



Provisions – Major accounting changes on the horizon

Proposed amendments to IAS 37

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What's the issue?

As the business world evolves, companies may face additional challenges when accounting for more complex transactions and uncertainties.

Accounting for provisions is one such area that has prompted the following long-standing questions.

- How do you determine if a present obligation exists and when do you recognise a provision?
- Which costs do you include in measuring a provision?
- Which rate do you use in discounting a long-term provision?

In response, the International Accounting Standards Board (IASB) is proposing to clarify the related requirements in *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* and withdraw *IFRIC 21 Levies*.



What's the impact?

Under the proposals:

- some provisions could be recognised earlier, progressively; and
- some provisions may become larger.

The impact of the proposals would depend on the nature of a company's obligations and its existing accounting policies.

New judgements would be required – e.g. to estimate whether future thresholds are expected to be met for threshold-based obligations.



What's next?

Companies should:

- consider the proposals;
- assess their potential impact; and
- provide feedback to the IASB.

Use this guide to help with the analysis.

Which three key areas do the IASB's proposals address?



How to determine if a **present obligation** exists and **when to recognise** a provision



Which **costs** to include in measuring a provision



Which **rate** to use in **discounting** a long-term provision



Under the IASB's proposals, some provisions could be recognised **earlier, progressively**, and some provisions may become **larger**.

When to recognise a provision

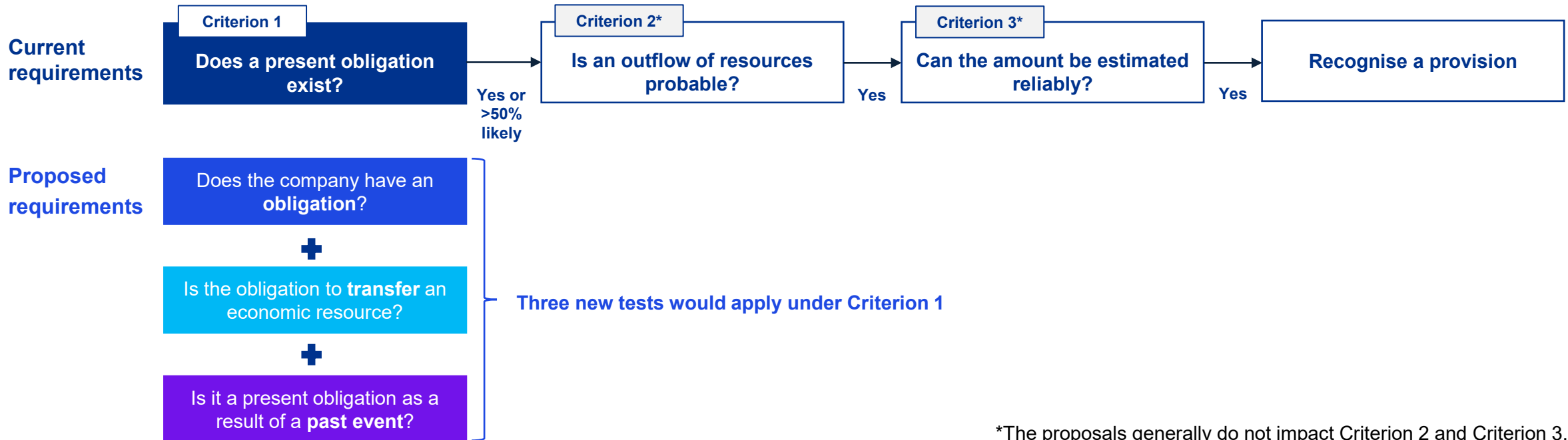
Under IAS 37, a company recognises a provision if and when:

- it has a **present obligation** arising from a past event (Criterion 1);
- an outflow of economic resources is probable (Criterion 2); and
- the amount can be estimated reliably (Criterion 3).

Applying Criterion 1 has prompted questions from companies, particularly in relation to climate-related commitments and threshold-based obligations.

In response, the IASB is proposing:

- **three new tests under Criterion 1** to determine whether a present obligation exists;
- specific guidance for [threshold-based obligations](#); and
- new illustrative examples to replace IFRIC 6 *Liabilities arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment* and IFRIC 21.



