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Re.: IASB Exposure Draft (ED)/2024/8: Provisions – Targeted Improvements (Proposed amendments to IAS 37)

Dear Mr Barckow

The IDW (Institut der Wirtschaftsprüfer in Deutschland e.V.)¹ is pleased to comment on the International Accounting Standards Board's IFRS Accounting Standard Exposure Draft (ED)/2024/8 "*Provisions – Targeted Improvements (Proposed amendments to IAS 37)*".

We welcome the Board's objectives to align the definition of a liability (and the recognition criterion based on it) in IAS 37 with the Conceptual Framework for Financial Reporting (revised in 2018) and to make the requirements for the recognition of a provision clearer and easier to understand.

The amendments proposed in the ED to the first criterion for recognising a provision in accordance with paragraph 14(a) of IAS 37 are extensive. Nevertheless, we also consider it appropriate in this context to incorporate IFRIC 6 *Liabil-*

¹ The IDW is a voluntary membership organisation representing the interests of the profession of public auditors in Germany and counts over 79 % of this profession as members.

ities Arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment and the accounting for levies (previously addressed in IFRIC 21 *Levies*) into the main body of the future IAS 37.

Despite all the IASB's efforts, the proposed requirements for the present obligation recognition criterion have become very complex. While the three-part decision tree and the updated and added illustrative examples in the Implementation Guidance for IAS 37 may help to improve understanding, in our view, there are still some ambiguities, inconsistencies and questions, that we will address in detail in our comments on Question 1.

Since the amendments relating to the present obligation recognition criterion have not been previously consulted before the issuance of this ED, it is crucial that the IASB carries out further outreach and comprehensive field testing with preparers after analysing the feedback on this ED.

Further, the IDW generally agrees with the Board's proposals on the two aspects relating to the measurement of a provision. Notwithstanding this, we believe that additional application guidance and an illustrative example would be helpful to better understand what costs an entity needs to include when estimating the future expenditure required to settle an obligation.

Regarding the discount rate used by an entity for the measurement a provision, we generally support the Board's proposed clarification that the discount rate under IAS 37 should not reflect non-performance risk. However, this requirement will lead to different measurement approaches for provisions under IAS 37 compared to IFRS 3 and IFRS 9. Here we still see a need for further standard setting activities by the IASB. This also applies to the question of whether entities should use real or nominal discount rates. The proposed requirement to disclose the discount rate used by the entity will increase transparency in financial statements, from our point of view.

Further, we would like to comment on the specific proposals as follows:

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?

The IDW welcomes the Board's objective of aligning the definition of a liability (and the recognition criterion based on it) in IAS 37 with the Conceptual Framework for Financial Reporting (revised in 2018). This alignment, combined with the intention to provide greater clarity and transparency in the recognition of provisions, is likely to lead to fundamental changes to IAS 37 regarding the question of whether, and if so when, a provision is to be recognised.

As the planned amendments will have far-reaching impacts on many entities, we ask the Board to conduct further extensive outreach activities and field testing to check the consistency and practicability of the proposals after a thorough analysis of the feedback on this ED.

Please find below our comments on the three conditions of the first present obligation recognition criterion:

Obligation condition (paragraph 14A(a))

According to paragraph 14A(a) in connection with **paragraph 14B(a)** of the ED, an entity has an obligation only if a mechanism is in place that imposes a responsibility on the entity if it obtains specific economic benefits or takes a specific action.

In our view, the obligation condition set out in the ED ignores the case that an entity may also be imposed a responsibility if it does *not* obtain specific economic benefits or take a specific action. Based on Example 6, the case could also be made that all entities are subject to a new legal requirement to install smoke filters in their exhaust systems, regardless of whether and, if so, how

much smoke they produce in their operations. The mere absence of smoke filters at the time the law comes into force triggers the fine. Based on the current wording of paragraph 14B(a), it is unclear whether the conditions for the existence of an obligation are met in this case.

