International Accounting Standards Board

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FAR comments on Exposure Draft Provisions – Targeted Improvements, Proposed amendments to IAS 37.

FAR, the Institute for the Accountancy Profession in Sweden, is responding to your invitation to comment on the Exposure Draft Provisions – Targeted Improvements, Proposed amendments to IAS 37.

Summary of FAR's comment letter response

FAR supports the efforts to increase consistency in practice in some areas and the expected improvements in usefulness from the changes in timing of recognise some provisions. Please see FAR's input on the questions in the Exposure Draft in the appendix below. FAR makes reservations for the difficulty to anticipate how the proposed standard will affect and be applied to all kinds of different fact patterns.

Appendix
FAR's responses on the Questions addressed in the Exposure Draft

Question 1 — Present obligation recognition criterion
The IASB proposes: • to update the definition of a liability in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* to align it with the definition in the *Conceptual Framework for Financial Reporting* (paragraph 10); • to align the wording of the recognition criterion that applies that definition (the present obligation recognition criterion) with the updated definition of a liability (paragraph 14(a)); • to amend the requirements for applying that criterion (paragraphs 14A–16 and 72–81); and • to make minor amendments to other paragraphs in IAS 37 that include words or phrases from the updated definition of a liability (Appendix A). The proposals include withdrawing IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment* and IFRIC 21 *Levies* (paragraph 108). Paragraphs BC3–BC54 and BC86 of the Basis for Conclusions and Appendix A to the Basis for Conclusions explain the IASB's reasoning for these proposals. Do you agree with these proposals? Why or why not? If you disagree, which aspects do you disagree with and what would you suggest instead?

FAR's response

FAR supports the updated definition of liability in IAS 37 to align it with the definition in the Conceptual Framework and the aligned wording in paragraph 14(a).

However, FAR believes that the revised criteria for when a provision should be recognised could be further improved (paragraphs 14A-16). FAR is of the opinion that it is relevant that some of these paragraphs and related illustrative examples are clarified to avoid different interpretations, as noted below and in the answer to question 6.

FAR recommends that the Board either amends IAS 37 to require the recognition of a legal obligation based only on enacted legislation, or uses the same phrase as in IAS 12 with expanded explanation to that provided in paragraph 48 of IAS 12 since IAS 37 applies more broadly than only tax legislation.

Paragraphs 14I-14L introduce a distinction between a *transfer* of an economic resource and an *exchange* of an economic resource, where the latter is not an obligation to transfer an economic resource. FAR encourages the IASB to clarify the distinction between transfer and exchange to avoid different interpretations and application in practice. In Example 7, the transfer condition is not met since the training provider (supplier) is an external party and therefore the conclusion is that this is an exchange transaction since the entity pays cash and receive services from the provider. On the other hand, and as FAR understands, in Example 2A/B, the transfer condition is met since the clean-up services are provided internally. FAR believes that the IASB could clarify how to make the distinction between *transfer* and *exchange*, including whether the answer would be different if the entity in Example 2A/B had purchased these services externally.

Paragraph 14P makes a distinction between activities that occur over time (thresholds) and the obligation is related to a threshold and obligations that arises if an entity takes two (or more actions). FAR considers that Example 13A-13C could be further improved and clarified, please find comments below related to Question 6.

Paragraph 14P refers to an entity's own activities to which a threshold applies (and paragraph 14Q to an entity taking actions). For instance, in the aviation industry, an airline will be required to pay a levy if the global aviation industry emissions exceed a certain threshold during a period. The levy for each entity (airline) will be in proportion to the airlines' contribution to that excess. Hence, the obligation is not only dependent on the entity's own activities. As FAR understands, it is not clear if the proposed amendments address this type of situation.

FAR observes that paragraph 18 of the current standard has been deleted. The question is how useful this paragraph has been in practice in enforcing the principle that future operating expenses should not be provided for. FAR does not see where this aspect may have been reproduced in the revised standard, nor have FAR noted any explanation in the Basis for Conclusions about the deletion, nor is there any discussion in the BC about a decision to change this principle. FAR therefore suggests that the IASB ensure that the principle of the guidance in paragraph 18 is carried forward and is sufficiently visible within the amended standard.

Question 2 — Measurement—Expenditure required to settle an obligation
The IASB proposes to specify the costs an entity includes in estimating the future expenditure required to settle an obligation (paragraph 40A). Paragraphs BC63–BC66 of the Basis for Conclusions explain the IASB's reasoning for this proposal. Do you agree with this proposal? Why or why not? If you disagree, what would you suggest instead?

