Preliminary views of EFRAG TR TEG and EFRAG CFSS on three targeted improvements to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
Issues Paper

Objective

1 The objectives of this session are to receive EFRAG FR TEG and EFRAG CFSS members' tentative views on the IASB tentative decisions in relation to the IASB project *Provisions—Targeted Improvements*. The IASB's project:

(a) clarifies/changes to the requirements on when an entity has a presentation obligation as a result of a past event;

(b) specifies which costs an entity includes in estimating the future expenditure required to settle the entity's present obligation; and

(c) specifies the rate an entity uses to discount that future expenditure to its present value and the related disclosure requirements.

Scope of the IASB project and the IASB's tentative decisions to date

2 The IASB has announced that it plans to issue an exposure draft in H2 2024 on three targeted amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* ('the Amendments'). The Amendments aim to:

(a) Clarify requirements on when an entity has a present obligation as a result of a past event; and

(b) Specify, in relation to measurement of a provision:

(i) the costs an entity includes in estimating the future expenditure required to settle the entity's present obligation; and

(ii) the rate an entity uses to discount that future expenditure to is present value and the related disclosure requirements.

Requirements on when an entity has a present obligation

3 On the clarification on when an entity has a present obligation as a result of a past event, the Amendments will be based on the revised Conceptual Framework. In particular, the Amendments are expected to propose to:

(a) Update the liability definition to correspond to the definition in the Conceptual Framework. Currently, IAS 37 defines a liability as "*a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits"*. According to the Conceptual Framework a liability is "*a present obligation of the entity to transfer an economic resource as a result of past events"*. Updating the definition would mean that an obligation can meet the definition of a liability even if a transfer of economic resources is not expected (probable). However, the recognition criteria will require that it should be probable that the entity would have to transfer an economic resource. Accordingly, it is not the intention that the change should result in a different outcome than the current requirements.

(b) Change some requirements supporting the present obligation recognition criterion—specifically, changes to requirements affecting the timing of recognition of provisions for obligations (typically levies) that depend on two or more actions of the entity and requirements for costs payable if a measure of the entity's activity in a period exceeds a specific threshold.

(i) Changing the requirements on obligations that depend on two or more actions of the entity would result in some liabilities being recognised earlier than currently. These changes would include deleting the current requirement in IAS 37 (par. 19) that a provision should only be recognised to the extent an obligation exists independently of an entity's future actions. The changes would mean that the timing of the recognition of a provision could change if an obligation to transfer an economic resource depends on two or more actions of the entity, and these actions occur at different times. An entity would then recognise a provision as soon as it has taken any of the actions and has no practical ability to avoid the other actions (assuming that, at that time, the other recognition criteria are also met). The practical consequences would be that some liabilities would be recognised earlier and progressively over a period, rather than all at once at a point in time. For example, if an entity has to pay a levy (and the levy is a non-reciprocal transaction) as soon as it generates revenue in 20X1 and the amount of the levy is based on the revenue generated in 20X0, the entity should recognise a provision for the levy in 20X0, if the entity has no practical ability to avoid generating revenue in 20X1.

(ii) For costs payable resulting from an entity's activity in a period exceeding a specific threshold, the IASB has tentatively decided that if an entity will have to transfer an economic resource only if a measure of its activity in a period exceeds a specific threshold, a present obligation arises as the entity performs the activity that contributes to the total amount on which the transfer is measured. (However, a provision will still only be recognised if it is probable that it will result in an economic outflow). For these threshold-triggered costs, at any date within the measurement period, the amount of the present obligation is a portion of the total estimated cost for the measurement period, the portion being the amount attributable to the activity performed to date.