Under **paragraph 14F(a)(ii)** of the ED, an entity has no practical ability to avoid discharging a responsibility if, – in the case of a legal obligation – as a result of that right, the economic consequences for the entity of not discharging the responsibility are expected to be significantly worse than the costs of discharging it. We have some serious concerns about whether an entity should be required under IFRS to weigh the economic consequences of not fulfilling the responsibility against the costs of fulfilling the responsibility to determine whether it has a legal obligation. In our view, the question of whether a legal obligation exists should not depend on an assessment by management.

Further, it is not clear why the economic consequences of not discharging a responsibility must be “*significantly worse*” than the costs of discharging it. According to this, no provision must be recognised if the costs of not fulfilling the responsibility are the same or slightly different than the economic consequences of not discharging it, even though a legally enforceable obligation exists, and the economic outflows are the same as if the obligation had been discharged.

In addition, the term “expected” indicates that an entity must perform a probability assessment, which includes evaluating the economic effect of not discharging a responsibility. If this is intended, it is essential to clarify the relationship between the requirement in paragraph 14F(a)(ii) and the probability assessment in paragraph 14(b). We are concerned that in applying paragraph 14F(a)(ii), an entity might use a threshold of “expected” that means something different from “probable” in paragraph 14(b). To avoid inconsistencies and resulting diversity in practice, we think that all probability considerations relating to a present obligation should be made solely in paragraph 14(b) of IAS 37 and not (partially or additionally) in the requirements relating to the present obligation recognition criterion.

According to **paragraph 14G** of the ED, an obligation already arises when the legislation is “virtually certain to be enacted as drafted” and not only when the law has been enacted. This requirement seems to contradict paragraph 14(B)(a) of the ED, which links the existence of an obligation to a mechanism that is in place and imposes a responsibility on the entity. As a legislative enforcement mechanism cannot be in place until enactment occurs, we recommend that the Board take a closer look at the interaction between the two paragraphs.

Transfer condition (paragraph 14A(b))

According to paragraph 14I of the ED, the transfer condition is met if the nature of the entity's obligation is to transfer an economic resource. However, an obligation to exchange economic resources with another party is generally not an obligation to transfer an economic resource to that party (we refer to **paragraph 14L**). In our opinion, the distinction or interaction between the terms “transfer” and “exchange” is not clear and has considerable potential for discussion in practice. Every transfer of economic resources is associated with some kind of benefit for the entity that it receives in exchange for the transfer of economic resources. The benefits can exist in different forms and to different extents; ultimately this is a matter of subjective assessment.

Please find below two examples of how arguments could be put forward that we believe run counter to the actual intention of the Board:

Example 15 of the ED (“climate-related commitments”):

The transfer condition is not considered to be fulfilled with regard to the obligation to offset remaining emissions because the buying and retiring of carbon credits is allegedly not offset by the receipt of an economic resource. It could be argued that without buying and retiring of the carbon credits, the entity would not be able to fulfil its publicly stated commitment, which could have enormous economic consequences (e.g. loss of credibility and damage to the brand, resulting in a drop in sales; exclusion from participation in tenders for public sector contracts).

Example (“Decommissioning, Restoration and Similar Liabilities”):

If a contaminated land site must be cleaned up, the entity invests its own economic resources to clean up the site. In exchange for the entity's investment, the land is upgraded and can therefore be sold on the market at a higher price, thus the entity receives economic resources. According to our understanding of the current wording of the ED, no obligation must be recognised.

Past-event condition (paragraph 14A(c))

The proposed amendments to the definition of “past event” and its role in determining whether a provision should be recognised are substantial and could significantly alter the accounting treatment of certain types of provisions. Since these amendments have not been previously consulted before the issuance of this ED, we believe it is crucial to carry out further outreach and comprehensive field testing with preparers.

Further, we recommend that the Board clarify how the guidance in paragraph 14O of the ED (i.e., a present obligation has to be accumulated over time if an

action is taken over time) interacts with the requirements in paragraph 14Q of ED (i.e., an obligation is triggered if an entity takes two or more separate actions), as both paragraphs may apply to the same fact pattern. The same recommendation applies to paragraphs 14P (i.e., threshold-triggered obligation) and 14Q of the ED.

