Climate-related Commitments (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*)

The Committee received a request asking it to clarify:

a. whether an entity's commitment to reduce or offset its greenhouse gas emissions creates a constructive obligation for the entity;
b. whether a constructive obligation created by such a commitment meets the criteria in IAS 37 for recognising a provision; and
c. if a provision is recognised, whether the corresponding amount is recognised as an expense or as an asset when the provision is recognised.

The Committee considered this request by reference to the following fact pattern.

Fact pattern
In 20X0 an entity, a manufacturer of household products, publicly states its commitment:

a. to gradually reduce its annual greenhouse gas emissions, reducing them by at least 60% of their current level by 20X9; and
b. to offset its remaining annual emissions in 20X9 and in subsequent years by buying carbon credits and retiring them from the carbon market.

To support its statement, the entity publishes a transition plan setting out how it will gradually modify its manufacturing methods between 20X1 and 20X9 to achieve the 60% reduction in its annual emissions by 20X9. The modifications will involve investing in more energy-efficient processes, buying energy from renewable sources and replacing existing petroleum-based product ingredients and packaging materials with lower-carbon alternatives. Management is confident that the entity can make all these modifications and continue to sell its products at a profit.

In addition to publishing the transition plan, the entity takes several other actions that publicly affirm its intention to fulfil its commitments.

Does the entity have a constructive obligation?
Paragraph 10 of IAS 37 defines a constructive obligation as an obligation that derives from an entity's actions where:

a. by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
b. as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

Paragraph 20 of IAS 37 states that an obligation always involves another party to whom the obligation is owed, but that it is not necessary to know the identity of that party—the obligation may be to the public at large. The Committee observed that a constructive obligation to reduce or offset greenhouse gas emissions, if one exists, would be owed to all people adversely affected by the emissions so would extend to the public at large.
The Committee further observed that whether an entity's statement of its commitment to reduce or offset its emissions creates a valid expectation that it will fulfil the commitment—and hence creates a constructive obligation to do so—depends on the facts of the commitment and the circumstances surrounding it, including any actions the entity has taken that publicly affirm its intention to fulfil the commitment. Management would apply judgement to reach a conclusion at each reporting date considering all relevant facts and circumstances existing at that date. If the facts or circumstances change from one reporting date to the next, so too could the conclusion.

If the entity's statement has not created a constructive obligation, the entity does not recognise a provision. If the entity's statement has created a constructive obligation, the next question to consider is whether that obligation satisfies the criteria for recognising a provision.

Does the constructive obligation satisfy the criteria for recognising a provision?
Paragraph 14 of IAS 37 requires an entity to recognise a provision when:

a. the 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.

An entity recognises a provision only if all three of these recognition criteria are met.

Present obligation as a result of a past event
The first criterion for recognising a provision is that the entity has a present obligation as a result of a past event.

The Committee observed that, just as the enactment of a law is not sufficient to give an entity a present legal obligation, the publication of a policy or statement is not sufficient to give an entity a present constructive obligation—an entity has a present legal or constructive obligation only when the event to which the law, policy or statement applies has occurred. For example, as illustrated in Illustrative Example 2B accompanying IAS 37, an entity with a widely published policy of cleaning up land it contaminates incurs a present obligation only when it contaminates land—publishing the policy is necessary but not sufficient to give the entity a present obligation.

In explaining the requirement for a present obligation, paragraph 18 of IAS 37 states that 'no provision is recognised for costs that need to be incurred to operate in the future' and paragraph 19 of IAS 37 states that 'it is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions'.

