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International Accounting Standards Board
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Comments on the Exposure Draft *Provisions—Targeted Improvements (Proposed amendments to IAS 37)*

To the IASB Board Members:

The Japanese Institute of Certified Public Accountants (JICPA) appreciates the continued efforts of the International Accounting Standards Board (IASB) to develop high quality accounting standards and welcomes the opportunity to comment on the Exposure Draft *Provisions—Targeted Improvements (Proposed amendments to IAS 37)* (Exposure Draft).

JICPA supports the IASB's approach to make targeted improvements to certain aspects of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* encountered in practice.

At the same time, we do not think the ED provides a clear enough explanation for the distinction between 'an obligation to transfer an economic resource to another party,' which represents one of the conditions for meeting the present obligation recognition criterion as proposed in the ED, and 'an obligation to exchange an economic resource to another party' as stated in paragraph 14L. This may cause entities having a hard time determining whether or not they meet the present obligation recognition criterion. Therefore, we strongly suggest the IASB additionally develop a detailed explanation or guidance with respect to the distinction between an exchange of an economic resource and a transfer of an economic resource.

Please see our comments to each Question in the following pages.

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?

Comment:

JICPA generally agrees with the proposals. However, we recommend further clarification should be made in the following areas:

Distinction between 'an obligation to transfer an economic resource to another party' and 'an obligation to exchange an economic resource with another party'

According to paragraph 14I of the ED, the second condition for meeting the present obligation recognition criterion is that the nature of the entity's obligation is to transfer an economic resource. Further, paragraph 14L says that an obligation to exchange economic resources with another party is not an obligation to transfer an economic resource to that party unless the terms of the exchange are unfavourable to the entity. However, the distinction between an exchange of an economic resource and a transfer of an economic resource is not clear enough in the ED. Without a detailed explanation for the difference between the two, we are afraid entities may have a hard time determining whether or not they meet the present obligation recognition criterion. Therefore, we strongly suggest the IASB additionally develop a detailed explanation or guidance with respect to the distinction between an exchange of an economic resource and a transfer of an economic resource.

The following represents certain cases where the difference between a transfer of an economic resource and an exchange of an economic resource could be hard to tell:

- When an entity is required under laws and regulations to utilise a specific asset in conducting a business, the obligation to acquire an item of property, plant and equipment for compliance purposes represents 'an obligation to exchange an economic resource with another party,' as the entity is purchasing the asset. Although the entity would not have acquired such asset if it were not required by laws and regulations, it is still considered that the transaction does not meet the transfer condition unless the terms of the exchange are unfavourable to the entity. However, we can argue that the expenditure to acquire the asset is an incremental cost, so to speak, to comply with laws and regulations, or a cost to meet the obligation, and thus the nature of the entity's obligation is to transfer an economic resource, rather than an exchange of an economic resource. From an economic point of view, it might be possible to account for the additional expenditure to acquire a specific asset as a 'transfer of an economic resource' under such circumstances.
- When entities are required to purchase carbon credits under laws and regulations for the purpose of reducing greenhouse gas emissions, there are cases where the acquired carbon credits meet the recognition criteria of an asset and are accounted for as an item of inventory or intangible asset on the basis that the item can be sold again in the market or to third parties. In accordance with the ED, an acquisition of such carbon credits meeting the recognition criteria of an asset can be interpreted as 'an obligation to exchange economic resources with another party.' In other words, the obligation will not meet the transfer condition unless the terms of the exchange are onerous. However, when carbon credits are acquired for the purpose of offsetting CO2 emissions to comply with related laws and regulations, such carbon credits are subsequently written off without receiving any economic resources. Accordingly, from an economic point of view, it might be possible to account for the carbon credit acquisition as a 'transfer of an economic resource' in such cases.

When considering the 'past-event condition,' there are cases where an action or event that triggers a present obligation could arise from other entities or members, not from the entity's own action, without the entity having any control over the action or event.

According to the proposal in the ED, the 'past-event condition' (from paragraphs 14M to 14R) and the reference to paragraphs 14B(a) and 14D are all indicating that an action that triggers a present obligation is to be taken by the entity itself.

