IASB PUBLISHES EXPOSURE DRAFT PROVISIONS – (PROPOSED AMENDMENTS TO IAS 37)

STATUS: Exposure draft

ACCOUNTING IMPACT: The proposed amendments may significantly affect entities that currently apply IFRIC 21 in situations where levies are charged if an entity takes two or more specific actions. The proposed amendments also affect the costs to be included in the measurement of provisions and the discount rate to be used for determining the present value of provisions.

Target: improvements to three aspects of IAS 37 Provisions, Contingent Liabilities and Contingent Assets, one related to recognition and two related to measurement.

1. Recognition: Amend the recognition criterion related to whether a present obligation exists, which must be met in order to recognise a provision.
2. Measurement: Amend the requirements related to the costs an entity includes in estimating the future expenditure required to settle its present obligation. And propose that the discount rate used for determining the present value of provisions does not reflect non-performance risk i.e. the risk that the entity will not settle the obligation.

What do the proposals require?

IAS 37.14 currently provides three criteria that need to be met in order for a provision to be recognised:

(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.

The ED proposes to amend the first criterion i.e. the present obligation recognition criterion. No amendments are proposed to the second and third criteria.

The proposed amendments consist of the following:

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

II. **Aligning the wording of the present obligation recognition criterion with the updated definition of a liability:** An entity has a present obligation (legal or constructive) to transfer an economic resource as a result of a past event (paragraphs 14A–16).

III. **Three conditions within the present obligation recognition criterion, instead of the 'obligating event':** These proposals would fundamentally change how the present obligation recognition criterion is applied to assess whether a provision is required to be recognised.

1. **Obligation condition:** The ED proposes that an entity has an obligation if all three of the following criteria are met;
    - Existence of a mechanism imposing a responsibility on the entity if it obtains specific economic benefits or takes a specific action
        a) Such mechanism can be legal or constructive.
    - The entity owes that responsibility to another party
        a) The entity need not know the identity of the party to whom the responsibility is owed.
        b) The other party could be a person(s) or another entity(ies) or society at large.
    - The entity has no practical ability to avoid discharging the responsibility if it obtains the specific economic benefits or takes specific action
        a) Legal obligation: The other party has a right to act against the entity if the entity fails to discharge the responsibility and as a result of that right, the economic consequences for the entity of not discharging the responsibility are expected to be significantly worse than the costs of discharging it.
        b) Constructive obligation: The entity's pattern of past practice, published policy or sufficiently specific current statement creates valid expectations in other parties that the entity will discharge the responsibility.
2. **Transfer condition:** For the transfer condition to be met, the obligation must have the potential to require the entity to transfer an economic resource to another party. The condition requires such potential to exist. It does not need to be certain or even likely that the entity will be required to transfer an economic resource.
3. **Past-event condition:** The ED proposes that an entity's obligation becomes a present obligation that exists as a result of a past event when the entity
    - has obtained specific economic benefits or taken a specific action; and

  - as a consequence of having obtained those benefits or taken that action, will or may have to transfer an economic resource it would not otherwise have had to transfer.

Summary of the recognition criteria:

The following summarises the criteria that need to be met for recognising a provision under the proposed amendments:

- **Present obligation recognition criterion (IAS 37.14(a))**
  - Obligation condition:
    - Mechanism imposing responsibility
    - Responsibility owed to another party
    - No practical ability to avoid discharging the responsibility
  - Transfer condition
  - Past-event condition

- **Transfer of economic resources probable (IAS 37.14(b))**
  No amendments proposed, except some changes in wording.

- **Reliable estimate (IAS 37.14(c))**
  No amendments proposed.

IV. Redefining a past event

The proposed amendments to the past event condition aim to address the criticism of IFRIC 21. As discussed in point (III.) above, in some cases, levies are charged if an entity takes two or more specific actions. In such circumstances, IFRIC 21 requires the entity to recognise the liability only when it takes the last of those actions, triggering the charge. The ED proposes to clarify that in such situations, the past-event condition is met when the entity has taken the first action (or any of the actions) and has no practical ability to avoid taking the second action (or all the remaining actions).

V. Threshold-triggered costs

The IASB concluded that the action that satisfies the past-event condition is all activity that contributes to the total activity on which the cost is assessed, both activity below the threshold and activity above the threshold. Therefore, the past event condition begins to be met as soon as an entity starts carrying out the activity that contributes to the total being assessed. Therefore, at any date within the assessment period, the present obligation is a portion attributable to the activity carried out to date.

VI. Restructuring costs - improved wording

IAS 37.70-83 set out recognition requirements for restructuring provisions. Those paragraphs currently require an entity to recognise a restructuring provision when it has a ‘constructive obligation to restructure’. Therefore, the IASB decided to amend the wording related to the requirements for restructuring costs without changing the substance of the requirements. Instead of a ‘constructive obligation to restructure’, the ED proposes to amend the wording to a ‘present obligation for the costs of the restructuring’ in IAS 37.72. The ED proposes similar wording changes in other paragraphs related to restructuring costs.

