# STAFF PAPER

**February 2022**

## IASB Meeting

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| **Project** | **Provisions—Targeted Improvements** | | |
| Paper topic | Project review | | |
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## Overview

1 The International Accounting Standards Board (IASB) has on its work plan a project to make targeted improvements to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets.*

2 The IASB has not discussed this project for some time. The purpose of this meeting is to review the project's prospects for progress and decide whether to keep the project on the IASB's work plan.

3 The staff recommend that the IASB keep the project on its work plan.

## Paper structure

4 This paper includes:

(a) a recap of the history and objectives of the project (paragraphs 5–9); and

(b) a discussion of factors affecting the project's prospects for progress (paragraphs 10–12).

## Project history

5 From 2015 to 2019, IASB staff researched possible problems with IAS 37.

6 At its meeting in January 2020, the IASB considered a staff research summary and project proposal.[1] The IASB decided to add a standard-setting project to its work plan, with the objective of making three targeted improvements to IAS 37.

7 The IASB has not discussed the staff's work further since that meeting due to other priorities.

## The project objectives

8 The three objectives of the Provisions—Targeted Improvements project are to:

(a) align the IAS 37 liability definition and requirements for identifying liabilities with the liability definition and supporting concepts in the IASB's *Conceptual Framework for Financial Reporting* (*Conceptual Framework*);

(b) clarify which costs to include in the measure of a provision; and

(c) specify whether the rate at which an entity discounts a provision should reflect the entity's own credit risk.

9 The appendix to this paper describes for each of those objectives:

(a) the problem that the project is seeking to address; and

(b) potential solutions the IASB has identified and discussed with stakeholders.

[1] IASB Meeting January 2020 Agenda Paper 22 *Provisions—Project proposal* and Agenda Paper 22A *Provisions—Research summary*.

## Factors affecting the project's prospects for progress

10 As explained in Agenda Paper 24A *Third Agenda Consultation—Projects on the current workplan—proposed response to feedback*, some respondents to the Request for Information *Third Agenda Consultation* suggested that the IASB reassess the priority of projects on its current work plan. A few respondents suggested that the IASB consider whether to proceed with or discontinue work on the Provisions—Targeted Improvements project. Some of those respondents identified this project as one of several that have been on the work plan for a considerable time and, in their view, are unlikely to progress.[2]

11 However, the staff think this project is capable of progressing efficiently:

(a) progress has been limited to date only because of competing priorities. We expect that the staff assigned to this project will have more time to spend on it soon. And we think the project will not be resource intensive because much of the thinking required to complete the project—for example, the development of new concepts for identifying liabilities—has already been done.

(b) we are not aware of any other possible obstacles to efficient progress. The IASB selected matters to address in this project only after examining a range of possible problems with IAS 37 and consulting stakeholders on each one. The three matters the IASB has included within the scope of the project are all matters for which stakeholders generally agreed:

(i) there is a practical need for improvements to IAS 37; and

(ii) the solutions the IASB has identified and developed are feasible.

12 It is possible that the need for this project is, if anything, growing. As explained further in paragraphs A2–A9 of the appendix, the IAS 37 criteria for identifying liabilities are proving difficult to apply to some climate-related measures now being implemented by governments around the world. Aligning IAS 37 with the *Conceptual*

2 Paragraphs 45–46 of IASB December 2021 meeting Agenda Paper 24A *Third Agenda Consultation—Feedback summary—Other comments*.

*Framework* could provide preparers of financial statements with more robust criteria for judging whether and when an entity subject to such measures has an obligation that meets the definition of a liability.

## Staff recommendation

13 For the reasons described in paragraphs 11–12, the staff recommend that the IASB keep the Provisions—Targeted Improvements project on its work plan.

| Question for the IASB |
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| Do you agree? |

## Appendix—Project objectives and how they could be achieved

A1 The three objectives of the Provisions—Targeted Improvements project are to:

(a) align the IAS 37 liability definition and requirements for identifying liabilities with the liability definition and supporting concepts in the IASB's *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) (paragraphs A2–A9);

(b) clarify which costs to include in the measure of a provision (paragraphs A10–A13); and

(c) specify whether the rate at which an entity discounts a provision should reflect the entity's own credit risk (paragraphs A14–A17).

### *Alignment with the Conceptual Framework*

*Perceived problem*

A2 Over the years, stakeholders have often identified problems with IAS 37 requirements for identifying liabilities. These problems tend to stem from requirements and guidance in IAS 37 that do not distinguish clearly between:

(a) actions that give rise to an obligation—which must have occurred in the past (a timing fact); and

(b) actions that settle an obligation—which the entity will have to take in the future because it has no realistic alternative to settling the obligation (an enforceability assessment).

A3 In response to requests for more clarity, the IFRS Interpretations Committee (Committee) issued two Interpretations: IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment* and IFRIC 21 *Levies*.

A4 These interpretations have not resolved all the problems. As explained further in the staff research summary:

(a) the requirements they introduce for levies are perceived to be inconsistent with requirements in IAS 37 for other types of provisions—for example, constructive obligations and restructuring provisions—and with the requirements of other IFRS Accounting Standards; and

(b) IFRIC 21 has been criticised by a range of stakeholders because, in combination with other IFRS Accounting Standards, it results in some levies whose amount accumulates over a period being recognised as expenses at a single point in time at or after the end of that period.

