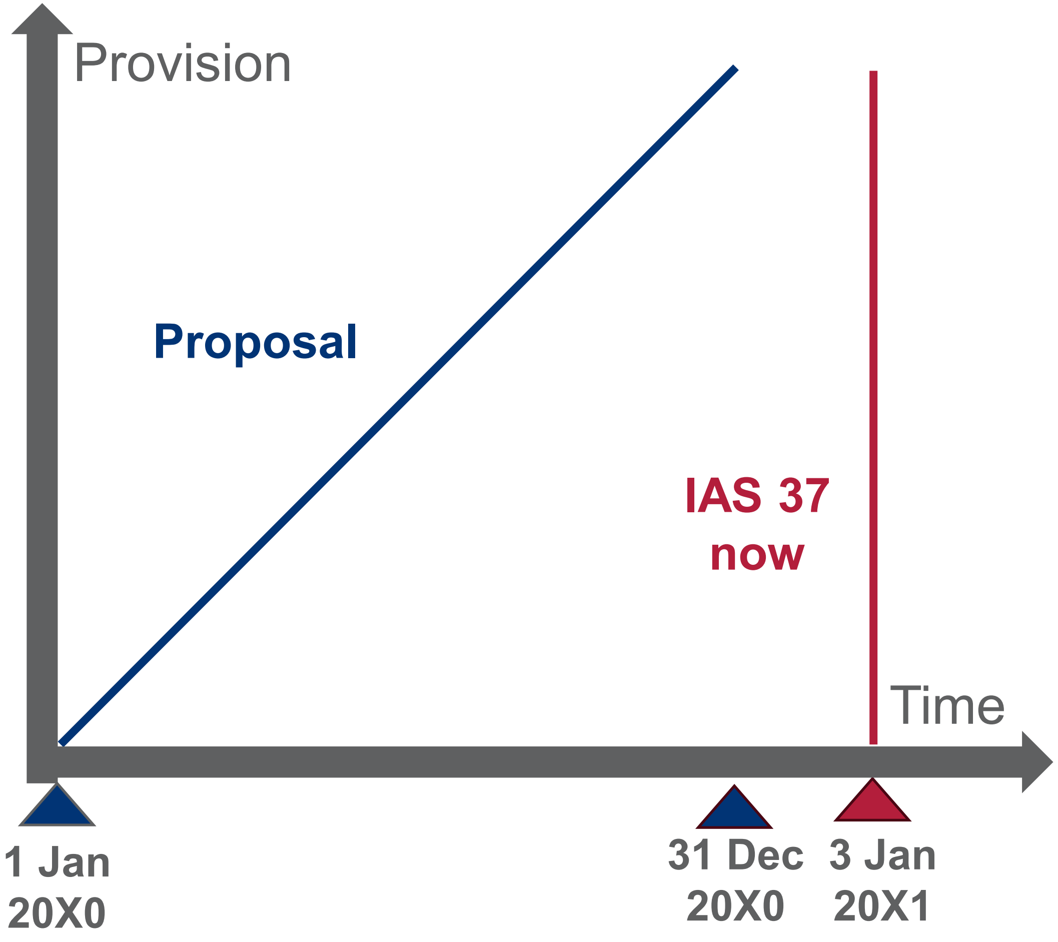
3 Meaning of 'present obligation'—illustration

- Levy triggered when entity generates revenue in a market in 20X1
- Levy is 1% of revenue generated in 20X0
- Entity generates revenue evenly throughout 20X0, and in 20X1 starts to generate revenue on 3 January 20X1
- Throughout 20X0, management judges entity has no practical ability to exit market before 20X1

Two separate actions of entity:
1. Generate revenue in 20X0
2. Start to generate revenue in 20X1



4 New application requirements—threshold-triggered costs

Threshold-trggered costs—costs payable if a measure of entity's activity in a period exceeds a specified threshold

Examples

- Levy payable by entity whose annual revenue exceeds specified monetary amount
- Maintenance costs lessee pays if condition of leased asset at end of lease falls below specified threshold
- Penalties imposed on entity whose greenhouse gas emissions in specified period exceed allocated quota

