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Mr. Wolf Klinz

President of the EFRAG Financial Reporting Board

European Financial Reporting Advisory Group

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Belgium

Ref: Comment Letter on the EFRAG DCL on Provisions—Targeted Improvements (Proposed amendments to IAS 37)

Madrid, 24 February 2025

Dear Wolf,

On behalf of the Institute of Accounting and Auditing (ICAC), we are writing to express our comments on your Draft Comment Letter regarding the IASB's Exposure Draft IASB/ED/2024/8 Provisions—Targeted Improvements (Proposed amendments to IAS 37).

In general, the ICAC supports the IASB's proposed amendments to IAS 37. We particularly welcome the alignment of the definition of a provision with the definition of a liability in the Conceptual Framework, which we believe is a necessary step towards ensuring consistency and internal coherence across IFRS Standards.

We also recognize the value of the targeted improvements introduced by the proposal, particularly the clarification of specific situations and the inclusion of illustrative examples, which will enhance the practical application of the standard and reduce interpretative divergences.

Regarding the new recognition criterion for provisions arising from two separate actions or from exceeding a threshold (which implies the withdrawal of IFRIC 21), we support its conceptual basis, as it improves the correlation between revenues and expenses, enhancing the understandability of financial statements. Furthermore, we consider it more prudent, as it

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ensures that risks are accounted for as soon as their occurrence is deemed probable and can be reliably measured.

However, we acknowledge that the increased reliance on management judgment may present some challenges. Besides, we have identified specific cases related to levies in which the application of the new criterion may not provide the most faithful representation and clarification would be welcome. Given this potential complexity, we believe that the inclusion of additional illustrative examples would be beneficial to facilitate the practical application of the new requirements.

We also support the clarification of the measurement of provisions, particularly the inclusion of directly attributable costs, which enhances consistency and comparability across IFRS Standards, although we consider that an example to avoid doble reporting of cost already included in the provision could be beneficial

Regarding discount rates, we agree with the IASB's proposal to require the use of a risk-free rate, as it eliminates subjectivity related to non-performance risk.

Regarding transition requirements, we support the IASB's approach. Nevertheless, we share EFRAG's observations that additional guidance, including illustrative examples, would be helpful to ensure smooth implementation.

Finally, with respect to disclosure requirements for subsidiaries applying IFRS 19, we agree with the IASB's proposal that disclosing the discount rate used is sufficient, as it provides useful and comparable information while maintaining the cost-effectiveness of reporting for entities without public accountability.

The appendix to this letter sets out our responses to the questions in the Exposure Draft.

We would like to end this letter by thanking you for the opportunity to allow this Institute to participate in this comment process and hope that our input will contribute to the development of the project.

Please don't hesitate to contact us if you would like to clarify any point of this letter.

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Yours sincerely,

Santiago Durán Domínguez

Chairman of the ICAC

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APPENDIX: EFRAG QUESTIONS FOR RESPONDENTS

Question 1—Present obligation recognition criterion
Paragraphs 7 to 8 list arguments in favour and against the proposals in the ED on when a present obligation exists as a result of a past event. 1.1 Do you have additional arguments in favour and against the proposals? 1.2 Do you support (some of) the proposals, or would you prefer the current requirements as reflected in IFRIC 21? Would your answer depend on the type of provision being considered (e.g. reciprocal versus non-reciprocal transactions)? If so, for which types of provisions would you support/not support the proposals? 1.3 The ED proposes to maintain the requirements that a provision should only be recognised if (1) it is probable that an entity will be required to transfer an economic resource to settle the obligation; and (2) a reliable estimate can be made of the amount of the obligation. It will still be specified that it is only in extremely rare cases that an entity will not be able to make a reliable estimate of the amount of the obligation. Do you consider that these requirements should be amended following the proposals of the ED on when an entity has a present obligation? 1.4 Would the proposals have any economic impact on some sectors (e.g. sectors in which funds have to be set aside to cover provisions)? 1.5 Could you foresee the proposals resulting in any unintended consequences? If so, which? 1.6 Do your answers to the question above depend on whether you consider the proposed requirements in relation to the annual financial report or in relation to an interim financial report? If so, please specify how your answers differ for the two types of financial reports.

The ICAC generally supports the IASB's proposed improvements to IAS 37. In particular, we agree with aligning the definition of a provision with the definition of a liability in the

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Conceptual Framework is a necessary amendment to ensure consistency and internal coherence within IFRS Standards.

Additionally, the proposed amendment introduces targeted improvements that we believe will facilitate the practical application of the standard by preparers of financial statements. In this regard, we appreciate the inclusion of specific situations and illustrative examples that were previously absent from the standard and could lead to interpretative divergences.

Regarding the new recognition criterion for provisions arising from two separate actions or from exceeding a threshold, we support the conceptual basis of the proposal. The new criterion enhances the matching principle by improving the correlation between revenues and expenses, which facilitates the understandability of financial statements—particularly regarding the statement of profit or loss.

