**Accounting Standards Advisory Forum meeting**

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| Date | **July 2023** |
| Project | **Provisions** |
| Topic | **Present obligation recognition criterion** |
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**Accounting Standards Advisory Forum, July 2023, Agenda paper 6A (Appendix A)**

This paper was discussed at the International Accounting Standards Board's (IASB's) April 2023 meeting as Agenda Paper 22 (Appendix A). 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 IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

**Abbreviations in staff notes:**

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|---|---|---|
| CFx.xx | = | Paragraph x.xx of the *Conceptual Framework for Financial Reporting* |
| IAS37.xx | = | Paragraph xx of IAS 37 |

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## Definitions

10 **The following terms are used in this Standard with the meanings specified:**

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

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

**Definition of a liability CF4.1**

**A *legal obligation* is an obligation that derives from:**

**(a) a contract (through its explicit or implicit terms);**

**(b) legislation; or**

**(c) other operation of law.**

**Definition of obligating event**

Deletion explained in paragraph 40 of Agenda Paper 22.

**A *constructive obligation* is 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.**

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## Recognition

### Provisions

14 **A *provision* shall be recognised when:**

**(a) an entity has a present obligation (legal or constructive) to transfer an economic resource as a result of a past event;**

**(b) it is probable that the entity will be required to transfer an economic resource 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.**

Reference to transferring an economic resource explained in paragraph 64 of Agenda Paper 22.

### Present obligation to transfer an economic resource as a result of a past event

14A An entity recognises a provision only if:

(a) it has obligation;

(b) the obligation is to transfer an economic resource; and

(c) the obligation is a present obligation that exists as a result of a past event.

**CF4.27**

Replaces definition of obligating event

#### Obligation

**CF4.29**

14B An obligation is a responsibility that an entity has no practical ability to avoid.

14C An obligation is always owed to another party. The other party 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 to whom the obligation is owed.

First half of paragraph 20, moved up from past event section.

Edited to align wording with **CF4.29**

14D An entity has no practical ability to avoid a responsibility:

Paragraph 17, moved up from

(a) in the case of a legal obligation where:

(i) the other party has a right to take action against the entity if it fails to discharge the responsibility; and

(ii) as a result, the economic consequences for the entity of not discharging the responsibility are expected to be significantly more adverse than the economic consequences of discharging it; or

Possible clarification explained in paragraphs 41 – 44 of Agenda Paper 22.

(b) in the case of a constructive obligation, where an action of the entity creates valid expectations in other parties that the entity will discharge the responsibility.14E Because an obligation always involves a commitment to another party, it follows that a management or board decision does not give rise to a constructive obligation at the end of the reporting period unless the decision has been communicated before the end of the reporting period to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will discharge its responsibilities.

By definition, the event must be an ...ty

Second half of paragraph 20, moved up from past event

14F In some situations, an entity's responsibility to transfer an economic resource arises from past events (as described in paragraphs 19A) but is conditional on a particular future action that the entity itself may take. The action could be, for example, operating in a specified market on a specified future date, or exercising options within a contract. In such situations, the entity has an obligation if it has no practical ability to avoid taking that action.

**CF4.32**

Paragraph 14F works with paragraph 19A to address obligations conditional on two or more actions of the entity. These paragraphs replace IAS37.19.

CF4.32 was developed with levies in mind, but also helps with the analysis of restructuring costs. See new paragraph 72A

14G A conclusion that it is appropriate to prepare an entity's financial statements on a going concern basis also implies a conclusion that the entity has no practical ability to avoid a transfer that could be avoided only by liquidating the entity or by ceasing to trade.

**CF4.33**
Possibly useful for IAS 37 because some levies could be avoided only by ceasing to trade.

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.

16 In almost all cases it will be clear whether a past event has given rise to a present obligation. In rare cases, for example in a lawsuit, it may be disputed either whether certain events have occurred or whether those events result in an obligation. In such a case, an entity determines whether an obligation exists at the end of the reporting period by taking account of all available evidence, including, for example, the opinion of experts. The evidence considered includes any additional evidence provided by events after the reporting period. On the basis of such evidence:

(a) where it is more likely than not that a present obligation exists at the end of the reporting period, the entity recognises a provision (if the recognition criteria are met); and

(b) where it is more likely that no present obligation exists at the end of the reporting period, the entity discloses a contingent liability, unless the possibility of the entity being required to transfer an economic resource is remote (see paragraph 86).