4 New application requirements—threshold-triggered costs

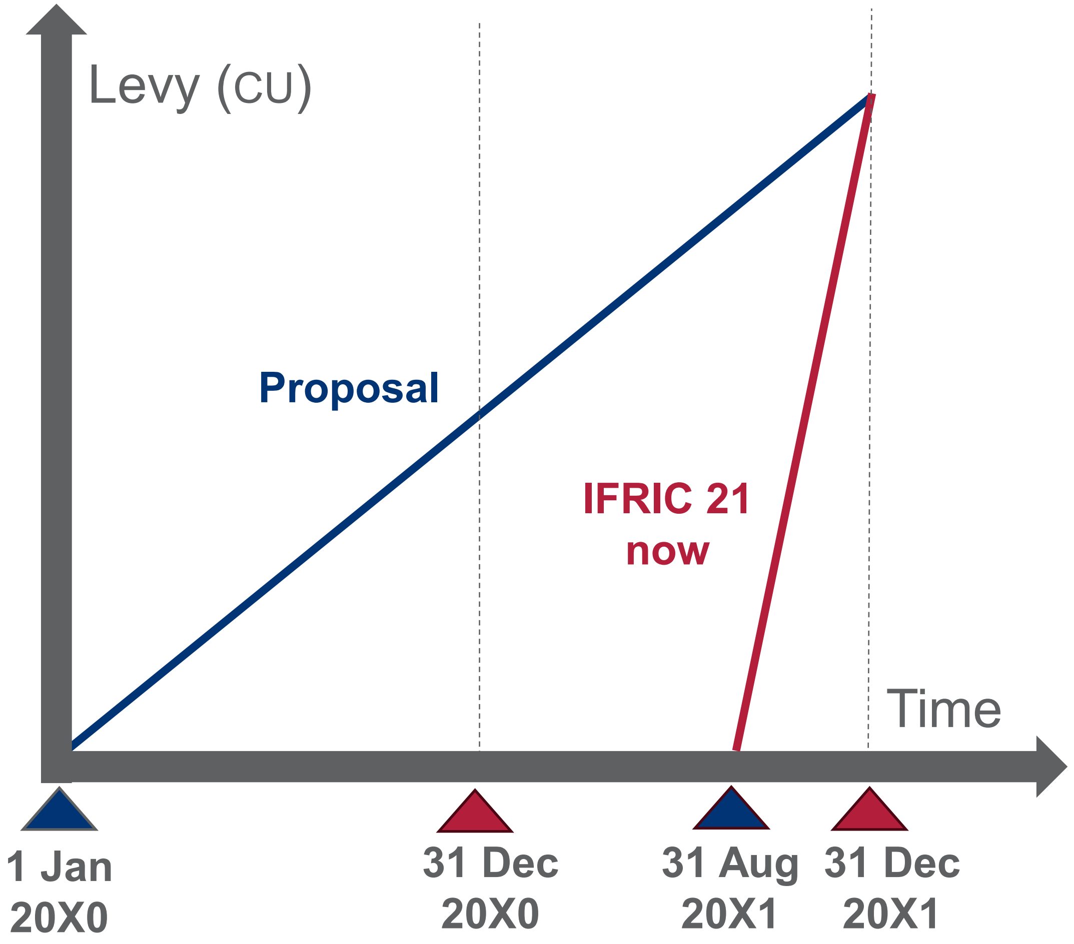
IAS 37 now	Likely proposal
IFRIC 21 Example 4 • Present obligation arises only when activity exceeds threshold	• Present obligation arises as entity conducts activity that contributes to total activity on which cost is measured • Amount is portion of expected total cost • Provision is recognised if other recognition criteria are met: 1. probable transfer—ie probable that activity will exceed threshold, and 2. amount can be reliably estimated

4 Threshold-triggered costs—example

- Entity will pay levy if revenue exceeds CU200 million in two-year period—1 Jan 20X0 to 31 Dec 20X1
- Levy = 1% of revenue above threshold
- Management forecasts entity will generate revenue of CU10 million / month (CU240 million in 2-year period)
- Actual revenue equals forecast—crossing threshold on 31 August 20X1

Complications in practice

Actual revenue likely to differ from forecasts and forecasts could change over time—catch up adjustments would be required



5 Additional illustrative examples

Proposals could include new examples based on the fact patterns of:

- IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*
- Various levies, including fact patterns like those in the examples accompanying IFRIC 21
- Interpretations Committee Agenda Decision *Negative Low Emission Vehicle Credits*
- Interpretations Committee Agenda Decision *Climate-related Commitments*

Question for EEG members

What are your views on the proposals described on slides 14–23?

You could consider whether:

- the clarifications described on slides 15–17 would make IAS 37 easier to apply
- the changes described on slides 18–19 would result in more useful information for investors
- the application requirements for threshold-triggered costs described on slides 20–22 would make IAS 37 easier to apply and result in useful information for investors
- there are other transactions (in addition to those described on slide 23) for which illustrative examples might be helpful.

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