Three new tests for present obligations: Obligation test

Does the company have an **obligation**?



Is the obligation to **transfer** an economic resource?



Is it a present obligation as a result of a **past event**?

Under the proposals, in determining whether it has an obligation, a company would need to answer the following three questions.



Is there a **mechanism** that imposes a **responsibility** if the company obtains specific economic benefits or takes action?



Does the company owe that responsibility to **another party**?



Does the company have a **practical ability to avoid** the responsibility if it obtains benefits or takes action?

Currently, a company considers its ability to avoid settling its obligation when determining whether it has a present obligation arising from a past event. Under the proposals, the **test will shift** from the ability to avoid the transfer of economic resources **to the practical ability to avoid the obligation** under the law or another specific mechanism.

As a result, companies may need to recognise some provisions progressively and at an earlier date.



Three new tests for present obligations: Transfer test

Does the company have an **obligation**?



Is the obligation to **transfer** an economic resource?



Is it a present obligation as a result of a **past event**?

The proposals introduce a new, specific test, which would require a company to assess whether:



its obligation has the **potential** to require the company to transfer an **economic resource**; and



the transfer of economic resources is to **another party**.



This new test **does not consider the probability** of the transfer, which remains part of Criterion 2 – i.e. whether an outflow of resources is probable.

A transfer of economic resources is **not an exchange** of economic resources, unless the terms of the exchange are unfavourable to the company. A transfer may also be contingent upon a specific uncertain future event.

Three new tests for present obligations: Past event test

Does the company have an **obligation**?



Is the obligation to **transfer** an economic resource?



Is it a present obligation as a result of a **past event**?

The proposals shift the focus from an event at a point in time that creates an obligation to an activity that contributes to an obligation.

Under the proposals, a company has a **present obligation as a result of a past event** if it has:



obtained **economic benefits** or **taken action**; and



consequently, will or may need to transfer an **economic resource**.



Under current IAS 37, a past event is considered to arise at a point in time regardless of its nature.

Under the proposals, if a company obtains economic benefits or takes the action over time, then the **present obligation** would arise **over time**.

What is proposed for threshold-based obligations?

IAS 37 currently provides no specific guidance on threshold-based obligations and instead, companies apply IFRIC 21.

Under IFRIC 21, a company recognises recurring periodic levies at a single point in time when the threshold is reached. If a levy is dependent on multiple specific actions, then a liability arises when the last action is taken.

Under the proposals, a **present obligation would accumulate** as the company carries out the activity linked to the threshold that it expects to exceed at the end of the compliance period. For example, in relation to an emissions obligation, a present obligation would arise as the company emits pollutants if it expects to exceed the threshold for the compliance period. It would recognise a provision if Criteria 2 and 3 are also met.