FAR's response

FAR agrees with the intention to increase consistency in practice regarding the measurement of a provision. Therefore, FAR agrees with the development of a principle about which type of costs to include but believes more guidance on what to include in the provision is needed, either directly in the standard, via example and/or via application guidance. FAR specifically considers that further guidance is needed on how the requirements would be applied to obligations not settled by the provision of goods or services, such as legal claims. FAR believes that more specific guidance will lead to even more consistent application. Other IFRS Accounting Standards provide examples of the types of costs that are included or excluded (for example, IFRS 15 Revenue from Contracts with Customers, IAS 16 Property, Plant and Equipment and IFRS 17 Insurance Contracts). FAR suggests that similar guidance, without providing an exhaustive list, should be provided in IAS 37 to help entities identify the types of incremental costs and other costs that relate directly to settling obligations.

FAR notes that the proposed amendments to include direct costs in an estimate of the future expenditure required to settle an obligation raises questions about how to measure a liability when there are no such costs, even though an entity is obliged to transfer economic resources. For example, in Example 14, an entity recognises a provision for the best estimate of the expenditure required to obtain and surrender enough positive credits to eliminate the negative credits due for the reporting period. Management expects the entity to generate the positive credits itself (thus avoiding the need to buy them) by manufacturing in the next reporting period cars with average fuel emissions lower than the government target. If an entity expects to manufacture and sell cars at a profit, it does not incur any additional costs related to the generation of positive credits. In such a situation, should a provision be measured by reference to the incremental costs of settling the obligation (i.e., nil) or by reference to the value of positive credits which will need to be surrendered?

Question 3 — 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 (paragraphs 47–47A). 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) (paragraph 85(d)). Paragraphs BC67–BC85 of the Basis for Conclusions and Appendix B to the Basis for Conclusions explain the IASB's reasoning for these proposals. Do you agree with: (a) the proposed discount rate requirements; and (b) the proposed disclosure requirements? Why or why not? If you disagree, what would you suggest instead?

FAR's response

FAR agrees with excluding the effects of non-performance risk in the discount rate.

<u>Non-performance risk as an adjustment to the cash flow</u>

Paragraph 47A explicitly states that the discount rate should exclude non-performance risk. However, the proposed amendments do not provide clarity on whether non-performance risk can be adjusted in the cash flows for measuring a provision. If the objective was to remove non-performance risk from measurement of liabilities under IAS 37, this should be explicitly stated. Otherwise, some entities might include non-performance risk in the cash flows to achieve the same outcome as including it within the discount rate.

Other difference in practice

Regarding the discount rate, another difference that exists in practice than the one dealt with in the ED is the estimation of the unwind of the discount (described below). It can be considered whether, if possible at this stage, this difference should also be dealt with.

In the balance sheet, the same carrying amount should be recognised whether the measurement is in nominal or real terms. But for the unwind, using a real or nominal discount rate creates different effects in the financial statements. It may create differences in allocation between finance and operating expense or with IFRIC 1 between the finance expense and the asset.

A similar issue relates to the risk-adjustment in IAS 37.47(b). If certainty equivalent cash flows are used, the discount rate is a risk-free rate. If future cash flows are not adjusted for the risk in paragraph 47(b), the discount rate should be risk-adjusted. For the unwind, which of these two rates should be used?

Disclosures

FAR supports the proposed requirement to disclose the discount rates used and the approach used to determine such rates. FAR believes the proposed disclosures would result in useful information for users of financial statements. However, FAR believes it would be useful with a clarification of what is meant with 'approach'.

Question 4 — Transition requirements and effective date
4(a) Transition requirements The IASB proposes transition requirements for the proposed amendments (paragraphs 94B–94E). Paragraphs BC87–BC100 of the Basis for Conclusions explain the IASB's reasoning for these proposals. Do you agree with these proposals? Why or why not? If you disagree, which aspects do you disagree with and what would you suggest instead? **4(b) Effective date** If the IASB decides to amend IAS 37, it will decide on an effective date for the amendments that gives those applying IAS 37 sufficient time to prepare for the new requirements. Do you wish to highlight any factors the IASB should consider in assessing the time needed to prepare for the amendments proposed in this exposure draft?

FAR's response

FAR agrees with the proposal for retrospective application (subject to two exceptions) of the amended standard. FAR also agrees with the proposed requirements for the cost exception, that are in line with the approach taken for the amendments to IAS 37 made in 2020 to specify the costs an entity includes in assessing whether a contract is onerous.

