The IASB project: Provisions – Targeted Improvements
Definition of Liability - Present Obligation
Cover note

Objective

1 The objective of the session is to:

(a) provide the EFRAG CFSS members with an update on the development in the IASB Project *Targeted Improvements* and the recent IASB discussions, and

(b) discuss possible amendments to the requirements and illustrative examples supporting the 'present obligation' recognition criterion in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, and in particular to discuss:

(i) initial suggestions for possible amendments to the requirements and illustrative examples supporting the 'present obligation' recognition criterion in IAS 37,

(ii) whether to add to IAS 37 application requirements specifying when an entity has a present obligation for costs payable if a measure of its activity (for example, its revenue or carbon emissions—exceeds a specified threshold), and

(iii) what guidance, if any, to include in IAS 37 on the meaning of 'no practical ability to avoid'.

2 The project background and a summary of the past discussions is provided in Appendix 1 of this paper.

The topics for the discussion

Suggested amendments to the definition of a liability in IAS 37

3 A summary of the discussions in regard to the amendments to the definition of a liability in IAS 37, suggested by the IASB Staff, is provided in paragraphs 8 to 29 of Appendix 1 of this Agenda Paper.

4 The details of the IASB Staff suggestions are provided in Agenda Paper 08-03, which is the topical paper, Agenda Paper 08-04 – the suggestions to amend IAS 37 requirements, and Agenda Paper 08-05 - the suggestions to amend IAS 37 Illustrative Examples.

Thresholds

5 Based on the suggested amendments to IAS 37 requirements, some of the conclusions may still be not clear – for instance a conclusion regarding the situation where an entity is required to pay a levy if it generates revenue in excess of specified threshold in a calendar year. However, the facts pattern involving payments triggered when a cumulative or

average threshold is reached are relatively common. They also include a range of incentive-based laws and regulations, including some pollutant pricing mechanisms – a project on pollutant pricing mechanisms is on the IASB's reserve list of projects and may be added in the future based on capacity availability.

6 Applying past event criterion as suggested by the IASB Staff, may result in either:

(a) present obligation arising only when the entity generates revenue **above** the threshold on which the levy starts to become payable; or

(b) present obligation arising as an entity generates revenue as a consequence of which it might exceed the threshold (from the start of the year), if at that time management judges that the entity has no practical ability to avoid exceeding the threshold.

Meaning of "no practical ability to avoid"

7 The new concepts related to when an entity has a present obligation, were reflected in the amended definition of a present obligation in paragraphs 4.43 and 4.44 of the Conceptual Framework (see Appendix 2 of this paper for the details) and the definition of an obligation. Furthermore, the amended Conceptual Framework introduces new terminology e.g. 'practical ability to avoid' instead of 'realistic alternative to settling' (see paragraphs 4.29 and 4.32 of the Conceptual Framework provided in Appendix 2 of this Agenda Paper). Moreover, as explained by the IASB, 'No practical ability to avoid' is intended to have the same meaning as 'no realistic alternative to settling'.

8 On the other hand, the existing requirement in paragraph 17 of IAS 37 requires that a legal obligation 'can be enforced by law' but it gives no guidance on how to apply this requirement if a counterparty has a legal right to impose market-based sanctions that might leave an entity with no realistic alternative other than to comply.

9 This issue has been discussed by the IFRS Interpretations Committee in regard to Negative Low Emission Vehicle Credits. The IFRS Interpretations Committee (IFRS IC) reached the conclusion on this issue, however, the analysis of their discussion shows that the conclusion could have been easier to reach by the IFRS IC if IAS 37 provided better guidance on the factors to consider in assessing whether an entity has a realistic alternative to settling an obligation.

Questions for EFRAG CFSS and EFRAG FR TEG members

10 Do you have comments or question regarding the project update?

<u>*Definition of a liability*</u>

11 What are your overall reactions to the possible amendments to IAS 37 suggested in Agenda Paper 08-03 (ASAF Paper 6A)? For a brief reference please see Slide 9 of Agenda Paper 08-02 (ASAF Paper 06).

12 Do you have specific comments on any aspects of the possible amendments as suggested in Agenda Paper 08-03?

<u>*Present obligation*</u>

13 **What are your views on whether to add application requirements to IAS 37, specifying when an entity has a present obligation** for costs payable if a measure of its activity - for example, its revenue or carbon emissions — exceeds a specified threshold. Please refer to Slide 11 of Agenda Paper 08-02.