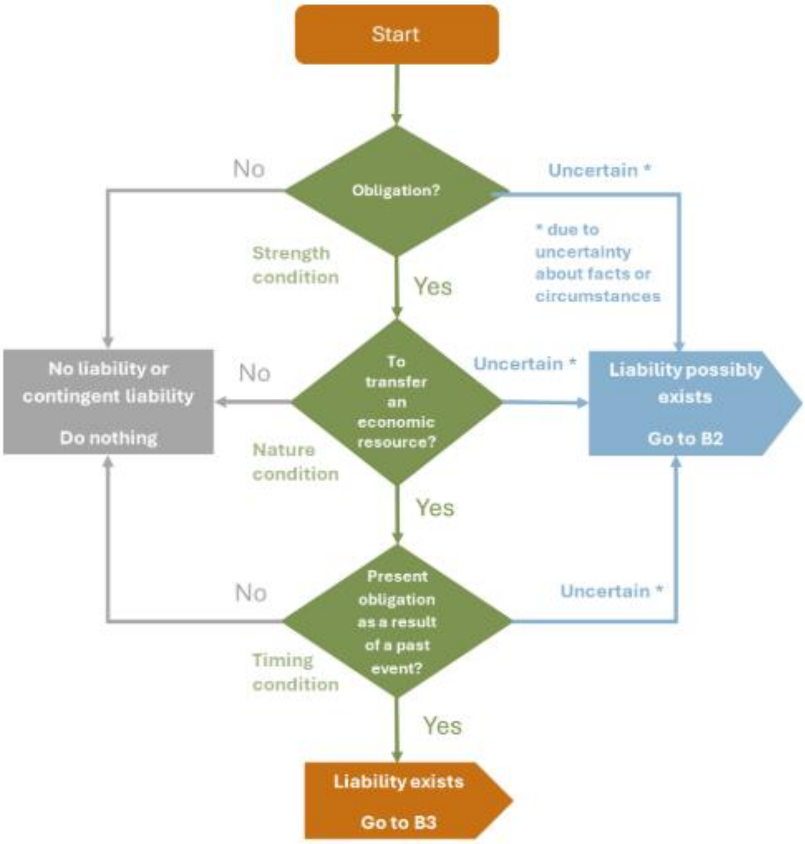
(c) Clarify other requirements supporting the present obligation recognition criterion, which would include:

(i) Deleting the requirement for, and definition of, an obligating event.

(ii) Disentangling three distinct conditions within the criterion related to the present obligation:

- Strength (the entity has an obligation): In relation to strength the most substantive change would be to replace the existing requirement that settlement of a legal obligation can be enforced by law (which caused problems when the counterparty could not use the courts to force an entity to comply with legal requirements but could take other actions to leave the entity with no practical ability to avoid complying) with broader criteria for identifying a legal obligation that an entity has no practical ability to avoid.
- Nature (the obligation is to transfer an economic resource): An explicit requirement that the obligation must be an obligation to transfer an economic resource would be added and it would be clarified that an obligation to exchange resources is not an obligation to transfer a resource unless the exchange is unfavourable.
- Timing condition (the obligation is a present obligation that exists as a result of a past event): As mentioned in (b) above, the requirements would change the timing of recognition of some provisions. Obligations for payments triggered if only an entity takes two (or more) actions (or has obtained economic benefits) would be recognised when the entity has taken the first action, if the entity has no practical ability to avoid the other action(s). At present, no provision is recognised until the entity has taken the last action.

(iii) Expand the decision three included in IAS 37. A new decisions tree could expand on when a liability exists. The following has been suggested by the IASB staff:



(d) <u>Improve the explanation of the requirements for restructuring obligations</u> which could include avoid stating that an entity has a constructive obligation to restructure (as a restructuring is not an obligation in itself). Instead, it would be explained that an entity may have a variety of (legal or constructive) obligations to pay specific costs (such as redundancy costs) if it restructures its business.

(e) <u>Adding new examples to the Guidance on implementing IAS 37 and updating the explanation of the conclusions for some of the existing examples.</u> The conclusions of a few examples would also have to be changed following the amended requirements on when an obligation is present. (Implementation guidance and the basis for conclusions accompanying IFRS Accounting Standards are not endorsed in the EU.)