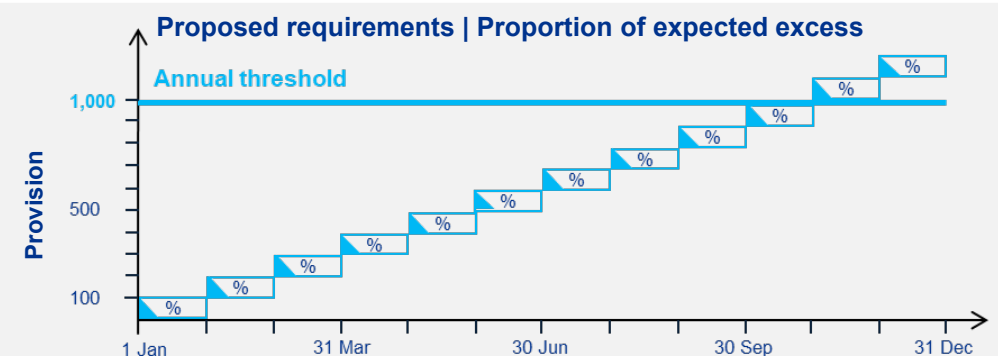
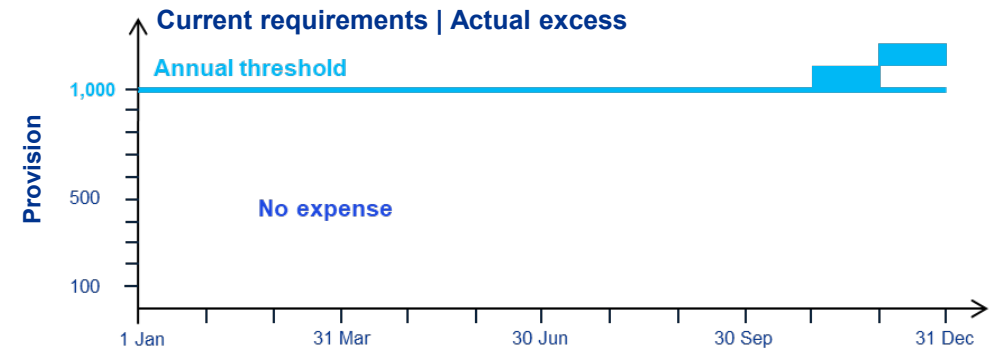
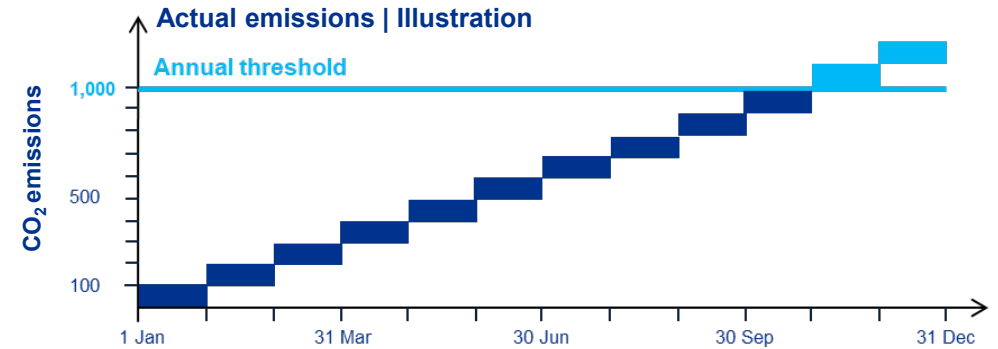
If a transfer of economic resources is dependent on multiple specific actions, then a company incurs a present obligation when it takes the first action and has no practical ability to avoid taking the other actions.

This means that a company would **recognise some provisions earlier and progressively**.



The proposals shift the focus from the threshold being exceeded to the activity the threshold is linked to – e.g. shifting from exceeding the emissions threshold to emitting pollutants.

They would also require management to make **new judgements and estimates** throughout the reporting period, including whether a threshold will be exceeded.



Which costs to include in measuring a provision

IAS 37 provides no specific guidance on which costs to include in measuring a provision. Therefore, companies' approaches vary depending on the nature of the provision and their accounting policy.

For example, a provision for an onerous contract generally includes incremental costs and an allocation of other direct costs. This is consistent with the test for determining whether a contract is onerous.

Conversely, a provision for a legal claim may include only incremental costs relating to payments to external lawyers and the claimant.

Under the proposals, a company would include **all direct costs** when measuring **any provision**. These costs would include:

- incremental costs; and
- an allocation of other costs that relate directly to settling the obligation.



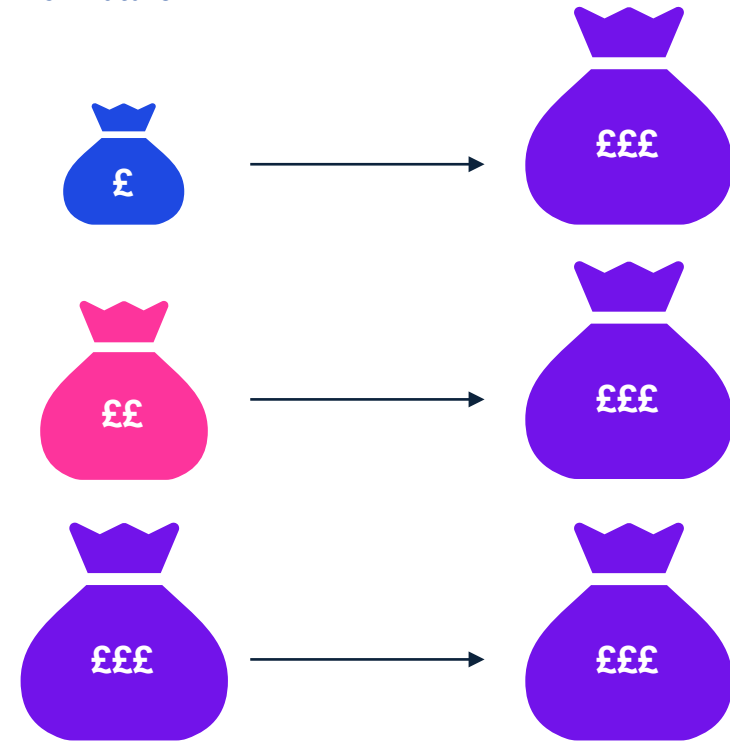
The proposals could cause some provisions to become **larger** – e.g. those currently measured using incremental costs only.

