Feedback received on three targeted improvements to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
Issues Paper

Objective

1 The objective of this session is to present and receive comments of EFRAG FRB on the feedback received to date on the IASB project *Provisions—Targeted Improvements*.

2 EFRAG FRB has previously noted that although the EFRAG FRB has classified the project as project on which EFRAG should not spend many resources, it is a project the EFRAG FRB wants to receive updates on as the effects of the proposals can be significant.

Scope of the IASB project

3 The IASB's project:

(a) clarifies/changes to the requirements on when an entity has a present obligation as a result of a past event;

(b) specifies which costs an entity includes in estimating the future expenditure required to settle the entity's present obligation; and

(c) specifies the rate an entity uses to discount that future expenditure to its present value and the related disclosure requirements.

4 The proposals and the input received in relation to these three areas are summarised in the sections below.

Requirements on when an entity has a present obligation as a result of a past event

Proposals

5 The main practical consequence of these proposals is that some liabilities would be recognised earlier and progressively over a period, rather than all at once at a point in time. The changes would mean that the timing of the recognition of a provision could change if an obligation to transfer an economic resource depends on two or more actions of the entity, and these actions occur at different times. An entity would then recognise a provision as soon as it has taken any of the actions and has no practical ability to avoid the

other actions (assuming that, at that time, the other recognition criteria are also met). For example, if an entity has to pay a levy (and the levy is a non-reciprocal transaction) as soon as it generates revenue in 20X1 and the amount of the levy is based on the revenue generated in 20X0, the entity should, according to the proposals, recognise a provision for the levy in 20X0, if the entity has no practical ability to avoid generating revenue in 20X1. Currently, the entity would only recognise a liability as soon as it generates revenue in 20X1.

6 The proposed changes incorporate the revised definition of a liability introduced in the revision of the Conceptual Framework 2018. At that time, EFRAG supported the revised definition, however, noted that additional guidance would be necessary to determine when a liability that would depend on multiple factors should be recognised.

Preliminary EFRAG FR TEG discussions

7 When discussing the proposals, EFRAG FR TEG members have expressed differing views on the proposals. Some support the directions of the proposals, but generally consider that additional guidance may be needed, while others prefer the current requirements.

8 Those supporting the proposals consider that they result in more relevant information. In the levy example included in paragraph 5 above, they thus consider that it results in more relevant information for predicting future cash flows to recognise the expenses from a levy an entity would have to pay based on the revenue it is generating, when that revenue is generated. They also consider that it is not useful that under the current requirements, on 31 December 20X0, no liability is recognised for a levy the entity ‘knows’ it will have to pay immediately (as soon as it is starting to generate revenue) in 20X1 based on the revenue generated in 20X0.

9 Those who do not support the proposals consider that the proposals are blurring the distinction between recognition and measurement. They consider that the entity only has a liability when it has generated revenue in 20X1. The revenue it has generated in 20X0 is only relevant for measuring that obligation. Also, they do not consider it useful to recognise a liability on 31 December 20X0 that the entity would not have to pay if, for example, it would be dissolved before generating any revenue in 20X1.

10 As EFRAG FR TEG members have differing views on the issue it would therefore have to discuss what recommendations to provide to the EFRAG FRB.

Input from EFRAG FR working groups

11 As the proposals could change the point in time an entity recognises an obligation that depends on two or more actions of the entity (and the related expenses), the EFRAG

Secretariat has asked some of EFRAG's working groups to provide examples of such obligations. Considering those examples could help highlighting some issues with the proposed requirements.

12 EFRAG working groups have provided two examples. One example relates to a business property tax in a particular European jurisdiction. The contributions banks have to make to the Single Resolution Fund is another example.

13 For the business property tax, the tax is to be paid to the region in a specific country in which an entity is using a building (so if a building is leased, it is the lessee and not the lessor who should pay). The tax is based on the rental value of the building. If an entity is using the building in the region in Year-2, and unless a company moves away from the region or ceases to exist, it should pay the tax of the building in Year0. If it moves to another region or closes, it should not pay the tax. It should pay the tax even if it is not using the building in Year0.

If the entity moves to a new region, it should pay the tax related to a building it is using based on the rental value in the year it is starting using the building. For example, if an entity started to use a building in 20X1. The tax in the various years should be based on the rental values as follows:

20X1: 20X1 value

20X2: 20X1 value

20X3: 20X1 value

20X4: 20X2 value.