(f) <u>Absorb the IFRIC Interpretations (i.e., withdrawal of IFRIC 6 and IFRIC 21) and the IFRS Interpretations Committee agenda decisions (e.g., Negative Low Emission Vehicle Credits).</u> Following the changes explained in (b) above, the outcome of the Amendments would in some cases be different than under IFRIC 21. For example, in the levy example described in (b) above, a provision would not be recognised until 20X1 under IFRIC 21.

EFRAG Secretariat observations

4 The EFRAG Secretariat has previously consulted EFRAG CFSS and EFRAG FR TEG on some of the proposals. In addition, selected EFRAG working groups have provided input. For the IASB's proposals on the present obligation recognition criterion, the views expressed can generally be categorised as follows:

(a) View 1: It is not useful to have a discussion about specific elements of when a provision should be recognised before a more general discussion has been held about when to recognise a provision versus impairing an asset.

(b) View 2: The current requirements in IFRC 21 (see paragraph 3(f) above) better reflect when a provision should be recognised than the requirements the IASB is likely to propose. The tentative proposals of the IASB could result in various liabilities being recognised earlier because of the going concern assumption. The fact that the size of a levy would depend on e.g. the revenue generated in a previous year is a measurement issue, and not a recognition issue.

(c) View 3 (the view in accordance with the view previously expressed by EFRAG in relation to the consultation on the revision to the Conceptual Framework, and probably also the view held by most of those the EFRAG Secretariat has consulted on the current IASB project): The proposals generally result in more relevant information as they would result in a better matching of the expenses (form e.g. a levy) and the related revenue. However, many of those supporting View 3 have also noted that additional guidance/requirements are necessary to support the proposals. This would include clarifying when an entity would not have a practical ability to avoid taking another action or actions (see paragraph 3(b)(i) above) and providing illustrative examples that clearly would describe conclusions are reached based on the facts described in the illustrative examples and the requirements. When the EFRAG Secretariat has considered some real-life examples (e.g. contributions to the Single Resolution Fund), it has also been noted that the requirements potentially could result in the recognition of provisions for which the measurement uncertainty is significant. This happens because the liability would be recognised earlier than currently. This could result in fluctuations in profit or loss resulting from changes in estimates of provisions that were recognised in previous periods. Some have therefore considered lowering the bar for when a provision should not be recognised because of measurement uncertainty (currently this is only allowed in extremely rare cases).

5 In addition to the need for additional guidance described above in paragraph 4(c), the EFRAG Secretariat also assesses that it is necessary to clarify what the ‘unit of account’ would be for recognition. To illustrate this, consider the following examples:

(a) Example A: Entity A will have to pay a levy if it is operating on 1 January 20X6. The levy will be 0.3% of the revenue it is generating in 20X4. As this is a legal obligation, the entity does not consider it has a practical ability to avoid paying the levy and it also does not consider it has a practical ability not to be operating on 1 January 20X6.

Based on the proposed guidance, should Entity A:

(i) Recognise a provision when it generates its first revenue in 20X4. The amount of revenue it is generating in 20X4 affects the measurement of the provisions, and accordingly, when Entity A recognises a liability with it first generates revenue in 20X4, it measures this liability based on the expected revenue it will generate in 20X4.

(ii) Recognise a provision as it generates revenue in 20X4. That is for each additional euro of revenue it generates, it recognises an additional liability of 0.003 euro.

(iii) Recognise a provision on 1 January 20X6.

(iv) Recognise a provision at another point in time than those suggested above.

(b) Example B: Entity B is a bank. If it is operating as a bank on 1 January 20X6 it will have to pay a levy. The levy will be 0.03% of customer deposits as of 31 December 20X4. From January to July 20X4, Entity B, in order to obtain additional capital to invest, offers new customers a high, fixed interest rate if the new customers deposit money on a one-year fixed term savings account. In order to make the example sufficiently simple assume that Entity B does not receive other customer deposits. As this is a legal obligation, the entity does not consider it has a practical ability to avoid paying the levy and it also does not consider it has a practical ability not to be operating as a bank on 1 January 20X6

Based on the proposed guidance, should Entity B:

(i) Recognise a provision in the beginning of January 20X4, when new customers are placing money on deposit accounts. The provision would correspond to 0.03% of expected customer deposits as of 31 December 20X4.

