IFRS Accounting

Staff paper

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Project	**Provisions**
Topic	**Present obligation recognition criterion**
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Accounting Standards Advisory Forum, July 2023, Agenda paper 6A (Appendix B)
This paper was discussed at the International Accounting Standards Board's (IASB's) April 2023 meeting as Agenda Paper 22 (Appendix B). Agenda papers referred to in this paper are other agenda papers for the IASB's April 2023 meeting, unless otherwise noted.

Initial staff suggestions for amendments to **Illustrative Examples** accompanying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

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C Examples: recognition

…Example 5A Closure of a division – no implementation before end of the reporting period

On 12 December 20X0 the board of an entity decided to close down a division. Before the end of the reporting period (31 December 20X0) the decision was not communicated to any of those affected and no other steps were taken to implement the decision.

Present obligation as a result of a past event – The entity has not yet taken the actions that leave it with no practical ability to avoid closing its division. Hence it does not have an obligation for the costs of closure. **Conclusion** – No provision is recognised (see paragraphs 14,72 and 72A).

Example 5B Closure of a division – communication/implementation before end of the reporting period

On 12 December 20X0, the board of an entity decided to close down a division making a particular product. On 20 December 20X0 a detailed plan for closing down the division was agreed by the board; letters were sent to customers warning them to seek an alternative source of supply and redundancy notices were sent to the staff of the division.

Present obligation as a result of a past event – By the end of the reporting period, the entity has taken the actions that leave it with no practical ability to avoid closing the division, and hence with a present obligation for costs of closing the division.

An outflow of resources embodying economic benefits in settlement – Probable.

Conclusion – A provision is recognised at 31 December 20X0 for the best estimate of the costs of closing the division (see paragraphs 14F, 72-72A and 80).

Example 6 Legal requirement to fit smoke filters

Under new legislation, an entity is required to fit smoke filters to its factories by 30 June 20X1. The entity has not fitted the smoke filters.

(a) At 31 December 20X0, the end of the reporting period

Present obligation as a result of a past event – There is no obligation because there is no obligating event either for the costs of fitting smoke filters or for fines under the legislation. Any obligation to fit smoke filters is an obligation to exchange one economic resource (cash) for another (smoke filters), not an obligation to transfer an economic resource. Receiving and fitting smoke filters is the activity that establishes a present obligation to pay for the filters and their fitting. Operating without filters after 30 June 20X1 is the activity that establishes an obligation to pay any fines for non-compliant operation of the factory. Neither of these activities has occurred by 31 December 20X0 so there is no present obligation as a result of past events.

Suggested amendments to Examples 6, 11A and 11B explained in paragraphs 57 – 64 of Agenda Paper 22.

Conclusion – No provision is recognised for the cost of fitting the smoke filters (see paragraphs 14, 16C and 19A).

(b) At 31 December 20X1, the end of the reporting period

Present obligation as a result of a obligating event – There is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the receipt and fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation because the obligating event has occurred (the non-compliant operation of the factory).

A transfer of economic resources in settlement – Assessment of probability of incurring fines and penalties by non-compliant operation depends on the details of the legislation and the stringency of the enforcement regime.

Conclusion – No provision is recognised for the costs of fitting smoke filters. However, a provision is recognised for the best estimate of any fines and penalties that are more likely than not to be imposed (see paragraphs 14, 16C and 19A).

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Example 11 Repairs and maintenance

Some assets require, in addition to routine maintenance, substantial expenditure every few years for major refits or refurbishment and the replacement of major components. IAS 16 *Property, Plant and Equipment* gives guidance on allocating expenditure on an asset to its component parts where these components have different useful lives or provide benefits in a different pattern.

Example 11A Refurbishment costs – no legislative requirement

A furnace has a lining that needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years.

Present obligation as a result of a past event – There is no present obligation to transfer an economic resource.

Conclusion – No provision is recognised (see paragraphs 14, 16C and 18–19A).

Relining a furnace involves the exchange of one economic resource (cash) for another (the restoration of service potential of the furnace)—not the transfer of an economic resource. Instead of a provision being recognised, the depreciation of the lining takes account of its consumption, ie it is depreciated over five years. The re-lining costs then incurred are capitalised with the consumption of each new lining shown by depreciation over the subsequent five years.