For example, a provision for a legal claim would include an allocation of internal legal team payroll costs and other related costs *in addition to* amounts paid to external lawyers and the claimant.

Companies may require **new processes** to identify all direct costs and an allocation method.

Current practice | Measurement varies based on nature

Proposed requirements | All direct costs



● Provision includes only incremental costs

● Provision includes costs determined on a different basis

● Provision includes all direct costs

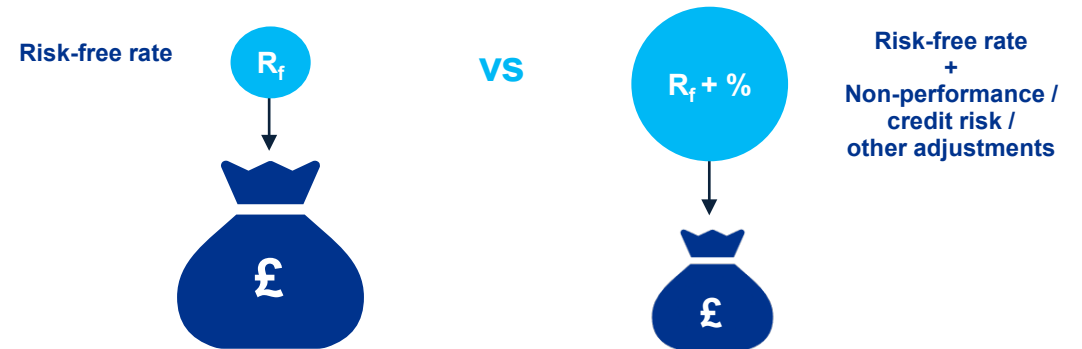
Which rate to use in discounting a long-term provision

To reflect the time value of money in measuring a provision, IAS 37 requires companies to use a pre-tax discount rate that reflects the risks specific to the liability.

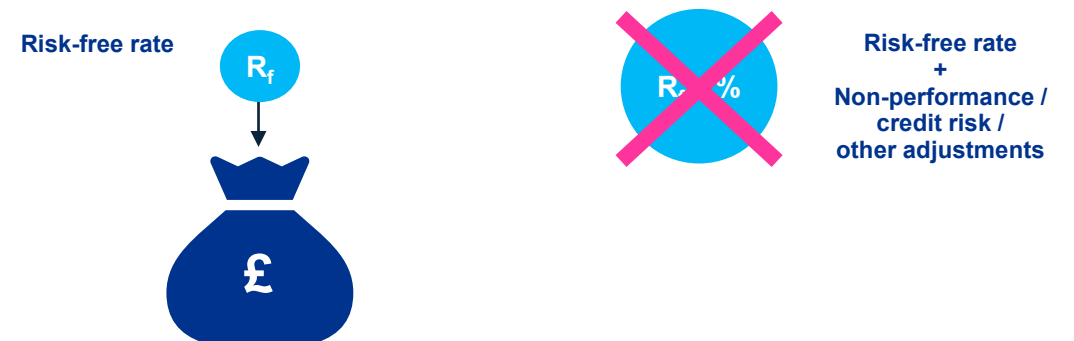
The approach to determining that rate varies between companies because the accounting standard provides no detailed guidance. Some companies use a risk-free rate; others adjust the rate for non-performance or their own credit risk.

Under the proposed approach, a company would use a **risk-free rate**. It would make no further adjustments – e.g. for non-performance or own credit risk.