(ii) Recognise a provision as it receives customer deposits in 20X4. That is for each additional euro it receives, it recognises an additional liability of 0.0003 euro.

(iii) Recognise a provision on 1 January 20X6.

(iv) Recognise a provision at another point in time than those suggested above.

(c) Example C: This example is similar to Example A, except that if Entity C would not have been operating in 20X4 (which it is), the amount it would have to pay in 2026 would be 36% of the revenue it would generate in January 20X6. Accordingly, in Example C, Entity C will have to pay a levy if it is operating on 1 January 20X6. The levy will be 0.3% of the revenue it is generating in 20X4. If Entity C would not have been operating in 20X4, the levy would be 36% of the revenue it would generate in January 20X6.

Based on the proposed guidance, should Entity C:

(i) Recognise a provision when it generates its first revenue in 20X4. The amount of revenue it is generating in 20X4 affects the measurement of the provisions, and accordingly, when Entity A recognises a liability with it first generates revenue in 20X4, it measures this liability based on the expected revenue it will generate in 20X4.

(ii) Recognise a provision as it generates revenue in 20X4. That is for each additional euro of revenue it generates, it recognises an additional liability of 0.003 euro.

(iii) Recognise a provision on 1 January 20X6.

(iv) Recognise a provision at another point in time than those suggested above.

Costs included in the estimation of the expenditure required to settle a provision

6 The IASB has tentatively decided that the expenditure required to settle the entity's present obligation should be the costs that relate directly to settling that obligation, which consist of both:

(a) the incremental costs of settling the obligation; and

(b) an allocation of other costs that relate directly to settling obligations of that type.

7 A similar requirement was recently included in IAS 37 for the assessment of whether a contract is onerous (when the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it, i.e., onerous contract).

EFRAG Secretariat observations

8 The EFRAG Secretariat's preliminary assessment is in favour of the tentative decisions taken to specify which costs an entity includes in estimating the future expenditure required to settle the entity's present obligation. The EFRAG Secretariat thus notes that the proposal is consistent with the 2020 narrow scope amendment to IAS 37 specifying which costs an entity includes in assessing whether a contract is onerous, and hence in assessing whether the entity needs to recognise an onerous contract provision.

9 The EFRAG Secretariat also notes that most of the feedback it has received from EFRAG working groups has supported the IASB's tentative decisions. However, the following comments against the tentative decisions have also been made:

(a) It is inconsistent to state that only costs *directly* related to settling an obligation should be included in the measurement and specifying that this includes an *allocation* of other costs directly related to settling obligations of that type.

(b) The requirements are not completely aligned with the requirements in IFRS 15 *Revenue from Contracts with Customers* on contract costs.

The discount rate and related disclosure requirements

10 The IASB tentatively decided that an entity should discount the estimated future expenditure at a rate that reflects:

(a) the time value of money—represented by a risk-free rate—with no adjustment for non-performance risk (i.e., the risk that the entity will not settle the obligation); and

(b) risks surrounding the amount or timing of the expenditure required to settle the obligation if those risks are not reflected in the estimates of the cash flows.

11 However, the IASB tentatively decided not providing further application guidance on estimating the time value of money for the following reasons:

(a) practice is already well-established without any guidance in IAS 37 (e.g., policy of discounting at a risk-free rate or as the starting point for estimating a credit-adjusted rate);

(b) provisions within the scope of IAS 37 vary widely in their terms and the circumstances of their settlement; and

(c) risk of unintended consequences because several other IFRS Accounting Standards already require assets or liabilities to be measured by reference to risk-free rates.

12 This approach would allow/require entities to apply judgement in estimating an appropriate rate. The rate might be determined by reference to the current market yield on a very low risk market investment (for example, a low-risk government bond) in a currency consistent with that of the provision. But adjustments might be required, for example if the provision is of longer duration, or less liquid, than the closest available market investment.

13 Furthermore, the IASB tentatively decided to propose requiring an entity to disclose, for each class of provision:

(a) the rate or rates used in measuring the provision; and

(b) the approach used to determine those rates.

