iGAAP in Focus
Financial reporting

IASB proposes targeted improvements to the accounting for provisions

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This *iGAAP in Focus* outlines the proposed amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* set out in Exposure Draft (ED) *Provisions—Targeted Improvements*, published by the International Accounting Standards Board (IASB) on 12 November 2024.

- The IASB proposes amendments to the criterion to recognise a provision in IAS 37, including:
  - updating the definition of a liability in IAS 37 to align with the definition of a liability in the *Conceptual Framework*
  - amending the requirements that support the present obligation recognition criterion
  - withdrawing IFRIC 21 *Levies*, whose requirements are not consistent with those proposed in the ED, and replacing it with illustrative examples in the *Guidance on implementing IAS 37*
- With regard to measurement of provisions, the IASB proposes to specify that:
  - the expenditure to settle its present obligation comprises the costs that relate directly to the obligation, which include both the incremental costs of settling that obligation and an allocation of other costs that relate directly to settling obligations of that type
  - the discount rate used should be a risk-free rate—that is, a rate that excludes non-performance risk
- The ED does not include a proposed effective date—it will be set when the IASB redeliberates the proposals
- The IASB proposes specific transition requirements for the proposed amendments
- The comment period for the exposure draft ends on 12 March 2025.

Background

The IASB has received consistent feedback from stakeholders about difficulties in disentangling the following conditions in the 'present obligation' criterion that must be met when recognising a provision:

- the obligation condition, which requires a mechanism that imposes responsibilities on the entity and leaves the entity with no realistic alternative to discharging those responsibilities if a specific event occurs

- the past-event condition, which requires that the specific event has occurred such that the obligation is a present obligation.

In addition, stakeholders expressed dissatisfaction with IFRIC 21, which interprets the present obligation recognition criterion, and reported difficulties in applying the existing requirements in IAS 37 to laws and regulations with novel enforcement mechanisms or settlement options.

In response to that feedback, the IASB added a standard-setting project to its work plan in 2020, with the objective of making targeted improvements to IAS 37. These proposed improvements are set out in the ED.

The proposed amendments

Recognition criteria

The IASB proposes that the following three criteria should be met in order to recognise a provision:

- the entity has a present obligation to transfer an economic resource as a result of a past event (the 'present obligation recognition criterion')

- it is probable that the entity will be required to transfer an economic resource to settle the obligation

- a reliable estimate can be made of the amount of the obligation.

The IASB is proposing significant changes to the present obligation recognition criterion. No changes are proposed to the two other recognition criteria.

Present obligation recognition criterion

The proposed revised wording of the present obligation criterion reflects the definition of a liability in the *Conceptual Framework* (i.e. a present obligation of the entity to transfer an economic resource as a result of a past event).

Starting from this revised definition, the ED proposes to set out more clearly the three underlying conditions:

- the obligation condition, which is met if:

  - there is a mechanism (legal or constructive) that imposes a responsibility on the entity if it obtains specific benefits or takes a specific action

  - the entity owes that responsibility to another party

  - the entity has no practical ability to avoid discharging the responsibility if it obtains the benefits or takes the action (guidance is proposed explaining what this means in the case of a legal obligation)

- the transfer condition, which is met if the obligation has the potential to require the entity to transfer an economic resource to another party

- the past-event condition, which is met when:

  - the entity has obtained specific economic benefits or taken a specific action

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

The proposed changes to the past-event condition would significantly affect the recognition of an obligation arising from economic benefits that are obtained, or from actions that are taken, over time.

In particular, if an entity has an obligation to transfer an economic resource only if a measure of its activity in a period (the assessment period) exceeds a threshold, the ED proposes that the past-event condition is the activity that contributes to the total activity on which the amount of the transfer is assessed. At any date within the assessment period, the entity would be considered to have a present obligation of the portion of the total expected obligation for the assessment period. A provision would be recognised if:

- it is probable that the entity's activity will exceed the threshold and the entity will be required to transfer an economic resource and
- a reliable estimate can be made of the amount of the obligation.

In addition, if the entity has an obligation to transfer an economic resource only if it takes two (or more) separate actions and the requirement to transfer the economic resource is a consequence of both (or all) these actions, the ED proposes that the past-condition is met when the entity has taken one of the actions and no practical ability to avoid taking the remaining action(s).

Observation
The current requirements in IFRIC 21 define the obligating event that gives rise to a liability to pay a levy as the activity that triggers the payment of the levy. If the obligating event is the reaching of a minimum activity threshold, the corresponding liability is recognised when that minimum activity threshold is reached. Applying IFRIC 21, entities are therefore generally required to recognise a provision later than they would applying the proposals in the ED. Consequently, the IASB is proposing to withdraw IFRIC 21 as its principles are inconsistent with the proposed revised wording of the present obligation criterion.

The proposals also include withdrawing IFRIC 6 *Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment* and replacing it with an illustrative example in the *Guidance on implementing IAS 37*

The IASB is also proposing amendments to the *Guidance on implementing IAS 37.* These amendments would update the guidance on applying the present obligation recognition criterion to reflect the proposed amendments to the requirements.

Measurement of a provision

Expenditure required to settle an obligation
IAS 37 requires an entity to measure a provision at the best estimate of the expenditure required to settle its present obligation. The IASB proposes to specify that this expenditure comprises the costs that relate directly to the obligation, which include both the incremental costs of settling that obligation and an allocation of other costs that relate directly to settling obligations of that type.

Observation
In May 2020, the IASB issued ***Onerous Contracts—Cost of Fulfilling a Contract (Amendments to IAS 37)***, which specified the costs an entity includes in *assessing* whether a contract is onerous, and hence in determining whether the entity recognises an onerous contract provision. The amendments did not specify which costs an entity includes in *measuring* an onerous contract provision and, more broadly, in measuring any type of provision within the scope of IAS 37. The IASB decided to address this absence of guidance with the proposal now included in the ED.

Discount rates
The IASB proposes to specify that an entity discounts the future expenditure required to settle an obligation at a rate (or rates) that reflect(s) the time value of money—represented by a risk-free rate—with no adjustment for non-performance risk.

The IASB also proposes to require an entity to disclose the discount rate (or rates) it has used and the approach it has used to determine that rate (or those rates).

Observation
The IASB decided not to propose to specify how an entity determines an appropriate risk-free rate, acknowledging that various approaches might be appropriate.

Disclosure requirements for subsidiaries without public accountability

The IASB proposes to add to IFRS 19 *Subsidiaries without Public Accountability: Disclosures* a requirement to disclose the discount rate (or rates) used in measuring a provision, but not to add a requirement to disclose the approach used to determine that rate (or those rates).

Effective date, transition and comment period

The ED does not propose an effective date. The effective date will be decided when the IASB redeliberates the proposals.

With regard to transition, the IASB proposes to require an entity to:

- identify, recognise and measure provisions as if the entity had always applied the amendments
- re-measure the carrying amount of related assets, if any, as if the entity had always applied the amendments
- recognise any resulting net difference in retained earnings or other component of equity, as appropriate.

The IASB also proposes specific transition requirements for cases in which an entity, to comply with the amendments, changes its accounting policy for the costs it includes in the measurement of a provision and for determining discount rates.

The comment period for the ED ends on 12 March 2025.

Further information

If you have any questions about the proposed amendments, please speak to your usual Deloitte contact or get in touch with a contact identified in this *iGAAP in Focus*.

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