That said, we recommend the IASB to think about cases where an entity belongs to a certain group with other members (e.g. an industry organisation), and the group has an obligation to transfer economic resources only if a measure of its activity as a whole exceeds a specific threshold. In this case, an action or event of other entities or members could also trigger a present obligation, without the entity having any control over the action or event. We are afraid the ED's proposal does not clearly explain how to account for such actions taken by others when considering the 'past-event condition.'

When 'threshold' in paragraph 14P is represented by a certain ratio, not a certain amount

According to paragraph 14P of the ED, it is said that 'In some situations, 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 specific threshold. In such situations, the action that meets the past-event condition is the activity that contributes to the total activity on which the amount of the transfer is assessed.' Further, according to Example 13A *A levy on revenue* in the Implementation Guidance, a specific 'threshold' is described as a certain amount of revenue an entity generates in a calendar year. It is clearly indicated in this example that a specific threshold is represented in a certain amount (absolute value). However, it is not clearly stated whether or not paragraph 14P of the ED would be applicable when a certain 'ratio' is used as a threshold (e.g. when setting the renewable energy usage rate to exceed a certain level in a calendar year as a threshold).

The use of terms 'probable' and 'more likely than not'

The ED uses both 'probable' and 'more likely than not' as a term to describe the probability threshold. Given that both terms have the same meaning as stated in the footnote of paragraph 23 of IAS 37, consistency should be maintained by using the term 'more likely than not,' which seems to better articulate the meaning. We also hope it will reduce confusion for translation purposes.

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?

Comment:
We agree with the IASB's proposal in terms of measuring onerous contract provisions. However, we believe other types of provisions need further consideration.

According to paragraph BC66(b) in the ED, it is of the IASB's view that 'the arguments on which the Board based its conclusions about the costs of fulfilling an onerous contract obligation (see paragraphs BC4–BC13 of the Basis for Conclusions on IAS 37) apply equally to the expenditure required to settle other types of provisions within the scope of IAS 37.'

According to paragraphs BC4–BC13 in the existing IAS 37, the Board's discussion on the assessment of onerous contracts came up when the new revenue recognition standard IFRS 15 *Revenue from Contracts with Customers* was introduced and certain issues emerged due to the withdrawal of IAS 11 *Construction Contracts.* Discussions at that time were mainly around onerous contracts that could arise in fulfilling a contract to manufacture goods or provide services. We believe the costs set out in paragraph 68A of IAS 37 to determine whether a contract is onerous should align with those costs in measuring the resulting onerous contract provision. From that point of view, we agree with the ED's proposal.

However, we are not sure whether the IASB's proposal can be effectively applied to the measurement of other types of provisions within the scope of IAS 37. Let's take the measurement of a provision for general litigations as an example. Questions would remain for the measurement of the provision, including what kind of incremental costs of settling the obligation are expected or how will other costs that relate directly to settling obligations can be allocated. Also, we understand the Board's argument in paragraphs BC4–BC13 in the existing IAS 37 do not necessarily cover all types of provisions. That said, we strongly recommend the IASB to further consider whether the same kind of logic for onerous contract provisions can be applied to expenditures required to settle other types of provisions within the scope of IAS 37.

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?

Comment:

JICPA agrees with the proposals.

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?

Comment:

JICPA agrees with the proposals.

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?

Comment:

No comment from JICPA.

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?

Comment:

We agree with the Board's proposal to expand the decision tree in Section B and to add and update illustrative examples in Section C. That said, we have some comments on Examples 5A and 5B as well as the decision tree presented in B1 *Present obligation recognition criterion*.

Examples 5A and 5B

Termination benefits are within the scope of IAS 19 *Employee Benefits*, not IAS 37. According to paragraph 165 of IAS 19, an entity is required to recognise a liability and expense for termination benefits at the earlier of the following dates:

(a) when the entity can no longer withdraw the offer of those benefits; and

(b) when the entity recognises costs for a restructuring that is within the scope of IAS 37 and involves the payment of termination benefit.

We suggest a description should be added to Examples 5A and 5B as to how the application of the recognition criterion in IAS 37 to termination benefits and the requirements in IAS 19, particularly paragraph 165(b) of IAS 19, are related to each other.