14 The IASB reached this proposal as a compromise between:

(a) the feedback received from preparers, which mainly highlighted the high level of uncertainty related to very long-term provisions, the costs associated to any additional disclosure and the disclosure overloading risk;

(b) the suggestions received by users, which also proposed to require information about the undiscounted amount and timing of the cash flows and a sensitivity analysis to allow them adjusting provisions amount by using other entities' rates; and

(c) the fact that this project is limited in the scope (i.e., it only aims to targeted amendments to IAS 37 and to not introduce disclosure requirements besides those already required by other IFRS Accounting Standards).

EFRAG Secretariat observations

15 The EFRAG Secretariat's preliminary assessment is in favour of the tentative decisions taken with respect to the discount rate used to measure a provision and the related disclosure requirements proposed.

16 The EFRAG Secretariat assesses that the proposals will remove some of the diversity in practice in relation to discounting provisions. Most notably whether performance risk

(including own credit risk) should be considered. The IASB's tentative decisions explains that this risk should not be reflected. There will, however, be divergence in practice on how to estimate the discount rate following the proposed requirements tentatively decided by the IASB. Following the experience with IFRS 17 *Insurance Contracts,* it can, for example, be expected that there will be diversity in practice when estimating any liquidity premium that can be included in the discount rate.

17 This problem related to this divergence is, however, to some extent reduced by the tentatively decided proposed disclosure requirements under which an entity will disclose the discount rate it has used and how it has been estimated.

18 Some types of rate-regulated entities could be significantly affected by the proposals as they have long-term provisions. Some of these entities are required to set aside funds for the amounts of provisions. Sometimes other regulation describes how the discount rate should be determined for this purpose. Some entities have therefore expressed the view that the regulatory discount rate has economic impact and accordingly should be used as the discount rate also when discounting provisions for general purpose financial reporting. For the entities the EFRAG Secretariat has been in contact with, the tentative assessment is, however, that these regulatory discount rates will meet the IASB's proposed requirements. Accordingly, these entities assess that they will not be significantly affected by the IASB's tentative decisions.

Questions for EFRAG FR TEG and EFRAG CFSS

19 Do EFRAG FR TEG and EFRAG CFSS members have other views on the IASB's tentative proposals on when an obligation is present than the three views listed in paragraph 4? What are the views of EFRAG FR TEG and EFRAG CFSS members?

20 Do EFRAG FR TEG and EFRAG CFSS members consider there to be a need to provide guidance on when an entity would have a practical ability to avoid taking another action or actions?

21 When do EFRAG FR TEG and EFRAG CFSS members think a provision should be recognised in the three examples in paragraph 5 according to the IASB's tentative proposals?

22 Do EFRAG FR TEG and EFRAG CFSS members agree with the initial support of the EFRAG Secretariat expressed in paragraph 8 for the proposed requirements on the costs to include in the estimation of the expenditure required to settle a provision?

23 Do EFRAG FR TEG and EFRAG CFSS members agree with the initial support of the EFRAG Secretariat expressed in paragraph for the proposed requirement on discount rate to be used for provisions, and the related disclosure requirements?

24 For local regulatory requirements, the discount rate used to discount certain provisions may be specified. Do you think IAS 37 should allow such discount rates to be used even if they would not fulfil the proposed requirements on the discount rate to be used?

Additional papers

25 In addition to this paper, the following papers have been made available for the session:

(a) Paper 05-02 ASAF Paper AP3: Project update;

(b) Paper 05-03 ASAF Paper AP3A: Present obligation;

(c) Paper 05-04 ASAF Paper AP3B: Threshold-triggered costs;

(d) Paper 05-05 ASAF Paper AP3C: Discount rates—application guidance;

(e) Paper 05-06 ASAF Paper AP3D: Discount rates—disclosure requirements;

(f) Paper 05-07 ASAF Paper AP3E: Indicative drafting—IAS 37;

(g) Paper 05-08 ASAF Paper AP3F: Indicative drafting—decision tree.