Contact: Sean Osborn
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Dr Keith Kendall
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Dear Dr Kendall

ED 336 Provisions-Targeted Improvements (Proposed amendments to AASB 137)

The Heads of Treasuries Accounting and Reporting Advisory Committee (HoTARAC) welcomes the opportunity to respond to ED 336 - *Provisions Targeted Improvements (Proposed amendments to AASB 137*) (ED 336). HoTARAC is an intergovernmental committee that advises Australian Heads of Treasuries on accounting and reporting issues. The Committee comprises senior accounting policy representatives from Australian state, territory and federal governments.

HoTARAC members recognise the importance of pursuing high quality reporting standards. We commend the IASB on amending IAS 37 to incorporate issues considered by the International Financial Reporting Interpretations Committee (IFRIC). These proposals will ultimately assist preparers, auditors and users in consistently applying a future revised standard.

The key concerns in the detailed response are summarized in the following points:

1. Divergence from a singular fulfilment concept for measuring provisions and contingent liabilities;

2. Potential for earnings management through timing of recognition of a provision;

3. Differing measurement bases for measuring Day 2 provisions arising from application of differing standards;

4. Reservations about the currently proposed examples; and

5. GAAP/GFS divergence.

The attachment to this letter sets out HoTARAC's response to the specific and general matters for comment and includes a number of recommendations and matters for further consideration by the AASB and IASB.

If you have any queries regarding HoTARAC's comments, please contact Mark Hort from Treasury WA by email to mark.hort@treasury.wa.gov.au.

Yours sincerely

Andy Hobbs
Chair
Heads of Treasuries Accounting and Reporting Advisory Committee
10 February 2025

ENCLOSED:

HoTARAC Comments to the AASB on ED 336 *Provisions Targeted Improvements (Proposed amendments to AASB 137*)

AASB Exposure Draft 336 *Provisions - Targeted Improvements (Proposed amendments to AASB 137)*

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?

In principle HoTARAC supports the proposals, particularly with reference to aligning IAS 37 to the *Conceptual Framework for Financial Reporting (Conceptual Framework)*.

One concern is the potential for earnings management through early recognition of a provision, and corresponding expense, when a threshold is partially satisfied (paragraph 14P). The threshold in paragraph 14P, and accompanying example in the body of the standard, rely on judgement about revenue measures to determine the present obligation. This judgement has potential to debit an 'expense' that is not realised in the next reporting period.

Where the overall threshold is not reached at the end of the measurement period, then the provision would be reversed. No transfer of economic resources (per the example) would occur.

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?

Paragraph 36 of IAS 37 and proposed paragraph 40A appear consistent with the "fulfilment value" measurement objective described in the *Conceptual Framework* (CF 6.17). However, paragraph 37 introduces an "exit price" for the transfer of a liability. Stakeholders may not have assessed this distinction in the past. This creates the risk of unintended consequences, including perhaps the reassessment of entities' existing obligations. The distinction between the two concepts is not always clear cut, particularly where out-sourcing is involved (e.g. compare the costs to an entity when undertaking environmental remediation against that same entity outsourcing those works).

Rationally, an entity would expect to pay a premium over fulfillment value to transfer a liability. Therefore, an understanding of the anticipated discharge mechanism is necessary for management to determine an estimate of the present obligation and this ought to be clearly articulated in the resultant accounting standard.

HoTARAC recommends that the IASB remove exit price references from paragraph 37, specifically:

- "or to transfer it to a third party at that time" from the first sentence; and
- "or transfer" from the last two sentences.

This reduces potential unintended consequences and ensures consistency with the measurement principle ('fulfillment') found in the *Conceptual Framework*.

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?

On balance HoTARAC supports the proposed amendment for an entity to use a discount rate that reflects the time value of money (represented by a risk-free rate) and "the risks surrounding the amount or timing of the expenditure required to settle the obligation", which we understand would exclude non-performance risk.

HoTARAC notes that in some circumstances a provision can be subsequently measured by a risk-free discount rate adjusted for non-performance risk (per IFRS 3 *Business Combinations*).

We suggest clearly signalling in the Standard that the proposed amendment is an exception to the measurement principle in the Conceptual Framework for Financial Reporting (Conceptual Framework), introduced as a practical expedient to reduce diversity in practice and costs incurred in measurement. [Appendix A paragraphs A23-A25].