Current practice | Mixed



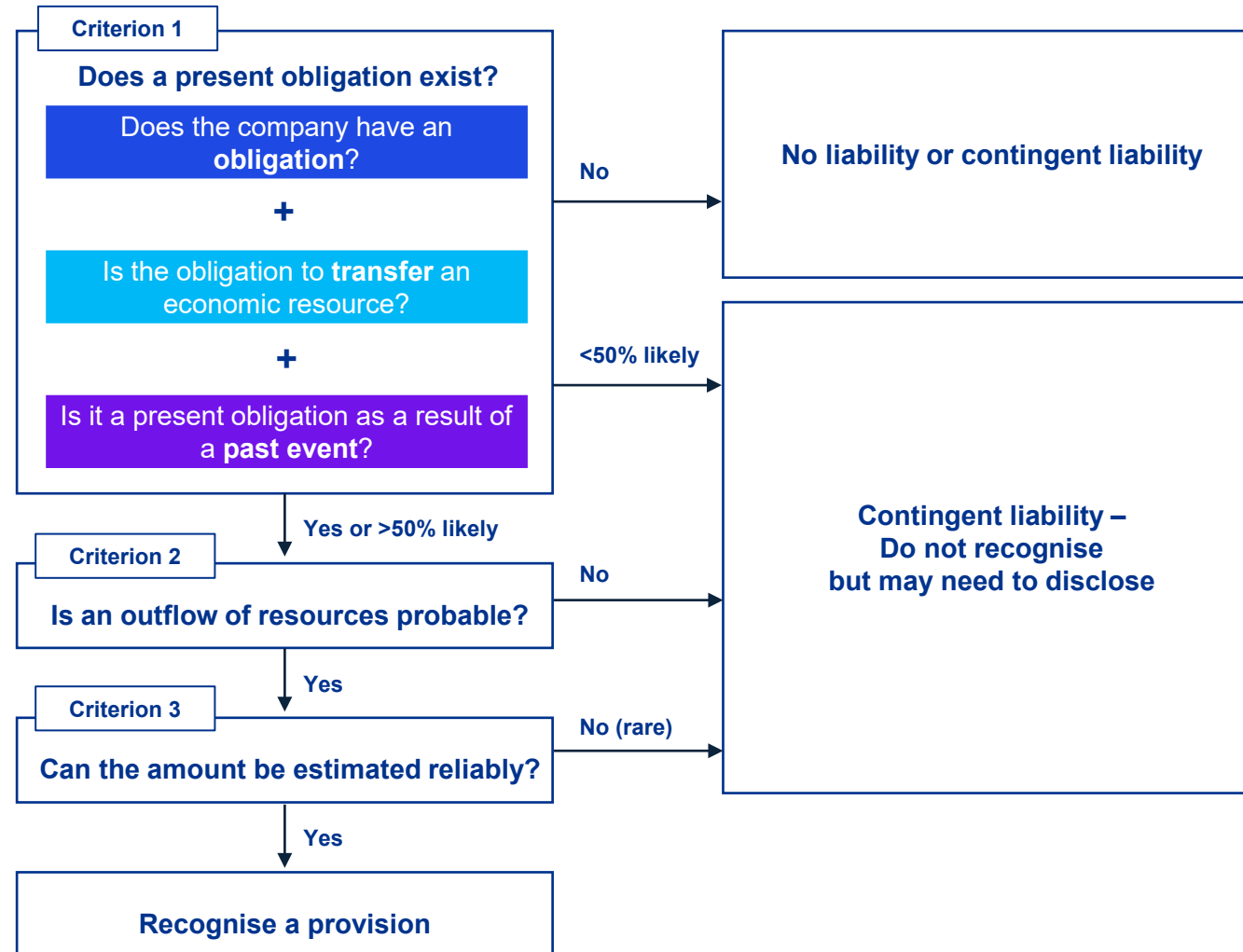
Proposed requirements | Risk-free rate only



The proposals could cause some provisions to become **larger** – e.g. those currently measured at risk-adjusted discount rates.

They could also cause provision amounts to become material and require recognition. For example, if a company measures a decommissioning provision for such work in the distant future at a risk-adjusted discount rate, then it may consider this amount currently as immaterial.

At a glance – Revised guidance for recognising provisions



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