**Transfer an economic resource**

16A The obligation must have the potential to require the entity to transfer an economic resource to another party or parties. For that potential to exist, it does not need to be certain, or even likely, that the entity will be required to transfer an economic resource—the transfer may, for example, be required only if a specified uncertain future event occurs.

**CF4.37**

16B However, the likelihood of the entity being required to transfer an economic resource will affect the decision on whether the entity recognises a provision or discloses a contingent liability (see paragraphs 14(b) and 23).

Applies **CF4.38**
Helps to clarify that a 'probable outflows' criterion still exists in IAS 37, and how it comes into play.

16C An obligation to exchange one economic resource for another economic resource is not an obligation to transfer an economic resource unless the terms of the exchange are unfavourable to the entity—for example, if the terms of an executory contract are onerous.

**CF4.39(a), CF4.47 and CF4.57**

Provides a basis for requirements for onerous contracts (IAS37.66–IAS37.69) and conclusions in Ilustrative Examples

**Present obligation as a result of a past event**

18 Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future. The only liabilities recognised

in an entity's statement of financial position are those that exist at the end of the reporting period.

19A An entity has a present obligation as a result of a past event only if the entity:

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

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

> **CF4.43**
>
> Replaces IAS37.19

19B 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.

> **CF4.44**
> Useful for levies.

19C [Requirements for situations in which a transfer of an economic resource will be required only if a measure of the entity's activities exceeds a specified threshold?]

> **FOR FURTHER STAFF ANALYSIS AND IASB DISCUSSION AT A FUTURE MEETING**
> The *Conceptual Framework* does not address thresholds. Requirements might be needed if we wish to incorporate Illustrative Example 4 from IFRIC 21 into the IAS 37 implementation guidance.

21 An event that does not give rise to an obligation immediately may do so at a later date, because of changes in the law or because an act (for example, a sufficiently specific public statement) by the entity gives rise to a constructive obligation. For example, when environmental damage is caused there may be no obligation to remedy the consequences. However, the causing of the damage will give rise to a present obligation when a new law requires the existing damage to be rectified or when the entity publicly accepts responsibility for rectification in a way that creates a constructive obligation.

21A Conversely:

(a) the enactment of a new law is not in itself sufficient to give an entity a present legal obligation. A present legal obligation arises only when, as a consequence of obtaining economic benefits or of taking an action to which the law applies, the entity will or may have to transfer an economic resource that it would not otherwise have had to transfer.

(b) having an established pattern of past practice, publishing a policy, or making a statement is not in itself sufficient to create a present constructive obligation for an entity. A present constructive obligation arises only when, as a consequence of obtaining economic benefits or taking an action to which the 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.

22 Where details of a proposed new law have yet to be finalised, an obligation arises only when the legislation is virtually certain to be enacted as drafted. For the purpose of this Standard, such an obligation is treated as a legal obligation. Differences in circumstances surrounding enactment make it impossible to specify a single event that would make the enactment of a law virtually certain. In many cases it will be impossible to be virtually certain of the enactment of a law until it is enacted.

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**CF4.45**

We suggest adding a 'net zero commitment' example to illustrate this point. See Example 15 in Appendix B.

**…**

## Application of the recognition and measurement rules

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### Restructuring

70 The following are examples of events that may fall under the definition of restructuring:

(a) sale or termination of a line of business;

(b) the closure of business locations in a country or region or the relocation of business activities from one country or region to another;

(c) changes in management structure, for example, eliminating a layer of management; and

(d) fundamental reorganisations that have a material effect on the nature and focus of the entity's operations.

71 A provision for restructuring costs is recognised only when the general recognition criteria for provisions set out in paragraph 14 are met. Paragraphs 72–83 set out how the general recognition criteria apply to restructurings.

**72 An obligation for restructuring costs arises only when an entity:**

**(a) has a detailed formal plan for the restructuring identifying at least:**

**(i) the business or part of a business concerned;**

**(ii) the principal locations affected;**

Suggestions for edits to the requirements for restructurings are explained in paragraphs 52 – 56 of Agenda Paper 22.