The disclosure of a risk-free rate does not appear to be controversial for entities preparing financial statements.

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?

HoTARAC broadly supports the transition proposals.

However, the jurisdictions represented have some concerns about the potential complexity introduced by proposing exceptions to be applied at two different dates:

a) The exception in relation to the costs an entity includes in the measurement of a provision is proposed to be applied as of the *date of initial application* (as defined in proposed paragraph 94D(b).

b) The exception in relation to the requirements on discount rates is proposed to be applied at the *transition date* (as defined in proposed paragraph 94E(a).

By not applying these measurement changes in combination, the effect is increased complexity for users in interpreting financial statements whilst requiring preparers to reconstruct a more extensive history of adjustments mentioned in BC96(c).

Consequently, a singular transitional date for application is recommended.

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?

HoTARAC supports the proposed requirement in IFRS 19 to disclose the discount rate (or rates) used in measuring a provision.

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.

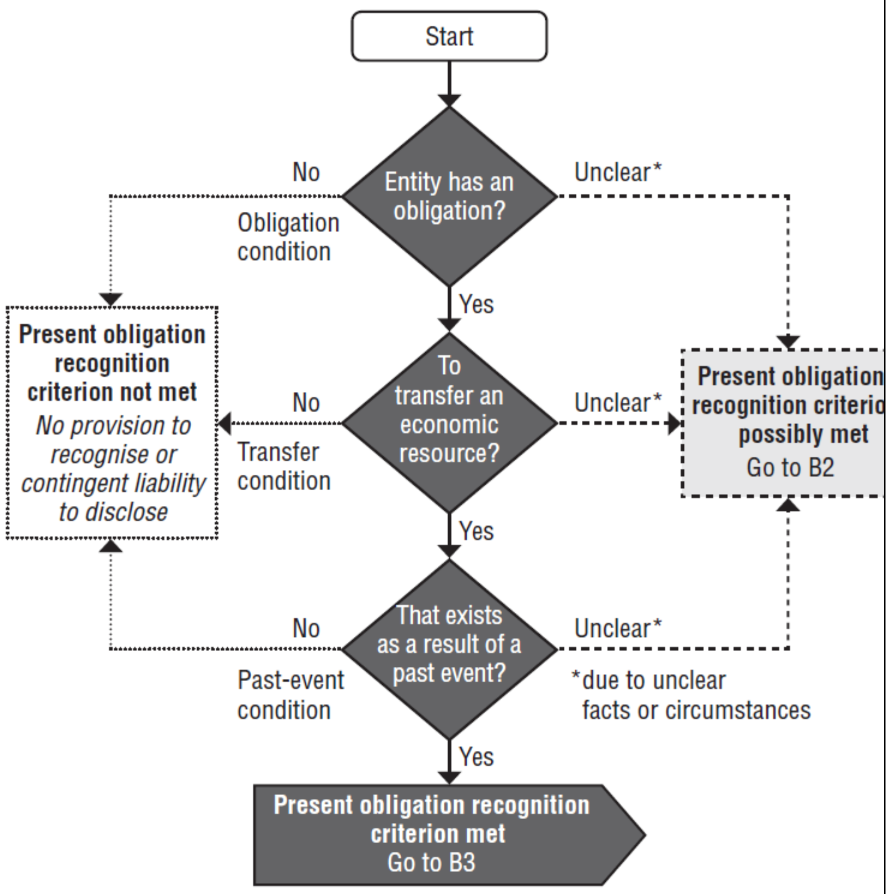
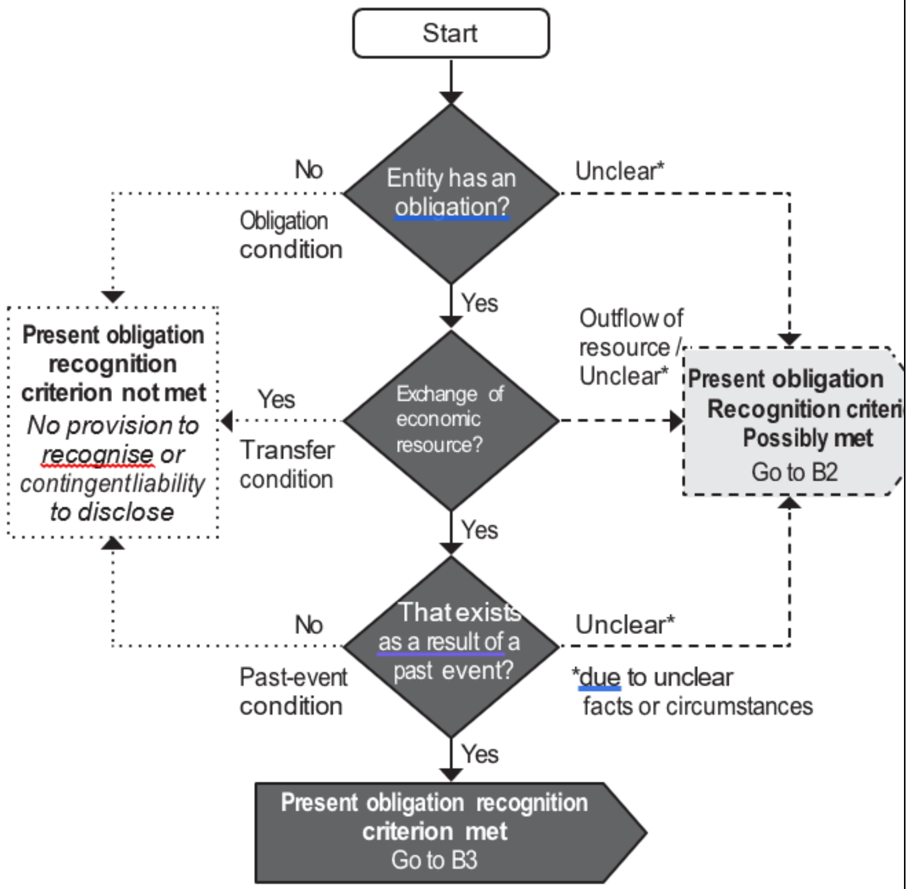
Paragraphs BC55–BC62 of the Basis for Conclusions explain the IASB's reasoning for these proposals.