Applying those paragraphs, the Committee concluded that if the commitments described in the fact pattern create a constructive obligation for the entity:

a. that obligation is not a present obligation as a result of a past event when the entity publicly states the commitments in 20X0. Neither stating a commitment nor taking actions that affirm the entity's intention to fulfil that commitment are events that create a present obligation. The events that create a present obligation are the events to which the statement applies and those events have not occurred at the time the entity states its commitment. The costs that the entity will incur to reduce its annual greenhouse gas emissions and to offset the greenhouse gases it emits in 20X9 and in subsequent years are costs that it will need to incur to operate in the future—the obligations for those costs do not exist independently of the entity's future actions.
b. at any given date, the entity does not have a present obligation to reduce its emissions after that date, because the costs of operating with lower emissions in the future will remain costs that need to be incurred to operate in the future. The entity will at some future date have a liability to pay for resources it buys to carry out those future operations—for example, to pay for new plant or equipment—but only when it receives those resources in an exchange transaction.
c. only when the entity has emitted the greenhouse gases that it has committed to offset will it have a present obligation to offset those greenhouse gases. The entity will have that present obligation only if and when it emits greenhouse gases in 20X9 and in subsequent years.

Probable outflow of resources
The second criterion for recognising a provision is that it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation.

The Committee concluded that if the commitments described in the fact pattern create a constructive obligation for the entity:

a. settling the constructive obligation to reduce the entity's annual greenhouse gas emissions will not require an outflow of resources embodying economic benefits. Although the entity will incur expenditure to modify its manufacturing methods, it will receive other resources—for example, property, plant, equipment, energy, product ingredients or packaging materials—in exchange, and will be able to use these resources to manufacture products it can sell at a profit.
b. settling the constructive obligation to offset the entity's remaining annual greenhouse gas emissions will require an outflow of resources embodying economic benefits. The entity will be required to buy and retire carbon credits without receiving any resources embodying economic benefits in exchange.

Reliable estimate
The final criterion for recognising a provision is that a reliable estimate can be made of the amount of the obligation.

Paragraph 25 of IAS 37 states that 'except in extremely rare cases, an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision'.

The Committee concluded that in the fact pattern described, it is likely that the entity would be able to make a reliable estimate of the amount of a constructive obligation that satisfies the other recognition criteria.

Conclusion on whether a provision is recognised

The Committee concluded that in the fact pattern described:

a. whether the entity's statement of its commitments to reduce and offset its greenhouse gas emissions creates a constructive obligation to fulfil those commitments will depend on the facts of the statement and the circumstances surrounding it.
b. if the statement creates a constructive obligation:
    i. the entity does not recognise a provision when it makes the statement in 20X0. At that time, the constructive obligation is not a present obligation as a result of a past event.
    ii. the entity does not recognise a provision between 20X0 and 20X9 because it does not have a present obligation as a result of a past event until it has emitted the greenhouse gases it has committed to offset.
    iii. as the entity emits greenhouse gases in 20X9 and in subsequent years, it will incur a present obligation to offset these past emissions. If the entity has not yet settled that obligation and a reliable estimate can be made of the amount of the obligation, the entity recognises a provision.

If a provision is recognised, is the corresponding amount recognised as an expense or as an asset when the provision is recognised?

The Committee observed that if a provision is recognised, the corresponding amount is recognised as an expense, rather than as an asset, unless it gives rise to—or forms part of the cost of—an item that qualifies for recognition as an asset in accordance with an IFRS Accounting Standard.

Other accounting and disclosure implications

The Committee observed that, irrespective of whether an entity's commitment to reduce or offset its greenhouse gas emissions results in the recognition of a provision, the actions the entity plans to take to fulfil that commitment could affect the amounts at which it measures its other assets and liabilities and the information it discloses about them, as required by various IFRS Accounting Standards.

Conclusion

The Committee concluded that the principles and requirements in IFRS Accounting Standards provide an adequate basis for an entity to determine:

a. whether an entity's commitment to reduce or offset its greenhouse gas emissions creates a constructive obligation for the entity;
b. the circumstances in which the entity recognises a provision for the costs of fulfilling a constructive obligation to reduce or offset its greenhouse gas emissions; and
c. if a provision is recognised, whether the corresponding amount is recognised as an expense or as an asset when the provision is recognised.

Consequently, the Committee decided not to add a standard-setting project to the work plan.