Furthermore, the new recognition criterion, compared with the IFRIC 21 criterion, enhances the application of the prudence principle in financial reporting. It ensures that risks to which a company is exposed are recognized as soon as their occurrence is deemed probable, and they can be reliably measured. This aspect is particularly relevant for entities required to prepare interim financial statements, as they may experience a more noticeable impact from the earlier recognition of provisions (e.g., recognizing a provision in Q1 instead of Q4). In contrast, entities that only report annual financial statements may experience less impact from this change in recognition criteria.

However, the main challenge of the new approach lies in the increased use of management judgment when determining when a provision should be recognized. First, distinguishing whether an action is a continuation of a previous event or a separate event may not always be straightforward. Second, once the first action has been performed, companies must assess whether they have the ability to avoid the second action or, in the case of a threshold being exceeded, whether its exceedance is probable. From this perspective, the recognition model under IFRIC 21 was easier to apply as it relied on more objective criteria.

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Therefore, while we support the theoretical reasoning behind the IASB's proposed changes, we believe that including additional illustrative examples would be highly beneficial to facilitate the practical application of the new recognition criterion by preparers.

Additionally, we have identified specific cases where the new recognition criterion could result in a premature recognition of expenses if the amendment is not correctly interpreted, which may not be appropriate. For instance, in Spain, there is a specific tax whose taxable event is the economic activity (IAE -Business Activities Tax) potentially falls within the scope of the current IFRIC 21, as it requires a company to carry out an economic activity and exceed a specified revenue threshold. The determination of whether a company is subject to the tax in year *N* is based on its revenue from year *N-1*; however, the taxable event occurs in year *N*, when the company carries out an economic activity, which is also when the tax accrues. Therefore, it cannot be clearly stated that a present obligation exists in year *N-1*. In this specific case we understand that the obligation does not arise during year N-1 even though it is used as a reference to determine the income threshold.

A similar concern may arise in the case of sector-specific levies applicable to the banking and insurance industries, where the calculation of the levy is based on financial data from a different fiscal year than the one in which the taxable event occurs.

Consequently, we believe that a more thorough analysis and clarification is required to determine whether these cases genuinely involve two separate actions leading to a present obligation or whether they represent a single action with an additional quantitative condition based on a previous period.

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Question 2—Measurement—Expenditure required to settle an obligation

2.1 Although EFRAG assesses that the proposals related to the expenditure required to settle an obligation will result in useful information, it notes that performing an assessment of the internal cost (e.g., the cost of the internal legal department) related to settling obligation of the given type may be associated with uncertainty and cost.

Do you foresee any complexity/costly process in determining the costs that relate directly to settling the obligation(s) (which include both incremental costs and other directly attributable costs)? Please explain.

We agree with EFRAG's assessment that the inclusion of direct costs in the measurement of provisions, as outlined in paragraph 40A, is a positive step towards greater clarity and consistency in financial reporting. This approach is fully aligned with the May 2020 amendment to IAS 37, which clarified the cost components to be considered when evaluating whether a contract is onerous. In our view, using different cost bases for determining whether a contract is onerous and for, subsequently, measuring the provision would lead to inconsistencies that could impair the usefulness of financial information.

Beyond onerous contracts, we also support the broader applicability of the proposal to other types of provisions. This ensures alignment with other IFRS Standards, where direct costs are included in the cost of an asset, and contributes to reducing diversity in practice. By establishing a clear and consistent approach to the recognition and measurement of provisions, the proposal enhances comparability and improves the reliability of financial statements. Additionally, we believe it would be beneficial to have an example to highlight that including the proportional part of the corresponding expense in the provision does not duplicate the recording of the expense by nature.

Question 3—Discount rates

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3.1 In cases when regulation describes the rate(s) to be used or determined to discount certain provisions within the scope of IAS 37, do you agree with the proposal to use a risk-free rate(s) or would you prefer to use the rate prescribed by the applicable regulation? Please explain. 3.2 Do you consider that the IASB should specify whether an entity should include or exclude inflation expectations when estimating the future expenditure required to settle its present obligation and then discounting this amount (see paragraph 52)? If so, please explain how the IASB could address the issue. 3.3 Would you expect that in practice, differences between how provisions acquired in a business combination would be accounted for at the day of acquisition and subsequently would result in day-2 losses being reporting in profit or loss (see paragraph 49(b) above)? If so, how would you recommend the issue to be solved?

We support the proposed amendment to require a risk-free rate for discounting provisions, as it enhances comparability, consistency, and faithful representation in IFRS. Including non-performance risk introduces subjectivity and potentially distorts financial statements by allowing weaker entities to report lower provisions. The proposal aligns with other IFRS Standards and reduces diversity in practice, improving transparency and reliability in financial reporting.