With respect to the discount rate, FAR agrees with the simplified approach for changes in discount rate to apply the new guidance at the transition date (as defined in the proposed standard). However, FAR believes it would be helpful to provide an example of how an entity would determine the split between retained earnings and the related asset to ensure appropriate implementation of the approach proposed. In addition, it is not clear whether the use of 'current' in paragraphs 94E(i) and (ii) is intended to mean 'as at the date of transition' or 'at the reporting date in the first year of amendments' application'. FAR encourages the Board to specify this in the final amendments.

FAR also believes that the IASB should consider introducing a single transition date for the two different exceptions instead of proposing two different dates: the *date of initial application* in paragraph 94D and the *transition date* in paragraph 94E.

FAR agrees with the IASB's proposal to determine an effective date for the amendments that would allow for sufficient time to prepare for the new requirements. FAR believes that entities may find adoption of the revised requirements challenging and FAR encourages the Board to consider this in setting the effective date. Despite this, FAR also suggests that earlier application option should be permitted.

Question 5 — 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) (Appendix B). Paragraphs BC101–BC105 of the Basis for Conclusions explain the IASB's reasoning for this proposal. Do you agree with this proposal? Why or why not? If you disagree, which proposal do you disagree with and what would you suggest instead?

FAR's response
FAR has chosen not to respond to this question.

Question 6 — *Guidance on implementing IAS 37*
The IASB proposes amendments to the *Guidance on implementing IAS 37* Provisions, Contingent Liabilities and Contingent Assets. It proposes: (a) to expand the decision tree in Section B; (b) to update the analysis in the illustrative examples in Section C; and (c) to add illustrative examples to Section C.

Paragraphs BC55–BC62 of the Basis for Conclusions explain the IASB's reasoning for these proposals.

Do you think the proposed decision tree and examples are helpful in illustrating the application of the requirements? If not, why not?

Do you have any other comments on the proposed decision tree or illustrative examples?

FAR's response

FAR believes that the proposed decision tree and examples are helpful in understanding the proposed requirements and their application.

FAR recommends that some of the examples be amended for clarity as follows:

1. Example 5A – Closure of a division: no communication or implementation before the end of the reporting period

IAS 19 deals with termination benefits. The linkage with these requirements should be explained in the example.

2. Example 5B – Closure of a division: communication/implementation before end of the reporting period

This example considers the treatment of contractual termination penalties payable to customers. It is essential to determine whether these penalties should be accounted for under IAS 37 or IFRS 15. In this context, consideration of the IFRIC decision "Compensation for Delays or Cancellations (September 2019) is pertinent. The decision clarified that such compensation should be accounted for as a reduction of revenue under IFRS 15, rather than a provision under IAS 37.

In addition, the linkage with the requirements of IAS 19 should be explained.

3. Example 13B – A levy on an entity operating as a bank on the last day of its annual reporting period

In this example, the present obligation accumulates over the annual reporting period. FAR's understanding is that this conclusion is based on the assumption that the size of the levy depends on the length of the annual reporting period, and without that feature, the levy would be recognised only on the last day of the reporting period. FAR is of the opinion that this is confusing. Does the fact that the levy is dependent on the length of the annual reporting period mean that a company in such a case have to take one additional action, compared to a company operating in a jurisdiction where the size of the levy is independent of the length of the annual reporting period? In the first situation, the requirement to pay the levy is a consequence of the entity taking two separate actions – operating in its current annual reporting period and operating as a bank on the last day of the period, where both actions are required for the levy to be payable. In the second situation, the requirement to pay the levy is a consequence of the entity taking only one separate action – operating as a bank on the last day of the period. This latter situation would then lead to an outcome where the present obligation does not accumulate over the annual reporting period. Instead, the present obligation would only arise on the last day of the reporting period because the action that meets the past-event condition is operating as a bank on the last day of its annual reporting period. Providing explicit guidance with regard to such a variation of the example would be very beneficial for understanding the connection between the action "operating in its current annual reporting period" and the fact that the size of the levy is dependent on the length of the annual reporting period.

FAR assumes that if Example 13C would change such that the property tax would vary depending on the length of the annual reporting period, then the requirement to pay that tax would be a consequence of the entity taking two separate actions – operating in its current annual reporting period and owning the land and buildings on 31 December each year. But this is not easy to understand as this is not commented on specifically.