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?

Decision tree

HoTARAC recognises that the update of the decision tree in Section B provides a useful visual aid for the proposed new recognition requirements. However, the committee suggests that decision tree B1 explicitly identifies "*exchange* of economic resources" from proposed paragraph 14L and example 6a to enhance clarity of the decision occurring.

Decision Tree B1 (excerpt from ED 336)	Suggestion
	

Illustrative Examples

Illustrative examples are useful for users, preparers and auditors of financial statements. However, the committee:

- recommends that an example for adjusting the discount rate may improve consistency of application; and,
- expresses some reservations about the following proposed examples:

<u>Example 2A:</u> Virtual certainty of enactment of legislation is an extremely high threshold to meet for an obligation condition. The committee observes that the passage of legislation is fraught. Moreover, legislation enactment may not be effective as it may be repealed or it may not be proclaimed.

Whilst the decline in net asset value of the entity is not related to conditions in existence at the end of the reporting period, the example implies that a change in legislation is an adjusting event after the reporting period despite paragraphs 21-22 of IAS 10 *Events after the Reporting Period* requiring disclosures for non-adjusting events. This increases ambiguity in application of accounting standards, in addition to management making uncertain judgements concerning the effective date of legislative obligating events.

<u>Example 5A:</u> The termination benefits payable to employees is more appropriately measured and recognised under IAS 19 *Employee Benefits* which has express provisions on the topic (IAS 19: recognition in paragraph 165, measurement in paragraph 169, and disclosure in paragraph 78(d) of IAS 1 *Presentation of Financial Statements*). HoTARAC recommends that the example be changed to clearly reflect only those other costs of restructuring, or removing the example entirely.

<u>Example 5B:</u> The conclusion appears to contradict IAS 19 in respect of provisions for employee benefits (as noted for Example 5A).