Example 11B Refurbishment costs – legislative requirement

An airline is required by law to overhaul its aircraft once every three years.

Present obligation as a result of a past obligating event – There is no present obligation to transfer an economic resource.

Conclusion – No provision is recognised (see paragraphs 14, 16C and 18–19A).

The costs of overhauling aircraft are not recognised as a provision for the same reasons as the cost of replacing the lining is not recognised as a provision in example 11A. Even a legal requirement to overhaul does not make the costs of overhaul a liability, because overhauling an aircraft involves the exchange of one economic resource (cash) for another (the restoration of the service potential of the aircraft)—not the transfer of an economic resource.. Instead of a provision being recognised, the depreciation of the aircraft takes account of the future incidence of maintenance costs, ie an amount equivalent to the expected maintenance costs is depreciated over three years.

Example 12 Waste management costs

Incorporates IFRIC 6 as an illustrative example, allowing IFRIC 6 to be withdrawn,

The conclusion is the same as the consensus in IFRIC 6. Only minor changes in wording are needed.

In 20X3, a government enacts legislation requiring manufacturers of specified types of electrical equipment to contribute to the cost of environmentally-sound disposal of that equipment at the end of its useful life. One section of the legislation applies to equipment manufactured and sold before the legislation was enacted (historical equipment). It specifies that the disposal costs for all historical equipment will be allocated to manufacturers of that type of equipment in proportion to their market share in 20X5.

An entity that manufactured and sold historical equipment, and expects to have market share in 20X5, is preparing financial statements for the year to 31 December 20X3.

Present obligation as a result of a past event

At 31 December 20X3, the entity does not have a present obligation as a result of a past event. The event that gives rise to an obligation—the activity that will or may require the entity to incur disposal costs it would not otherwise have incurred—is participation in the market in 20X5. The entity's past manufacture and sale of historical equipment does not give rise to an obligation because those activities have no bearing on the costs the entity will incur.

Conclusion – No provision is recognised (see paragraphs 14 and 19A).

Examples 13A–13D incorporate the fact patterns of the four illustrative examples accompanying IFRIC 21 *Levies*.

As a result of aligning IAS 37 with the *Conceptual Framework*, the analysis and conclusions change in three of the four examples.

Example 13A Levy charged progressively as an entity generates revenue

A government charges a levy on entities that operate in a specified market. The levy is charged for each calendar year and is calculated as a percentage of the entity's revenue for that year. An entity that operates in the market is preparing financial statements for its annual reporting period to 30 June 20X1.

Present obligation as a result of a past event

The event that gives rise to a present obligation is the generation of revenue. As a consequence of generating revenue, the entity will have to pay a levy it would not otherwise have had to pay. Because the entity generates revenue over time, the present obligation accumulates over time. At 30 June 20X1, the entity has a present obligation for the levy attributable to revenue earned by that date. At that date, it does not have a present obligation for any levy that will be charged on revenue earned in later in the calendar year.

Conclusion – The entity recognises a provision for the it expects to pay in respect of revenue generated by 30 June 20X1 (see paragraphs 14 and 19A–19B).

Example 13B Levy charged when an entity generates revenue in two periods

A government charges a levy on entities as soon as they generate revenue in 20X1. The amount of the levy that each entity pays is calculated as a percentage of the revenue the entity generated in 20X0. An entity's reporting period ends on 31 December 20X0. The entity generated revenue in 20X0, and in 20X1 it starts to generate revenue on 3 January 20X1. Management judges that at 31 December 20X0 the entity had no practical ability to avoid generating revenue in 20X1.

Present obligation as a result of a past event

The event that gives rise to a responsibility to pay the levy is the generation of revenue in 20X0. As a consequence of generating revenue in 20X0, the entity may have to pay a levy it would not otherwise have had to pay. At 31 December 20X0, the entity's responsibility to pay the levy is conditional on the entity also generating revenue in 20X1. It has a present obligation for the levy because it has no practical ability to avoid generating revenue in 20X1.

Conclusion – The entity recognises a provision at 31 December 20X0 for the levy attributable to revenue generated in 20X0 (see paragraphs 14, 14F and 19A).