PROPOSALS RELATED TO EXPENDITURE REQUIRED TO SETTLE AN OBLIGATION

- IAS 37.68A specifies the costs that an entity is required to include when assessing whether a contract is onerous. These costs are the costs that relate directly to the contract i.e. the incremental costs of fulfilling the contract and an allocation of other costs that relate directly to fulfilling contracts.
- The ED proposes to clarify that the expenditure required to settle an obligation comprises the costs that relate directly to the obligation. Similar to the requirement for assessing whether a contract is onerous, the costs that relate directly to an obligation consist of both:
    - Incremental costs of settling the obligation, and
    - An allocation of other costs that relate directly to settling obligations of that type.

PROPOSALS RELATED TO DISCOUNT RATES

The IASB proposes to clarify that the current market assessments of the time value of money are represented by a risk-free rate. Instead of "risks specific to the liability," the IASB proposes that the discount rate would reflect 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 future cash flows.

Under the proposed requirements, the discount rate would be a pre-tax rate reflecting:

- ► A risk-free rate representing current market assessments of the time value of money and
- ► 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 future cash flows.

Non-performance risk:

'Risks specific to the liability' that IAS 37.47 currently requires to be reflected in the discount rate include the uncertainty in the amount or timing of the expenditure required to settle the liability. But IAS 37 does not currently specify whether risks specific to the liability also include non-performance risk, i.e. the risk that the entity will not settle the liability. The IASB proposes to clarify that the discount rate does not reflect non-performance risk.

OTHER PROPOSALS

<u>Disclosure requirements</u>

The ED proposes a new requirement to disclose the discount rate (or rates) used in measuring the provision and the approach used to determine that rate (or those rates).

<u>Implementation guidance</u>

The ED proposes to add a three-part decision tree that summarises the process of applying the three criteria for recognising a provision. The ED also proposes four new examples in the Implementation Guidance to assist users to apply the proposed requirements related to recognition of a provision. The existing examples are proposed to be amended to align them with the proposed requirements. All the examples illustrate how the three conditions of present obligation recognition criterion (obligation condition, transfer condition and past-event condition) may be assessed for the given fact patterns.

PROPOSED TRANSITION REQUIREMENTS

The amendments are proposed to be applicable retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. To apply the amendments retrospectively, an entity would be required to identify, recognise and measure provisions and re-measure the carrying amount of related assets as if the entity had always applied the amendments. Any resulting net difference would be recognised in retained earnings or other component of equity, as appropriate.

Mandatory exception to retrospective application:

The ED proposes one mandatory exception to retrospective application of the amendments, for costs included in the measurement of a provision. This exception would apply if an entity changed its accounting policy for the costs it includes in the measure of a provision to comply with the proposed requirements. The entity would be required to apply such a change only to obligations the entity has not yet settled at the date of initial application and without restating comparative information. The cumulative effect of initially applying the amendments would be recognised as an adjustment to the opening balance of a related asset (if any), retained earnings or other component of equity, as appropriate, at the date of initial application.

Optional exemption from retrospective application:

The ED also proposes an exemption from retrospective application that an entity may choose to apply. This exemption applies if an entity changes its accounting policy for determining discount rates to comply with the proposed amendments. The exemption permits an entity to not apply the requirements of IFRIC 1 Changes in Existing Decommissioning, Restoration and Similar Liabilities for changes in the measurement of a provision that occurred before the transition date, if the entity changes its accounting policy for determining discount rates to comply with the proposed requirements. The entity electing to use this exemption would apply the amended requirements to restate the provision at the transition date and apportion the amount by which it adjusts the provision at the transition date between the related asset and retained earnings:

- Assuming the current discount rate(s) and estimates of cash flows used in measuring the provision have not changed since the provision was first recognised; and
- Using current estimates of the useful life of the related asset.

This exemption is proposed because of the requirements in IFRIC 1 related to fluctuations in the amount of provisions for asset decommissioning or restoration liabilities. IAS 37 requires an entity to measure a provision using current estimates of the expenditure required to settle the present obligation and a current market assessment of the time value of money. As a result, the amount of provision for asset decommissioning or restoration liabilities fluctuates between reporting dates. IFRIC 1 requires such fluctuations to be added to or deducted from the cost of the related asset and are recognised prospectively in the statement of profit or loss with depreciation or impairment. To comply with the requirements of IFRIC 1 on retrospective application of the proposed amendments, an entity would be required to construct a historical record of every change to the asset's cost and accumulated depreciation, which could be onerous. Therefore, the IASB has proposed the above exemption to the transition requirements.

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If you have any questions about the information in this newsletter, please speak to your usual BDO contact or get in touch with BDO in Thailand's IFRS team at ifrsthailand@bdo.th.