In particular, we believe that clarification is needed on the nature of activities referred to in paragraphs 14P and 14Q of the ED. For example, based on the proposed requirements in paragraph 14Q, it is unclear how to deal with levies that depend not only on the actions of a single entity but, e.g., also on the actions of the relevant industry (e.g. CORSIA for the aviation industry). As the second action that triggers the levy is not within the control of the entity, we question whether the past-event condition is met.

In addition, the distinction between a single action, a single action 'over time', a threshold-based action and multiple separate actions referred to in paragraphs 14O to 14Q of the ED should be clarified to ensure that entities do not have the ability to avoid triggers.

Paragraphs 14P and 14Q of the ED appear to introduce specific requirements for obligations imposed by governments on entities (also referred to as "non-exchange transactions" such as levies under IFRIC 21) that are not fully consistent with the general requirements in paragraph 14N, from our point of view. As the applicability of the requirements in paragraphs 14P and 14Q is not limited by the proposed wording in the ED to obligations imposed by governments on entities ("non-exchange transactions"), it should be examined what accounting outcomes result from these paragraphs when they are applied to "exchange transactions". This would allow the Board to ensure that there are no unintended accounting consequences.

From a structural point of view, we are not convinced that the requirements relating to obligations that arise when a measure of an entity's activity exceeds a specific threshold should be subsumed under the requirements relating to the past-event condition. For reasons of clarity, a separate (sub-)chapter would be desirable. From a conceptual point of view, it could be discussed whether the continuous recognition of a provision over a certain period of time as a result of a measure having exceeded a threshold is a matter of measurement.

Finally, we noted that paragraph 18 of IAS 37 is deleted in its entirety in the ED. We do not believe that the key principle (i.e., provisions should not be recognised for costs that need to be incurred to operate in the future) should be removed. We ask for confirmation and urge the Board to ensure that the key principle of paragraph 18 is clearly stated in 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?

The IDW supports the Board's objective of clarifying which costs an entity should include when measuring any type of provisions in accordance with IAS 37.

In general, we agree with the proposals. However, we believe that the principles for the costs to be included in the measurement of provisions according to the ED are partly unclear and raise some questions. Therefore, we believe that additional application guidance as well as an illustrative example is needed to better understand which costs are covered by the definition, respectively where the boundaries of the costs to be included are.

An example that regularly leads to discussions in practice is the treatment of legal fees in the event of a legal dispute: Should legal fees be included in the measurement of a provision for litigation? How should these costs be treated if the probability criterion in paragraph 14(b) of IAS 37 for recognising a provision for litigation is not met? Does it matter whether the costs are incurred internally or externally? Does it matter whether the entity is the plaintiff or the defendant?

In paragraph 66 of the Basis for Conclusions in this ED, the Board states that an entity includes in the measurement of a provision the types of costs that it would include in assessing whether a contract is onerous. Therefore, we would welcome full consistency between paragraph 40A(b) of the ED and paragraph 68A(b) of IAS 37 – both in substance and in wording.

Further, it is not clear whether the IASB intends to make a fundamental change in relation to the consideration of future operating costs in the measurement of provisions by deleting paragraph 18 of IAS 37. We do not suspect this but would be grateful for an explicit statement in this regard.

If the Board did not intend to delete the principle that no provision is recognised for costs that need to be incurred to operate in the future, we question whether

this principle is fully consistent with the proposed approach of measuring a provision at the “cost that relate directly to the obligation”. We kindly ask the Board to review this aspect.

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?

The IDW supports the IASB's objective of amending the requirements relating to the discount rate in IAS 37 to reduce the variety of discount rates used by entities when measuring provisions.

Paragraph 47A of the ED states that the discount rate should not reflect non-performance risk, i.e. the risk that the entity will not settle the obligation. However, it is unclear whether an entity can instead include non-performance risk in the expected cash flows or whether non-performance risk is generally excluded from both the expected cash flows and the discount rate. We therefore ask for further clarification.