Example 13B
Conclusion is different from that in IFRIC 21, reflecting changes introduced by the *Conceptual Framework*.

Example 13C Levy charged when an entity operates as a bank at the end of its annual reporting period

A government charges a levy on entities operating as banks at the end of their annual reporting period. The amount of the levy is calculated by reference to amounts in the bank's statement of financial position at that date. If a bank's reporting period is longer or shorter than 12 months, the levy is increased or reduced proportionately. For example, for a 9-month reporting period, the levy is 9/12ths of the initial amount calculated.

An entity operating as a bank has a 12-month reporting period ending on 31 December 20X1.

Present obligation as a result of a past event

The entity's duty to pay a levy is conditional on it operating as a bank at the end of its annual reporting period. The entity has an obligation if it has no practical ability to cease operating as a bank by that date. The obligation is a present obligation that exists as a result of past events to the extent that it is attributable the length of the reporting period to date—the present obligation accumulates over time.

Conclusion – If the entity has no practical ability to cease operating as a bank before the end of its annual reporting period, it recognises a provision progressively over its annual reporting period (see paragraphs 14, 14F and 19A–19B).

Example 13C
We think the conclusion changes from that in IFRIC 21.

Note: We have expanded the description of the fact pattern to include another feature of the levy, ie that the amount is reduced or increased for reporting periods shorter or longer than 12 months. We have included this feature because:

1. We think the conclusion could depend on the presence or absence of this feature.
2. It is an actual feature of the real life levy on which the example in IFRIC 21 was based.
3. We think it likely that any levy of this type would include this feature for anti-avoidance reasons.

Example 13D Levy charged when an entity's revenue exceeds a threshold

A government charges a levy on entities if their revenue exceeds 50 million currency units (CU50 million) in a calendar year. The levy is two per cent of revenue in excess of CU50 million.

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

Present obligation as a result of a past event

[POSSIBLE ANALYSIS A: The requirement to pay a levy is a consequence of generating revenue above the CU50,000 threshold. A present obligation arises progressively from 17 July 20X1 as the entity generates revenue above that threshold.]

[POSSIBLE ANALYSIS B: The requirement to pay a levy is a consequence of generating revenue above the CU50,000 threshold. The liability arises as soon as the entity:

(a) generates revenue that will contribute to amount in excess of the CU50,000 threshold; and

(b) has no practical ability to avoid exceeding the threshold.

The entity would have the practical ability to avoid exceeding the threshold only if it had the practical ability to cease its revenue-generating activities between 17 July 20X1 and 31 December 20X1.**Conclusion**

[POSSIBLE CONCLUSION A– The entity recognises a provision between 17 July and 31 December 20X1. The amount is based on the revenue generated to date in excess of the CU50 million threshold (see paragraphs 14, and 19A– 19B).

[POSSIBLE CONCLUSION B– The entity recognises a provision as soon as it starts to generate revenue in 20X1 and management judges that the entity has no practical ability to avoid exceeding the CU50,000 threshold in that year. The amount is a based on the revenue generated to date as a proportion of the total revenue forecast for the year (see paragraphs 10D, 10L and 14).

Example 13D
In IFRIC 21, this example also discussed a variation on the fact pattern - if an entity's revenue exceeded CU50,000, the entity would be charged a levy of 2% on ALL its revenue. We have not included this variation because we think it is probably not a variation seen widely (if ever) in practice.

Example 13E Property tax

A government charges an annual property tax on owners of land and buildings. The tax is charged on land and buildings in business use on 1 January each year and has to be paid by 30 June that year. The owner of the land and buildings on 1 January remains liable to pay the full amount of the tax to the government even if it sells the land or buildings, or changes their use, after that date.

An entity has an annual reporting period that ends on 31 December. The entity owns a building it uses for business purposes on 1 January 20X1.

Present obligation as a result of a past event

The event that gives rise to a present obligation is the owning a building and using it for business purposes on 1 January 20X1. As a consequence of this action the entity has to pay a levy for the year and has no rights to any reduction of the amount payable if circumstances change after 1 January. On 1 January 20X1, the entity has a present obligation for the full amount of the levy attributable to the owning the building on that date.