14 **Do you have views on when the present obligation arises?** Please refer to initial views and potential requirements on slides 12 and 13 of Agenda Paper 08-02.

<u>*No practical ability to avoid*</u>

15 What guidance, if any, should be included in IAS 37 on the **meaning of 'no practical ability to avoid'**? Please refer to Slides 15 and 16 of Agenda Paper 08-02. What is your view:

(a) whether IAS 37 should retain the requirement that settlement of a legal obligation 'can be enforced by law'?

(b) what, if any, role should economic compulsion play in assessing an entity's practical ability to avoid an obligation?

Agenda papers

16 For **background**, in addition to this cover note, agenda papers for this session are:

(a) Agenda Paper 08-02 – ASAF paper AP6 – the IASB Staff presentation on present obligation recognition criterion,

(b) Agenda Paper 08-03 – ASAF paper AP6A – a topical paper of IFRS Staff introducing Agenda Papers 08-03 and 08-04.

(c) Agenda Paper 08-04 – ASAF paper AP6A-Appendix A on the IASB Staff suggestions for amendments to IAS 37, including the definition of a liability, and

(d) Agenda Paper 08-05 – ASAF paper AP6A-Appendix B on initial the IASB Staff suggestions for amendments to IAS 37 Illustrative Examples.

Future steps

17 The IASB will discuss the potential directions in the project at the ASAF meeting in June 2023.

Climate-related Risks in the Financial Statements

18 Recently, the IASB has added to the maintenance project pipeline a narrow-scope project on *Climate-related Risks in the Financial Statements*. As part of that project, the IASB might consider whether and, if so, what further narrow-scope actions might be needed to improve the application of IAS 37 in relation to reporting such risks.

19 EFRAG consulted the EFRAG CFSS members and the members of EFRAG Working Groups regarding this topic. This topic will be discussed at another session of the EFRAG FR TEG and CFSS meeting.

Appendix 1: Project background and the previous discussions of the IASB

Project background

1 Following the 2015 Agenda Consultation of the IASB, a research project on provisions was added to the IASB Research Agenda. The initial research summary was discussed by the IASB in July 2015. The summary identified the following main issues with IAS 37 guidance:

(a) two different principles in IAS 37 for identifying liabilities. The principles appear contradictory and have resulted in inconsistent and sometimes unsatisfactory requirements. For instance, IFRIC 21 *Levies*, an interpretation of IAS 37, has been criticised by a range of stakeholders, including users, preparers and auditors of financial statements and national standard-setters.

(b) unclear guidance on measurement, which has resulted in diversity in practice, for instance IAS 37 does not specify:

(i) whether the measure of a provision should include only cash flows directly related to fulfilment of the liability, or whether it should also include an allocation of other attributable or indirect cash flows. Moreover, IAS 37 is not clear about whether provisions should include costs payable to third parties, such as legal costs expected to be incurred in negotiating the settlement of a legal claim.

(ii) whether the rate used to discount future cash flows should take into account the risk of non-performance by the entity, sometimes called the entity's own credit risk. Taking account of the risk of non-performance can substantially reduce the measure of very long-term liabilities such as decommissioning and environmental rehabilitation obligations.

2 The summary also identified that the concepts developed for the revised *Conceptual Framework,* may help addressing the issues. Consequently, the IASB decided to hold the project in the research pipeline until the finalisation of the discussions on *Conceptual Framework*.

3 During 2015 and 2016, the IASB discussed the main points of the research summary with members of the Global Preparers Forum, Capital Markets Advisory Committee, Accounting Standards Advisory Forum and Emerging Economies Group, and with subject specialists at large accounting firms.

4 The project on provisions was reactivated in February 2018 and, in January 2020, the IASB decided to add a standard-setting project to its work plan, with the objective of making three targeted improvements to IAS 37, that is to:

(a) amend the liability definition and the requirements and guidance supporting the present obligation recognition criterion, applying concepts added to the *Conceptual Framework* in 2018;

(b) specify more precisely the rate an entity uses to discount a long-term provision to its present value; and

(c) specify which costs an entity includes in measuring an obligation to provide goods or services.