The diversity in practice also results from the fact that some entities use real discount rates whereas others use nominal discount rates. While both approaches would result in the same initial present value of the expenditures, the effect of the unwinding of the discount could be different for the two approaches. There could be an impact on allocation of the annual change in the provision between

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operating costs (if the original provision was recognised as an operating expense) and finance costs. Further clarification would also be helpful here.

It may not be the normal case, but depending on how the market environment develops, it is quite possible that risk-free interest rates could turn negative. Such a situation has already occurred in Europe in the recent past. We would therefore be grateful for application guidance on how to proceed in such a situation.

Further, the IDW notes that the proposed changes to the discount rate under IAS 37 will lead to an inconsistency with the measurement basis for the fair value of liabilities under IFRS 3 and IFRS 9. While IAS 37 explicitly excludes non-performance risk in the interest rate in the future, non-performance risk is regularly included in the discount rates used in accordance with IFRS 3 and IFRS 9. To better understand the reasons for the different approaches, we recommend that the Board considers the interaction between IAS 37, IFRS 3 and IFRS 9 in the Basis for Conclusions and/or considers further standard setting.

Finally, we welcome the Board's efforts to increase transparency in financial statements about the discount rates used by the entities. In our view, the proposed new disclosure requirements under paragraph 85(d) of the ED are important information for users that is currently missing.

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?

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In general, the IDW has no fundamental objections to the transition requirements for the amendments to IAS 37 proposed in the ED.

We agree with the full retrospective application of the proposal on the present obligation recognition criterion.

However, we consider the transition requirements on the two aspects relating to the measurement of a provision to be very detailed and complex. In this regard, we recommend that the Board provide for more uniform and simplified transition requirements. For example, entities that are required by the proposed amendments of IAS 37 to change their accounting policy – either to ensure that the costs included in the measurement of a provision are consistent with paragraph 40A of the ED and/or that the determination of the discount rate is consistent with the amendments in paragraphs 47-47A of the ED – may be required to apply the amendments from the transition date without restating comparative information.

In addition, we recommend allowing sufficient lead time before the effective date. As some proposals from the ED will lead to earlier recognition of some provisions, we see a risk that the transition requirements may result in the use of hindsight.

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?

n/a

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?

The IDW welcomes the three-part decision tree in Section B of the Guidance on implementing IAS 37, as it helps to understand the new requirements for recognising a provision according to the ED.

We generally welcome the examples provided by the Board to illustrate the ED’s new principles for different types of provisions in different scenarios. However, we believe that some examples should be revised for reasons of clarity, practicability and consistency. In our view, this applies in particular to example 6.

Further, we do not understand why Examples 5A and 5B were included in the ED on IAS 37, as the examples deal with termination benefits and penalties arising from customer contracts. These are matters that we would expect to be dealt with in IAS 19 and IFRS 15.

Regarding example 14, we agree with the analysis and the conclusion that a provision should be recognised at the reporting date based on the best estimate of the expenditure required to settle the obligation. However, we suggest adding another 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 on the expected full-year emissions.

Finally, we recommend adding some new examples on:

- onerous contracts (in particular to illustrate the interaction between IAS 37 and IFRS 15 in the case of an onerous sales contract) and
- the measurement of provisions (in particular to illustrate the proposed new requirements relating to the expenditure required to settle an obligation).

Question 7: Other comments

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

As already mentioned in our comments on Question 3, we recommend that the Board address the different measurement approaches between the initial recognition of a provision acquired in a *business combination* at fair value under IFRS 3 and the subsequent measurement of a provision under IAS 37. Due to the different ways of dealing with non-performance risk, losses may arise automatically as part of the subsequent measurement of the provision. To avoid this, e.g., an exemption could be introduced in IFRS 3, which prescribes the measurement of provisions in accordance with the amended IAS 37.

Further, there seems to be an overlap between the new paragraph 80A of the ED concerning restructuring provisions and the requirements for the recognition of termination benefits under IAS 19 *Employee Benefits*. We therefore recommend clarifying the interaction between the two standards in this area and avoiding overlaps wherever possible.

The IDW would be pleased to answer any questions that you may have or discuss any aspect of this letter.

Yours sincerely,

Daniel Siegel

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