<u>Example 6(a):</u> Liability not recognised due to obligating event occurring after balance date:

- The statement, “The three conditions specified in paragraph 14A of IAS 37 are not all met” can be clarified by inserting “for the obligations to fit smoke filters and to pay fines”.
- It is much easier to understand example 6(b) because the present obligation leads by identifying which attributes are met and unmet.
- Statement preparers and users find the example more useful if they know which sub-paragraphs have been met from which perspective.

<u>Example 6(b):</u> Liability not recognised for fines issued from enforcement action that has not yet occurred:

The example may have far broader application than intended by standard setters. By corollary from a self-incrimination angle, trucking and taxi companies would need to recognise provision for speeding offences committed by employees.

This is enabled by the likelihood that entities have information on excessive speed, observing that the fitting of GPS devices on fleet vehicles has become more common and enforcement is relatively advanced in many jurisdictions.

<u>Example 13C:</u> is challenging because it relates to valuations or index evidence provided in arrears, thereby giving rise to an adjusting event after the final audit has commenced. Until receipt of quarterly indices from third parties in some jurisdictions, uncertainty derived from three scenarios may be true:

- The probability of indices showing marginal valuation movement is high, therefore no further adjustment provision is recognised;
- The possibility that an index will materially increase after period after the last quarterly release of index publication is high, resulting in an increase in recognised provisions; or,
- The possibility that an index will materially decrease after period after the last quarterly release of index publication is high, resulting in a decrease in recognised provisions;

Experience has shown the valuation indices can be surprisingly volatile within a reporting period, thereby increasing uncertainty. This is notable in reporting by prominent listed companies that are subject to tight audit timelines. Users of their general purpose financial statements benefit from improved certainty of tax implications for an entity. This is not achieved with volatile indices causing recognitions then reversals where economic conditions that move abruptly from expansion to contraction.

The example contains an implicit assumption that values of land and buildings will always increase. This is often true, but is not always the case. Therefore the committee recommends altering the proposed wording from:

"The measure is the price paid for the land and buildings by the current owner, increased by the change in a specified price index between the purchase date and the date on which the tax is charged."

TO: *"The measure is the price paid for the land and buildings by the current owner,* ***adjusted*** *by the change in a specified price index between the purchase date and the date on which the tax is charged."*

Question 7 - Other comments

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

HoTARAC notes that IFRS 3 *Business Combinations* invokes IFRS 13 *Fair Value Measurement* when measuring liabilities. Inclusion of non-performance risk on application of IFRS 3, but excluding it when applying IAS 37 may give rise to profit or loss impacts on Day 2. Retaining the exception in paragraph 21A appears warranted and will likely enhance information for users of the general purpose financial statements by removing unnecessary short-term volatility arising solely due to Accounting Standards.

AASB Specific Matters for Comment

The AASB would particularly value comments on the following:

1. whether there are any regulatory issues or other issues arising in the Australian environment that may affect the implementation of the proposals, particularly any issues relating to:

(a) not-for-profit entities; and

(b) public sector entities, including GAAP/GFS implications?

Divergence between GAAP and GFS arises where:

- provisions are valued on a fulfillment basis, as GFS is valued on a current market value exchange basis [ASNS 2015, paragraphs 3.40 and 15.17]; and/or
- provisions increase or decrease in value, the changes are presented as neutral holding gains and real holding gains [ASNS 2015, paragraph 16.11].

2. whether, overall, the proposals would result in financial statements that would be useful to users;

HoTARAC expresses reservations about the effect of Day 2 losses mentioned in Question 7. The change in entity value between mere days, due to a technicality, does not induce confidence in estimates.

The other concern is increased interpretative complexity for users introduced by the different dates for proposed exceptions mentioned in Question 4.

3. whether the proposals are in the best interests of the Australian economy?

No comment.

4. unless already provided in response to specific matters for comment 1 – 4 above, the costs and benefits of the proposals relative to the current requirements, whether quantitative (financial or non-financial) or qualitative. In relation to quantitative financial costs, the AASB is particularly seeking to know the nature(s) and estimated amount(s) of any expected incremental costs, or cost savings, of the proposals relative to the existing requirements?

The chief benefit flowing from implementing the proposed changes is in clarifying practice that challenged preparers and auditors prior to the issue of various IFRIC rulings. With the exception of the commentary provided at 1 & 2 above, a focus on ongoing improvement of accounting standards is an admirable objective.