5 In February 2022, the IASB decided to keep the project based on the assessment that efficient progress is possible and to proceed with the standard setting process related to targeted amendments to IAS 37. Till now, the IASB already discussed:

(a) how to specify more precisely the rate an entity uses to discount a long-term provision to its present value (in October 2022); and

(b) how to amend the liability definition and the requirements and guidance supporting the present obligation recognition criterion, applying concepts added to the *Conceptual Framework for Financial Reporting* in 2018 (in April 2023).

Recent discussions of the IASB – entity's own credit risk

6 In October 2022, the IASB initially discussed whether the rate an entity uses to discount a provision should reflect non-performance risk - that is, the risk that the entity will not fulfil its obligation. The IASB decided to consult its advisory groups before continuing its discussion and deciding on project direction.

EFRAG discussion on the topic

7 EFRAG discussed the topic related to the non-performance risk and the discount rates used for measuring provisions at its EFRAG FR TEG and CFSS meeting in November 2022. The members had the following comments:

(a) Members were in general in favour of additional guidance on discount rates in IAS 37. Some members had indicated that non-performance is only one factor of discount rates, therefore, the IASB needed to focus on discount rates more broadly looking also at other factors.

(b) Some members did not have a view on whether the discount rates should include non-performance risk or not. While some other members were not in favour of including the non-performance risk in the discount rates.

(c) Some members indicated that the extent of the disclosures needed would depend on the decisions on the measurement issue on the discount rates.

(d) Some members considered disclosures on sensitivity analysis to be useful especially for long tail liabilities.

Recent discussions of the IASB – definition of a liability

8 In April 2023, the IASB initially discussed the potential amendments to:

(a) the definition of a liability;

(b) the wording of the recognition criterion applying that definition - the requirement for an entity to have a present obligation as a result of a past event (the present obligation recognition criterion); and

(c) requirements and guidance supporting that recognition criterion.

9 The IASB discussion covered the topics which are explained in more details below.

The main issues related to the definition of liability in IAS 37

10 In April 2023, the IASB discussed the following main application issues identified:

(a) difficulties in disentangling two distinct criteria within the present obligation criterion;

(b) issues related to application of requirements of paragraph 19 of IAS 37; and

(c) applying paragraph 17 of IAS 37 to climate-related regulations and commitments.

11 Generally, the application issues relate to whether, and if so when, a liability arises for an obligation that depends on two or more actions of the entity i.e. is it as soon as the first action occurs, or only when the last action occurs triggering the outflow.

Disentangling two distinct criteria within the present obligation criterion

12 In IAS 37, the definition of liability identifies two criteria regarding the existence of a past event that created a present obligation, and that there is no realistic alternative to settling this obligation. However, both criteria are discussed within a single section of the IAS 37 guidance and, in effect, it is not clear which parts of the IAS 37 guidance corresponds to which criterion.

13 For instance, paragraph 19 of IAS 37 explains that an entity does not have a present obligation if it can avoid future expenditure by its future actions. However, when considering paragraph 17 of IAS 37, it is not clear whether in situations where a past event of an entity could result in an outflow of economic resources, but the entity might avoid that outflow through its future actions, the entity should conclude that:

(a) it does not have a present obligation; or

(b) it has a present obligation, and it should be recognised if the actions required to avoid the outflow are not realistic.

14 According to the IASB, the intention was that an entity should not recognise a provision if it can avoid ***incurring an obligation*** through its future actions. However, the phrase avoiding expenditure in paragraph 19 of IAS 37, is in practice understood that an entity should not recognise a provision if it could avoid settling this obligation through its future actions.

Application of paragraph 19 of IAS 37 - IFRIC 21

15 In response to the above issue, the IFRS Interpretations Committee (IFRS IC) has been requested to clarify the guidance and issue interpretations. IFRS IC has issued the following Interpretations:

(a) IFRIC 6 *Liabilities arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment* and

(b) IFRIC 21 *Levies*.

16 Both Interpretations consider paragraph 19 of IAS 37 and concludes that an entity does not have a present obligation until it takes the actions to which a charge is linked, even if the entity has no realistic alternative to taking those actions.

17 However, such a conclusion appears inconsistent with other IAS 37 requirements e.g. the requirement to recognise liabilities for restructuring costs when a restructuring plan is announced or started to be implemented. The rationale is that, once an entity has announced a plan, it has no realistic alternative other than take the future actions that will trigger charges.