In relation to question 3.1, in cases where specific regulations mandate the use of a particular discount rate for certain provisions, this regulatory requirement should take precedence over the general proposal to use a risk-free rate. Regulatory discount rates are often designed to reflect the economic and legal environment in which entities operate and may incorporate factors relevant to the nature of the obligation, such as industry-specific risks or government-imposed funding requirements. Therefore, IASB should contemplate an exception, allowing

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entities to apply the regulatory-prescribed discount rate when required by law, ensuring alignment between financial statements and regulatory frameworks.

In response to question 3.2, the treatment of inflation across IFRS is not addressed in a uniform manner. For example, IAS 19 (Employee Benefits) allows flexibility in considering inflation when measuring long-term obligations, reflecting the fact that different liabilities may require different approaches depending on their nature and economic context. Similarly, different economies experience varying levels of inflation, meaning that a single prescribed method for incorporating inflation into the discounting of provisions may not always produce the most relevant or reliable information. Therefore, it may be prudent not to introduce a specific requirement regarding the treatment of inflation in the discounting of provisions under IAS 37, allowing entities to apply judgment based on their circumstances. However, to enhance transparency and comparability, it would be useful to require entities to disclose whether they have applied a nominal or real discount rate, enabling financial statement users to make informed adjustments where necessary.

Finally, regarding question 3.3, we agree that there could be a conflict between standards in measuring provisions acquired in a business combination. Under IFRS 3, provisions acquired in a business combination are initially measured at fair value, which reflects the amount a market participant would require to assume the obligation, including non-performance risk. However, under the proposed amendments to IAS 37, provisions should subsequently be measured using a risk-free discount rate, which excludes non-performance risk. This discrepancy in measurement criteria could result in a "day 2" loss, as the provision's carrying amount would increase once adjusted to IAS 37, impacting profit or loss.

In our view, to avoid these unintended financial consequences and ensure consistency in reporting, an exception could be introduced allowing provisions acquired in business combinations to retain their initial fair value measurement, rather than being remeasured under IAS 37. This approach would align better with the principles of business combination accounting and prevent artificial losses that do not reflect an economic outflow.

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Finally, we would like to note that we consider the wording of paragraph BC68 of the Basis of Conclusions certainly confusing, as it seems to state that the specific risks of a liability can be reflected in the discount rate by decreasing it.

However, in our view, the incorporation of risk into the discount rate actually increases it (rather than reducing it). In fact, this is one of the key reasons why including the performance risk in the discount type results in counterintuitive balance sheet effects, since when provisions are discounted using a higher discount rate, entities with greater risks report lower provisions on their balances.

Question 4—Transition requirements and effective date
4.1 Have you identified any possible difficulty in applying the proposed transition requirements, in particular related to the simplified retrospective approach for changes in discount rates? Please explain. 4.2 Have you identified any factors the IASB should consider in assessing the time needed to prepare for the proposals?

We support the IASB's transition proposal, as we believe that retrospective application in most cases will provide more useful and comparable information for financial statement users. Additionally, we recognize that the modified retrospective application and the option for a simplified retrospective approach to changes in discount rates will facilitate the implementation of the new requirements without imposing excessive costs on entities.

Furthermore, we endorse EFRAG’s observations in paragraphs 74 and 75 regarding the complexity of the proposed approach for transitioning changes in discount rates. In particular, we believe that including an illustrative example in the amendments, similar to the one presented in the IASB staff paper 22b (June 2024), would help clarify the application of the simplified method and the allocation of adjustments between accumulated depreciation and equity reserves. We also consider that the IASB should assess whether impairment testing

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under IAS 36 should be conducted for assets impacted by changes in the measurement of provisions, given that these changes may significantly increase their recorded cost.

In response to question 4.1, we have not identified any additional difficulties in applying the proposed transition requirements.

In response to question 4.2, we consider it important that companies be granted sufficient time to prepare for the change in accounting policy.

Question 5—Disclosure requirements for subsidiaries without public accountability
5.1 Do you think that disclosing the discount rate (or rates) used in measuring a provision, but not the approach used to determine that rate (or those rates) results in useful information for entities applying IFRS 19? Please explain.

We support the IASB's proposal regarding the disclosure requirements for subsidiaries applying IFRS 19. In our view, the disclosure of the discount rate used in measuring a provision could be sufficient for entities within the scope of IFRS 19.

Our reasoning is based on the fact that the most relevant piece of information is the discount rate itself, as it serves as a quantitative indicator that provides valuable insights for financial statement users and facilitates comparability across entities.

However, requiring subsidiaries to disclose the approach used to determine the discount rate could impose additional costs and administrative burdens. This would diminish the intended benefit of IFRS 19, which is to provide a simplified disclosure framework for entities without public accountability. Keeping the disclosure requirements focused on the discount rate itself ensures a balance between providing useful information and maintaining the cost-effectiveness of reporting for these entities.

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