- Transfer condition

The transfer condition in Examples 5A and 5B says the entity's obligation is to pay termination benefits to its employees, whereas the past-event condition indicates the first action, which is to employ (obtain services from) a person for at least a year, is already taken by the entity. In this situation, when looking into the transfer condition and determining whether the obligation is an executory contract or not (i.e. whether it is an obligation to exchange economic resources) in accordance with paragraph 14L, it appears the past-event condition (i.e. whether an entity has already obtained economic benefits) needs to be considered first.

In order to avoid any misinterpretations—for example, some may think it is an obligation to exchange economic resources as termination benefits are paid in exchange of services obtained from employees—and to promote a better understanding on the IFRS Standards, we highly recommend adding an explanation for decisions to be made for the transfer condition in Examples 5A and 5B about the relation between the transfer condition and the past-event condition, clarifying it shall not be regarded as an obligation to exchange economic resources. See our suggestion underlined below.

Example 5A

Transfer condition	✓	The entity's obligation is to pay termination benefits to its employees (paragraph 14I). <u>As the entity has already obtained services (economic benefits) from its employees, it is not an executory contract, and the obligation is not considered to be an obligation to exchange economic resources (paragraph 14L).</u>

Decision tree presented in B1 *Present obligation recognition criterion*

The decision tree indicates that decisions should be made in the order of 'Obligation condition,' 'Transfer condition,' and 'Past-event condition,' as the arrows are pointing downward in that order only in one way. However, some illustrative examples in the ED show that decisions to be made for the conditions can have interrelated effects. For example, the past-event condition may need to be considered first before making any decisions on the transfer condition.

If we take the second 'Transfer condition' as an example by referring to Examples 5A, 5B, 6, 7, and 11, it appears the decision on the third 'Past-event condition' needs to be made first as to whether an entity has already obtained economic benefits before determining whether an obligation is an executory contract or not (i.e. whether it is an obligation to exchange economic resources). Therefore, we propose either one of the following changes to be made to the decision tree in order to enhance a better understanding on the IFRS Standards: change the order of decisions to be made by putting 'Past-event condition' in front of 'Transfer condition,' which shall be the last condition subject to consideration; or use circulation arrows between 'Past-event condition' and 'Transfer condition' to indicate decisions made are interrelated.

Moreover, according to paragraphs 14N and 14Q, a decision needs to be made at the level of 'Past-event condition' as to whether or not an entity has a practical ability to avoid taking an action (or all the remaining actions). This may indicate that part of 'Obligation condition' is being re-assessed at 'Past-event condition.' Therefore, we may argue that 'Obligation condition' and 'Past-event condition' are also interrelated. Please see Examples 5A, 5B, and 13A for reference purposes.

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

Comment:

In order to avoid the risk of recognising Day 2 gains or losses under IFRS 3 *Business Combinations*, we recommend the IASB to provide an exception in IFRS 3 either to the measurement principle for liabilities and contingent liabilities within the scope of IAS 37 or to subsequent measurement on those liabilities.

The IASB proposes in the ED to specify that discount rates used in measuring liabilities within the scope of IAS 37 should not include non-performance risk. On the other hand, it is required under IFRS 3 for an acquirer to measure the liabilities assumed in a business combination at their acquisition-date fair values (paragraph 18 of IFRS 3), and the fair value should reflect the effect of non-performance risk (paragraph 42 of IFRS 13 *Fair Value Measurement*). If non-performance risk continues to be accounted for differently among the IFRS Standards, we are afraid Day 2 gains or losses may arise from liabilities assumed in a business combination that would be within the scope of IAS 37. Such Day 2 gains or losses do not depict an economic gain or loss and would not faithfully represent any aspect of the acquirer's financial performance. Therefore, in order to avoid the risk of recognising such Day 2 gains or losses, we recommend the IASB to take certain initiatives, including the following: revise IFRS 3 to provide an exception to the measurement principle for liabilities and contingent liabilities within the scope of IAS 37, so that the liabilities will be measured in accordance with the IAS 37 measurement principle, not at their acquisition-date fair values; or revise IFRS 3 to provide an exception for acquirers when accounting for subsequent measurement of liabilities and contingent liabilities within the scope of IAS 37.

Yours faithfully,

Eriko Otokozawa
Executive Board Member－Business Accounting Standards and Practice/Corporate Disclosure
The Japanese Institute of Certified Public Accountants