18 Furthermore, IFRIC 21 is criticised by a range of users, preparers, and auditors that it results in some recurring periodic levies being recognised as expenses at a single point in time while they believe that the economic substance of a recurring levy is that the entity is paying to operate over a period, and that this substance would be more faithfully represented by recognising the expense gradually over that period.

19 Finally, the consensus in IFRIC 21 seems not consistent with the approach taken in other IFRS standards e.g. recognition of a share-based plan based on future conditions under the requirements of IFRS 2 *Share-based payments*.

Applying paragraph 17 of IAS 37 to climate-related regulations and commitments

20 Recently, the IFRS IC was asked to provide explanations on application of IAS 37 requirements to present obligation recognition criterion in relation to climate-related

regulations and commitments. The identified application difficulties include accounting for situations where:

(a) responsibilities imposed by climate-related laws and regulations are not enforceable in conventional ways but are structured so an entity may have a strong economic incentive to do so (e.g. through restricting the market access); or

(b) an entity makes a public commitment to change its method of operation in the future, for instance to reduce greenhouse gas emissions to 'net zero'.

21 In July 2022 IFRS IC reached a conclusion on Negative Low Emission Vehicle Credits (see IFRS IC's agenda decision under the link).

22 The analysis of the IASB Staff was that the conclusion could have been easier to reach by the IFRS IC if:

(a) IAS 37 more clearly distinguished actions that give rise to an obligation (which must have occurred in the past) from actions that settle the obligation (which will occur in the future if the entity has no realistic alternative to settling the obligation);

(b) the conclusions in illustrative examples 6 (smoke filter) and 11B (aircraft overhaul) accompanying IAS 37 were better explained—so it was clearer why the conclusions for the fact pattern considered by the IFRS IC differed from those in examples 6 and 11B, and

(c) IAS 37 provided better guidance on the factors to consider in assessing whether an entity has a realistic alternative to settling an obligation.

23 The existing requirement in paragraph 17 of IAS 37 requires that a legal obligation 'can be enforced by law' but it gives no guidance on how to apply this requirement if a counterparty has a legal right to impose market-based sanctions that might leave an entity with no realistic alternative other than to comply.

24 The further details can be found in Agenda Papers 08-03, 08-04, and 08-05.

Suggestions for possible amendments

25 The similar application issues compared to the ones explained above, have been discussed by the IASB when developing the guidance for various types of transactions — for example, for share-based payments, variable lease payments and purchases subject to variable or contingent consideration. Consequently, the IASB decided to answer it at a conceptual level, as part of its *Conceptual Framework* project. The concepts it developed to address this question were among those it added to the *Conceptual Framework* in 2018.

26 Particularly, the new concepts related to when an entity has a present obligation, were reflected in the amended definition of a present obligation in paragraphs 4.43 and 4.44 of the *Conceptual Framework* (see Appendix of this paper for the details) and the definition of an obligation. Furthermore, the amended *Conceptual Framework* introduces new terminology (e.g. 'practical ability to avoid' instead of 'realistic alternative to settling'), discusses the concept of 'no practical ability to avoid', separates the discussion regarding the 'past event' and 'no practical ability to avoid' criteria.

27 At its April 2023 meeting, the IASB discussed the possible amendments to IAS 37 that would align the guidance and apply the new concepts. The details of the amendment suggestions discussed by the IASB are provided in Agenda Papers 08-04 (IAS 37 guidance) and 08-05 (accompanying examples), provided as the background papers for this session.

The summary of the suggested amendments

28 The amendments can be grouped in five categories:

(a) Changes to some requirements supporting the present obligation recognition criterion — these may change the timing of recognition of provisions for obligations that depend on two or more actions of the entity (e.g. levies).

These changes can be achieved by replacing the existing requirements in paragraph 19 of IAS 37 and the consensus in IFRIC 21 with concepts from paragraphs 4.32, 4.43 and 4.44 in the Conceptual Framework; and changing the conclusions of the relevant examples illustrating those requirements.

(b) Clarification of other requirements supporting the present obligation recognition criterion — for example, to distinguish more clearly the two criteria for a present obligation, and to provide more guidance on the meaning of 'can be enforced by law'. Clarifying these requirements could reduce diversity in practice, changing the way some entities apply them.