20X5: The company is not using the building anymore: 2023 value

20X6: The company has moved out of the region: 0

Concern has been raised that the proposals could mean that when an entity starts using a building in 20X1 it would have to recognise a provision for the taxes it will have to pay in 20X1, 20X2 and 20X3.

14 Contributions to the Single Resolution Fund are based on many different factors that are both within the control of a bank and outside the control of a bank. However, the contribution would, everything else being equal, increase with the level of deposits an entity reported in its financial statements in Year-2. Accordingly, if a bank was operating in 20X0, the contribution it would have to pay in 20X2 would depend on the level of deposits

in 20X0. However, if the bank would not be operating in 20X0, the contribution it would have to pay in 20X2 would depend on something else.

For this example, the first issue that has been identified is whether or not a bank operating in 20X0 should recognise an obligation in 20X0 for the amount it would have to pay in 20X2 (as this amount would depend on the level of deposits in 20X0). The issue here is, however, that if that bank would not have operated in 20X0, the levy would have been measured based on something else. It is therefore argued that e.g., the level of deposits in 20X0 does not affect recognition as the level does not affect whether an entity would have to transfer an economic resource, but (only) measurement. However, it is then unclear:

(a) What would have been the effect if there would have been two separate and different levies: A levy for entities operating in 20X0 and a levy for newly started banks.

(b) Whether only recognising a liability in 20X2 for the contribution that depends on the level of deposits in 20X0 results in the most relevant information.

(c) Whether, if a liability should already be recognised in 20X0, this liability could be estimated sufficiently reliably to provide useful information.

Costs an entity includes in estimating the future expenditure required to settle the entity's present obligation

Proposals

15 The proposals provide some requirements on the costs an entity should include in estimating the future expenditures required to settle a provision (i.e., what expenditures should be included in measuring a provision).

Feedback from EFRAG FR TEG and working groups

16 The feedback on these proposals has generally been supportive. The EFRAG Secretariat has therefore not identified any significant issue related to these amendments.

The rate to be used to discount future expenditure to their present value and related disclosure requirements

Proposals

17 The proposals will specify that an entity should apply a discount rate that excludes non-performance risk. However, if not included in the cash flows, the discount rate should reflect uncertainty related to the timing and amount of the future expenditure (including this risk in the discount rate would decrease the discount rate).

Feedback from EFRAG FR TEG and working groups

18 There has been general support for excluding non-performance risk in the discount rate used to calculate the present value of provisions.

19 It is acknowledged that the proposals will not remove all the diversity that is currently existing on the choice of discount rate. However, as the proposals will also require disclosures on the discount rate used, it is assessed that users will receive sufficient information to be able to compare the provisions of different entities and make any adjustments they consider necessary for their own analysis.

20 The EFRAG Secretariat has consulted EFRAG's Rate-Regulated Activities working group to understand whether entities for which the choice of discount rate can have significant implications have any concerns with the proposals. The IASB has taken comments from this industry into consideration and the latest input EFRAG has received is that these changes to the proposals have addressed the concerns of the entities.

21 EFRAG FR TEG will, however, have to consider whether it would recommend that for industries where the discount rate of provision is regulated for the purpose of the entity holding sufficient assets to cover the provisions, entities should be allowed to use the discount rate required by that regulation.

22 In addition, EFRAG FR TEG members consider it to be a missed opportunity of the IASB not to specify whether inflation should be reflected in the discount rate. Whether or not inflation is reflected in the discount rate has implications for whether the expenses related to the unwinding of the discounting are considered operating expenses.

Next steps

23 The IASB will issue the Exposure Draft related to the proposals in November. The comment period will be 120 days.

24 Given that the Exposure Draft will be issued shortly before the 'busy season' for many preparers and auditors, the EFRAG Secretariat recommends that EFRAG's Draft Comment Letter should be issued as soon as possible following the publication of the Exposure Draft.

25 In addition to the three issues mentioned above in paragraphs 3–22, EFRAG FR TEG will at its meeting in September also consider the proposed transition requirements.

Questions for EFRAG FRB

26 Does EFRAG FRB have any comments to the discussions of EFRAG FR TEG and the input received from EFRAG working groups?

27 Are EFRAG FRB members aware of levies that depend on two or more actions that could be used to 'test' the IASB's proposals related to when to recognise a provision (see paragraph 5 above)?