Conclusion – The entity recognises a provision at 1 January 20X1 for the property tax levied on the building for that year (see paragraphs 14 and 19A).

Example14 Negative low-emission vehicle credits

Legislation applies to entities that produce cars for sale in a specified market. Under the legislation, producers:

(a) receive positive credits if in a calendar year they have manufactured cars whose average fuel emissions are *lower* than a government target; or

(b) receive negative credits if in that year they have manufactured cars whose average fuel emissions are *higher* than the target.

The legislation requires a producer that receives negative credits for one year to eliminate those negative credits by obtaining and surrendering positive credits. A producer can obtain positive credits either by purchasing them from another entity or by generating them itself in the next year (by produciing cars whose average fuel emissions are lower than the government target).

Under the legislation, the government cannot force a producer to eliminate its negative credits, but can impose sanctions on a producer that fails to do so. These sanctions would not require payment of fines or penalties, or any other transfer of economic resources, but could deny the producer opportunities in the future, for example by restricting the producer's access to the market.

A producer is preparing financial statement for its annual reporting period to 30 June 20X1. The cars it produced in the six months to 30 June have average fuel emissions that exceed the government target.

> The fact pattern from IFRS Interpretations Committee Agenda Decision , *Negative Low Emission Vehicle Credits*, published in July 2022.
>
> Aligning IAS 37 with the *Conceptual Framework* does not change the conclusion for this example. But the explanation becomes simpler.

Present obligation as a result of a past event

Positive credits are an economic resource—they give the holder rights that have the potential to produce economic benefits. Therefore, an obligation to surrender positive credits is an obligation to transfer an economic resource. The producer's production of cars with average fuel emissions exceeding the government target is the action that means it will or may have to surrender positive credits.

The producer has the practical ability to avoid surrendering positive credits to eliminate negative credits only if it has the practical ability to accept the risk of future sanctions. It might have that ability if, for example, it is planning to withdraw from the market and so would not be adversely affected by restrictions on future market access, of if the government is unlikely to impose significant sanctions.

The producer's present obligation at 30 June 20X1 is determined by reference to the negative credits it would receive for cars manufactured by that date.

Conclusion – The producer recognises a provision as it produces cars whose average emissions exceed the government target, unless it has the practical ability to accept the risk of sanctions instead of surrendering positive credits (see paragraphs 14, 14D and 19A). The provision is determined by reference to the negative credits the producer would receive for vehicles manufactured by 30 June 20X1.

Example 15 Net zero commitment

In March 20X0, a manufacturer publicly announces its commitment to becoming 'net zero' by 20X5. It announces it will:

(a) immediately start to change the way it manufactures its products with the aim of gradually reducing its greenhouse gas emissions, so they are no more than 40% of their current level by 20X5; and(b) in 20X5 and thereafter, offset the remaining emissions by paying the forestry commissions of the countries in which it manufactures to plant trees.

Present obligation as a result of a past event

The manufacturer's public announcement indicates to the public that it has accepted a responsibility to eliminate or offset its greenhouse gas emissions from 20X5 onwards. This announcement creates a constructive obligation for the manufacturer if it creates a valid expectation among members of the public that it will discharge this responsibility. Whether the announcement creates such an expectation is a matter of judgement, determined by management taking into account the facts and circumstances.

An announcement that fulfils the criteria for creating a constructive obligation is not sufficient in itself to create a *present* constructive obligation. A present constructive obligation arises only when the manufacturer has taken actions that will require it to transfer an economic resource—that is, when it has emitted greenhouse gases it has committed to offset. It then has an obligation to pay for the amount of tree planting required to offset the past emissions. The manufacturer's commitment to change aspects of the way in which it manufactures its goods is not an obligation to transfer an economic resource.

Conclusion – The manufacturer recognises a provision as a result of its net zero commitment:

(a) when it has emitted the greenhouse gases it has committed to offset; and

(b) if at that time, management judges that its announcement has given rise to a constructive obligation to meet the net zero commitments.

The manufacturer would recognise a provision for the best estimate of the amounts payable to forestry commissions in respect of past emissions. (See paragraphs 10, 19A and 21A(b).)

The conclusion could also refer to the need to consider applicable disclosure requirements, including applicable sustainability disclosure requirements, in the periods before a provision is recognised.