(iii) **the location, function, and approximate number of employees who will be compensated for terminating their services;**

(iv) **the expenditures that will be undertaken; and**

(v) **when the plan will be implemented; and**

(b) **has raised a valid expectation in those affected that it will carry out the restructuring by starting to implement that plan or announcing its main features to those affected by it.**

72A Once an entity has taken the actions described in paragraph 72, it has no practical ability to avoid implementing its restructuring plan, and hence, in accordance with paragraph 10D, it has an obligation for transfers of economic resources necessary to implement the plan.

73 Evidence that an entity has started to implement a restructuring plan would be provided, for example, by:

(a) dismantling plant or selling assets, or

(b) by the public announcement of the main features of the plan, made in such a way and in sufficient detail (ie setting out the main features of the plan) that it gives rise to valid expectations in other parties such as customers, suppliers and employees (or their representatives) that the entity will carry out the restructuring.

74 Announcing the main features of a plan to those affected by it is sufficient to create a valid expectation that the entity will carry out the plan only if implementation is planned to begin as soon as possible and to be completed in a timeframe that makes significant changes to the plan unlikely. If it is expected that there will be a long delay before the restructuring begins or that the restructuring will take an unreasonably long time, it is unlikely that the plan will raise a valid expectation on the part of others that the entity is at present committed to restructuring, because the timeframe allows opportunities for the entity to change its plans.

75 A management or board decision to restructure taken before the end of the reporting period does not give rise to an obligation at the end of the reporting period unless the entity has, before the end of the reporting period:

(a) started to implement the restructuring plan; or

(b) announced the main features of the restructuring plan to those affected by it in a sufficiently specific manner to raise a valid expectation in them that the entity will carry out the restructuring.

If an entity starts to implement a restructuring plan, or announces its main features to those affected, only after the reporting period, disclosure is required under IAS 10 *Events after the Reporting Period*, if the restructuring is material and non-disclosure could reasonably be expected to influence decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

76 Although an obligation is not created solely by a management decision, an obligation may result from other earlier events together

with such a decision. For example, negotiations with employee representatives for termination payments, or with purchasers for the sale of an operation, may have been concluded subject only to board approval. Once that approval has been obtained and communicated to the other parties, the entity has an obligation for restructuring costs, if the conditions of paragraph 72 are met.

77 In some countries, the ultimate authority is vested in a board whose membership includes representatives of interests other than those of management (eg employees) or notification to such representatives may be necessary before the board decision is taken. Because a decision by such a board involves communication to these representatives, it may result in an obligation for restructuring costs.

**78 No obligation arises for the sale of an operation until the entity is committed to the sale, ie there is a binding sale agreement.**

79 Even when an entity has taken a decision to sell an operation and announced that decision publicly, it cannot be committed to the sale until a purchaser has been identified and there is a binding sale agreement. Until there is a binding sale agreement, the entity will be able to change its mind and indeed will have to take another course of action if a purchaser cannot be found on acceptable terms. When the sale of an operation is envisaged as part of a restructuring, the assets of the operation are reviewed for impairment, under IAS 36. When a sale is only part of a restructuring, a constructive obligation can arise for the other parts of the restructuring before a binding sale agreement exists.

**80 A restructuring provision shall include only obligations for the direct expenditures arising from the restructuring, which are those that are both:**

A provision is defined as an obligation, not as expenditure.

**(a) necessarily entailed by the restructuring; and**

**(b) not associated with the ongoing activities of the entity.**

80A A restructuring provision could include, for example:

(a) legal or constructive obligations to pay termination benefits to employees whose roles are made redundant by the restructuring—to the extent that the obligations relate to past employment; or

(b) contractual obligations to pay penalties for cancelling supply contracts the entity entered into before the end of the reporting period.

81 A restructuring provision does not include obligations for such costs as:

(a) retraining or relocating continuing staff;

(b) marketing; or

(c) investment in new systems and distribution networks.

These expenditures relate to the future conduct of the business. and are not present obligations at the end of the reporting period. Such expenditures are recognised on the same basis as if they arose independently of a restructuring.

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Paragraph 56 of Agenda Paper 22 explains the suggestion to add examples.

An employee benefits example dovetails well with IAS 19 *Employee Benefits* requirements:

- IAS 19 encompasses that both legal and constructive obligations for employee benefits.
- IAS 19 defines the term ‘termination benefits’.
- IAS19.165 requires entities to apply IAS 37 in recognising termination benefits payable as a result of a restructuring.