A5 Furthermore, questions continue to arise. The Committee is now considering a request relating to a government's measures to encourage the production of low emission—typically electric—vehicles. The measures apply to entities that produce vehicles for sale in a specific market. Under the measures, a producer that fails to produce a target proportion of low emission vehicles in one year is given 'negative credits', and is required to eliminate those negative credits by obtaining and surrendering positive credits in the following year. If such a producer fails to eliminate its negative credits, the government can impose sanctions on the producer, for example restrict its access to the market. A question raised by the request is whether a producer that has failed to produce the target proportion of low emission vehicles, but could avoid having to eliminate negative credits through its future actions (accepting sanctions):

(a) does not yet have a present obligation (a timing fact); or

(b) has a present obligation that meets the definition of a liability unless accepting sanctions is a realistic alternative for that producer (an enforceability assessment).

A6 The Committee has published a tentative agenda decision explaining its conclusion that, in the fact pattern of the request, a producer that has failed to produce the target proportion of low emission vehicles has a present obligation that meets the definition of a liability in IAS 37 unless accepting sanctions is a realistic alternative for that producer. However, the discussions among Committee members highlighted ambiguities in the wording of IAS 37 requirements. [3]

A7 We have been told that climate-related measures similar to those described in paragraph A5 are proliferating. It can be difficult to decide whether and when such measures give rise to liabilities because the obligations they impose may be linked to more than one activity or other condition (so identifying an obligating event can be difficult) and governments sometimes seek to achieve their objectives through economic incentives or sanctions rather than through more conventional legal powers (so enforceability assessments can be difficult). Furthermore, each set of measures has its own unique features and so needs to be analysed individually. Entities subject to the measures need robust criteria for assessing whether and when to recognise liabilities.

*Potential solution*

A8 In 2018, the IASB issued a revised *Conceptual Framework* with a new liability definition and new concepts to support that definition. The IASB developed those new concepts with the problems of IAS 37 in mind, and in part to provide a basis for improving IAS 37. The new concepts more clearly distinguish between timing and enforceability criteria, and describe each criterion more precisely than IAS 37 does.

A9 The IASB could align IAS 37 with the *Conceptual Framework* by:

(a) replacing the existing definitions of a liability and an obligating event (in paragraph 10 of IAS 37) and supporting requirements (in paragraphs 17–22 of IAS 37) with the definition and supporting concepts in paragraphs 4.26–4.47 of the *Conceptual Framework*.

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3 Interpretations Committee meeting papers: November 2021 Agenda Paper 4 *Negative Low Emission Vehicle Credits (IAS 37)—Initial Consideration* and February 2022 Agenda Paper 2 *Negative Low Emission Vehicle Credits (IAS 37)—Wording of tentative agenda decision*.

Interpretations Committee meeting summaries: November 2021 IFRIC *Update* and February 2022 IFRIC *Update*.

(b) updating the illustrative examples accompanying IAS 37. Updating the examples could include absorbing the examples presently in IFRIC 6 and IFRIC 21. The staff think that updating the examples would:

(i) change the conclusions only for some of the levy examples in IFRIC 21; but

(ii) clarify the reasons for the existing conclusions in some of the other examples accompanying IAS 37.

### *Clarifying which costs to include in the measure of a provision*

*Perceived problem*

A10 In May 2020, the IASB made a narrow-scope amendment to IAS 37. This amendment clarifies which costs an entity includes in assessing whether a contract is onerous, and hence in determining whether the entity needs to recognise an onerous contract provision.

A11 The amendment clarifies that, in assessing whether a contract is onerous, an entity includes all costs that relate directly to the contract. Such costs consist of both:

(a) the incremental costs of fulfilling that contract—for example, direct labour and materials; and

(b) an allocation of other costs that relate directly to fulfilling contracts—for example, an allocation of the depreciation charge for an item of property, plant and equipment used in fulfilling that contract among others.

A12 Preparers of financial statements might reasonably decide that all the costs included in assessing whether a contract is onerous should also be included in measuring any resulting onerous contract provision, and perhaps in measuring all other types of provisions within the scope of IAS 37. However, without an explicit statement to this effect, it is uncertain whether all these costs must be included.

*Potential solution*

A13 The IASB could resolve the uncertainty by clarifying which costs to include in the measure of a provision. To make the measurement requirements consistent with the onerous contract identification requirements, the IASB could add a new paragraph below paragraph 36 of IAS 37, specifying that the expenditure required to settle an obligation includes all costs that relate directly to settling that obligation.

### *Specifying whether discount rates should reflect an entity's own credit risk*

*Perceived problem*

A14 IAS 37 requires an entity to discount estimates of future cash flows to their present value, and states that the discount rate must reflect current market assessments of the time value of money and the risks specific to the liability.

A15 IAS 37 does not specify whether the rate should reflect the entity's own credit risk, that is the possibility the entity may fail to fulfil its obligation. An entity can reflect its own credit risk by discounting a liability at its borrowing rate instead of a risk-free rate.

A16 The staff research project identified diversity in practice. The predominant practice appears to be for entities to exclude their own credit risk. However, some entities—concentrated in particular jurisdictions and sectors—include their own credit risk, discounting liabilities using their borrowing rate instead of a risk-free rate, and reporting smaller liabilities as a result. For entities with large, long-term decommissioning or environmental rehabilitation provisions—for example entities in power supply and extractive industries—the difference has a substantial effect on their reported financial position and performance, leading to significant loss of comparability between entities.

*Potential solution*

A17 The IASB could add a sentence to IAS 37, specifying whether the rate at which an entity discounts a provision should include or exclude the entity's own credit risk. Almost all stakeholders consulted during the research project said they thought that own credit risk should be excluded.