FAR considers that the underlying principle behind the requirements in relation to obligations to transfer an economic resource only if an entity takes two (or more) separate actions is not clear. Clearly identifying the underlying principle would facilitate consistent application across a variety of fact patterns.

At present, it is difficult to rationalise precisely what leads to the identification of an "action" and therefore to clearly understand the difference between some of the examples in the guidance. It is also unclear how an entity should distinguish between actions and measurement basis. For example:

a) Example 13A assumes that the generation of revenue in the market in 20X0 is an "action". However, given that the fact pattern notes that only entities in the market on 1 January 20X1 are within the scope of the levy, it could be argued that the generation of revenue during 20X0 is not an action but only the basis for measuring the obligation. FAR considers that the distinction between what is merely a measurement basis and what is considered to be an "action" for purposes of the proposed amendments should be made clearer.

b) Example 13B considers that there are two distinct actions, i.e., operating in the entity's current annual reporting period and operating as a bank on the last day of that same period. FAR considers it would be helpful to explain the rationale for the difference from the conclusion in Example 13C, where only one action is identified. By analogy to Example 13B, without further clarification it could be argued that ownership of the property throughout the year is an action and an assessment would be needed as to whether the entity has a practical ability to avoid ownership of that property as of year-end.

4. Example 13C – A property tax

This example concludes that a provision for property tax is recognised only on 31 December 20X5 because the action that meets the past-event condition is "owning and holding land and buildings for business use on 31 December 20X5". FAR recommends providing additional guidance on the interaction with IAS 34 in an entity's preparation of interim financial statements. Providing explicit guidance or an illustrative example that includes mid-year reporting would be beneficial.

5. Example 13B – 13C

FAR believes that it could increase the understandability of the requirements and examples if variations of examples 13B and 13C were added. For example, effects on conclusions related to property tax if:

- the law takes into account the ownership of the asset throughout the year,
- there is an existing practice of compensation between the seller and the buyer relating to the property tax if the law does not take the duration of ownership into account,
- the tax is due on the first vs last day of the assessment period,
- the tax is based on a value of the asset in a previous period(s).

6. Example 14 – Negative low-emission vehicle credits

Firstly, it would be very helpful if the example would include an example of calculation of the provision in a case where the entity believes it expects that it would obtain positive credits by generating them itself, by manufacturing in 20X1 cars with average fuel emissions lower than the government target. Would such a provision be calculated based on the cost of purchasing such credits from another entity, although the entity does not foresee such a transaction to happen, or would such a provision be calculated based on some other method?

Secondly, FAR recommends including an additional example with a mid-year reporting date to clarify whether the provision should be measured based on the average level of emissions to date or based on the expected full-year emissions. FAR considers that measuring the provision based on the expected full-year emissions would be appropriate.

Question 7 Other comments
Do you have comments on any other aspects of the proposals in the Exposure Draft?

FAR's response

FAR draws attention to the following practical question which FAR believes needs to be addressed in the amendments. Suppose an entity enters into an onerous contract containing a cancellation fee that is lower than the cost of fulfilling the contract. The entity might conclude, after considering the economic consequences of not fulfilling the contract, that it has no practical ability to avoid fulfilling the contract, thus will incur higher expenses than the cancellation fees. In the context of this ED, it remains unclear at what amount the provision should be measured. Applying paragraph 68 of IAS 37 will lead to measuring it at the cancellation fee ("lower of"). However, doing so seems to create tensions with the "probable" criterion of paragraph 14 of IAS 37 and, potentially, the entity's conclusion that it has no practical ability to avoid fulfilling the contract. Also, there is no guidance around what to include in the cancellation fee, is it only the fee from the contract or should other costs be included such as legal advice, costs for termination of staff, termination of premises, etc. that are not needed if the contract is terminated.

FAR would also like to provide some broader comments regarding IAS 37 that are not addressed in the consultation document. FAR believes that a comprehensive review of IAS 37 should take place in addition to the changes currently proposed. This comprehensive review should include:

- Consider the consistency between the Conceptual Framework and IAS 37 regarding the recognition of liabilities, including a review of the probability criterion.
- Evaluate the structure of the standard, specifically whether it currently contains general principles, followed by additional guidance for areas such as loss contracts within the standard itself.
- The standard includes examples; these should be consolidated into illustrative examples.
- Conduct a comprehensive review of which examples may be relevant.
- Provide greater clarity regarding the scope, particularly to clarify the boundary between IFRS 9 and IAS 37, which is currently challenging in practice.

Yours sincerely,

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