These changes can be achieved by applying the new concepts from the *Conceptual Framework*, and would clarify:

- how to untangle two criteria within the present obligation recognition criterion or, in other words, separately discuss these two criteria – by removing the definition of an obligating event from IAS 37 and instead providing the concepts from the *Conceptual Framework* that will provide guidance on obligation.
- the meaning of 'can be enforced by law' - by discussing the factors that might affect the assessment of an entity's realistic alternatives to settling (practical ability to avoid) an obligation.
- when commitments to reduce emissions to 'net zero' are present obligations or not – based on paragraph 4.45 of the Conceptual Framework which discusses the enactment of new law.

(c) Improved explanations of the rationale for some requirements and the conclusions in some illustrative examples for the stakeholders to better understand the principles underlying the requirements and conclusions. These amendments could make it easier for stakeholders to apply IAS 37 to new types of obligation that emerge from time to time — for example, as governments strengthen their climate-related regulations.

This would apply to the explanations about restructuring provisions and obligations to exchange resources.

(d) Absorption of IFRIC Interpretations and IFRS IC agenda decisions into the amended IAS 37 requirements.

This would result in a withdrawal of IFRIC 6 and replacing it with a new illustrative example accompanying IAS 37, adding another illustrative example based on the Agenda Decision *Negative Low Emission Vehicle Credits*, and withdrawal of IFRIC 21 and adding a new illustrative example based on the example included in IFRIC 21.

(e) Updates to the wording of definition of a liability and the wording of the present obligation criterion based on the wording of the amended *Conceptual Framework* – with insignificant effect on application of the IAS 37 requirements.

Appendix 2: The existing guidance IFRS Accounting Standards (extracts)

IAS 37 Definitions and recognition criteria

1 The following terms are used in IAS 37 with the meanings specified:

Paragraph 10

A ***provision*** is a liability of uncertain timing or amount.

A ***liability*** is 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.1

An ***obligating event*** is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.

2 Recognition criterion:

Paragraph 14

A provision shall be recognised when:

(a) an 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.

If these conditions are not met, no provision shall be recognised.

3 *Paragraph 15*

In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period.

4 *Paragraph 17*

A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

(a) where the settlement of the obligation can be enforced by law; or

(b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation

5 *Paragraph 19*

It is only those obligations arising from past events existing independently of an entity's future actions (i.e. the future conduct of its business) that are recognised as provisions. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity. Similarly, an entity recognises a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused. In contrast, because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). Because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognised.

Definitions from *Conceptual Framework* (amended in 2018)

6 Definition of a liability

4.26 A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

4.27 For a liability to exist, three criteria must all be satisfied:

(a) the entity has an obligation (see paragraphs 4.28☐–☐4.35);

(b) the obligation is to transfer an economic resource (see paragraphs 4.36☐–☐4.41); and

(c) the obligation is a present obligation that exists as a result of past events (see paragraphs 4.42☐–☐4.4

7 Obligation

4.29 An obligation is a duty or responsibility that an entity has no practical ability to avoid. An obligation is always owed to another party (or parties). The other party (or parties) could be a person or another entity, a group of people or other entities, or society at large. It is not necessary to know the identity of the party (or parties) to whom the obligation is owed.

4.32 In some situations, an entity's duty or responsibility to transfer an economic resource is conditional on a particular future action that the entity itself may take. Such actions could include operating a particular business or operating in a particular market on a specified future date or exercising particular options within a contract. In such situations, the entity has an obligation if it has no practical ability to avoid taking that action.

8 Present obligation

4.43 A present obligation exists as a result of past events only if:

(a) the entity has already obtained economic benefits or taken an action; and

(b) as a consequence, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.

4.44 The economic benefits obtained could include, for example, goods or services. The action taken could include, for example, operating a particular business or operating in a particular market. ***If economic benefits are obtained, or an action is taken, over time, the resulting present obligation may accumulate over that time.***

4.45 If new legislation is enacted, a present obligation arises only when, as a consequence of obtaining economic benefits or taking an action to which that legislation applies, an entity will or may have to transfer an economic resource that it would not otherwise have had to transfer. The enactment of legislation is not in itself sufficient to give an entity a present obligation. Similarly, an entity's customary practice, published policy or specific statement of the type mentioned in paragraph 4.31 gives rise to a present obligation only when, as a consequence of obtaining economic benefits, or taking an action, to which that practice, policy or statement applies, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.