KPMG IFRG Limited
15 Canada Square
London E14 5GL
United Kingdom

brian.odonovan@kpmgifrg.com

Dr Andreas Barckow
International Accounting Standards Board
Columbus Building
7 Westferry Circus
London
E14 4HD

Our ref BOD/288

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Dear Dr Barckow

Exposure Draft *Provisions – Targeted Improvements – Proposed amendments to IAS 37*

We appreciate the opportunity to comment on the International Accounting Standards Board's (IASB's) exposure draft *Provisions – Targeted Improvements – Proposed amendments to IAS 37*. We have consulted with, and this letter represents the views of, the KPMG network.

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is one of the foundational IFRS Accounting Standards. As the business world evolves and the complexity of arrangements increases, there have been challenges in interpreting and applying the existing requirements. For example, there has been a significant rise in the number and complexity of emissions and green schemes and questions have been raised about the appropriate timing for recognising the related liabilities. In other areas, there is acknowledged diversity in practice in measuring provisions.

We support the IASB's efforts to clarify the requirements in IAS 37 related to the timing of recognition and measurement of provisions. We believe that the clarifications will help to improve financial reporting and reduce diversity in practice. However, we have concerns about the clarity of some of the proposals, as discussed below.

Present obligation criterion

We support the direction of the proposals and the IASB's aim to provide more useful information to the users of the financial statements. We generally agree that earlier and progressive recognition of some provisions supports this aim. However, we are concerned that the proposals would not address some existing challenges in practice and some of the proposed drafting may be open to interpretation – e.g. it may remain unclear when the present obligation criterion is met and whether a provision should be recognised over time or at a point in time.

There are important areas to be clarified before the proposals are finalised, including how to assess whether an obligation involves a single trigger or multiple separate actions and how to apply the proposals to obligations involving multiple parties (see our detailed comments in response to Questions 1 and 6).

Costs to include in measuring a provision

The proposals in relation to costs to include in the measurement of provisions are consistent with the recent amendments to IAS 37 on costs to include in the assessment of whether a contract is onerous. We support this alignment for the identification and measurement of an onerous contract and a resulting provision.

However, we believe that further work is needed to analyse other types of provisions and determine which costs need to be included depending on the specific type of provision. We note that the IASB did not perform a comprehensive analysis and therefore there may be unintended consequences (see our detailed comments in response to Question 2).

Discount rate

We understand that under the proposals, an entity would be required to use a risk-free rate, which appropriately reflects the timing and the amount of the expected outflow, to discount the future expenditure to present value. Any uncertainty about the timing or the amount would be reflected by either increasing the estimated cash outflows or decreasing the discount rate. We support these proposals – they will help to reduce diversity in practice and improve comparability through enhanced disclosure. However, the proposals do not address some of the current practice issues, which it would be helpful to clarify (see our detailed comments in response to Question 3).

Transition requirements

We generally support the retrospective approach to transition; however, we have concerns about the proposals related to changes in accounting policies for discount rates (see our detailed comments in response to Question 4).

Please contact Brian O'Donovan at brian.odonovan@kpmgifrg.com or Irina Ipatova at irina.ipatova@kpmgifrg.com if you wish to discuss any of the issues raised in this letter.

Yours sincerely

KPMG IFRG Limited

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Appendix

KPMG's responses to the specific questions raised in the exposure draft

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?

We support the direction of the proposals and the IASB's aim to address stakeholders' concerns so that some provisions would be recognised progressively at an earlier date. However, we are concerned that the proposals do not address some of the existing challenges and aspects of the drafting may be open to interpretation – e.g. it may remain unclear when the present obligation criterion is met and whether a provision should be recognised over time or at a point in time.

We think that further work is needed to address the following areas.

- **Single trigger vs multiple actions:** In determining how to apply the proposals, a key consideration is whether an obligation involves a single trigger or multiple separate actions – i.e. whether an obligation should be recognised at a point in time or over time. It is unclear how to make this assessment in some complex scenarios and which factors to consider (see our response to Question 6). We recommend adding guidance on how to identify an action which results in an entity having an obligation to transfer an economic resource vs a measurement factor which affects the amount of that obligation.

- **Obligations involving multiple parties** (e.g. a scheme under which an entity incurs an obligation if it operates in an industry and the industry collectively exceeds a certain target)**:** It is unclear how to apply the proposals to such scenarios. Paragraph 14P applies when an entity's activity exceeds a specific threshold and paragraph 14Q applies when an entity itself takes two (or more) actions. We believe that for obligations involving multiple parties the present obligation criterion should be assessed based on the entity's activity, and the likelihood of the collective target being exceeded (e.g. by the industry) should be considered in determining whether it is probable that the entity will be required to transfer an economic resource under paragraph 14(b). We recommend adding guidance which clarifies this.
- **The placement of guidance for threshold-based obligations:** The guidance on threshold-based obligations in paragraph 14P is included within the past-event condition section – i.e. the guidance on the present obligation criterion under paragraph 14(a). However, the proposed guidance requires an assessment of all three recognition criteria in paragraph 14 – i.e. the present obligation criterion in paragraph 14(a), the probable outflow criterion in paragraph 14(b) and the reliable estimate criterion in paragraph 14(c). This placement has caused confusion about whether the assessment of the probability of exceeding the threshold being met is part of the assessment of whether the past-event condition is met – i.e. part of the present obligation criterion under paragraph 14(a) – or is part of the assessment of whether the outflow of resources is probable under paragraph 14(b). Our understanding is that the probability assessment is intended to be part of the analysis under paragraph 14(b) and therefore we recommend relocating the new guidance in paragraph 14P on threshold-based obligations to a separate sub-section at the end of the recognition section.

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?

We support the proposals for the measurement of onerous contract provisions because this would be consistent with the approach applied to determining whether a contract is onerous.

However, we believe that further work is needed to analyse other types of provisions and determine which costs need to be included depending on the specific type of provision. We note that the IASB did not perform a comprehensive analysis, and therefore there may be unintended consequences. For example, including an allocation of future depreciation in a provision in the scope of IFRIC 1 *Changes in Existing Decommissioning, Restoration and Similar Liabilities* may result in double-counting of costs.

We are also concerned about the consistency of the direct cost approach with the principle in paragraph 63 of IAS 37 which prohibits an entity from recognising future operating losses. We note that paragraph BC12(b) states that considering such costs in determining whether a contract is onerous does not result in an entity recognising future operating losses. However, requiring all provisions to be measured at their direct cost could result in an entity recognising future operating losses.

We also note that some interpret paragraph 37 of IAS 37 as allowing a provision to be measured based on an exit price. We recommend that the interaction between the proposals in paragraph 40A and the existing requirements in paragraph 37 be clarified because they appear to be inconsistent.

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?

(a) We understand that under the proposals, an entity would be required to use a risk-free rate, which appropriately reflects the timing and the amount of the expected outflow, to discount the future expenditure to present value. Any uncertainty about the timing or the amount would be reflected by either increasing the estimated cash outflows or decreasing the discount rate. We support these proposals – they will help to reduce diversity in practice and improve comparability through enhanced disclosure. However, the proposals do not address the following current practice issues, which it would be helpful to clarify.

- **Impact of inflation:** Government bond yields are expressed either in real terms (excluding the effects of inflation) or nominal terms (including the effects of inflation). Irrespective of the required approach, we believe that the cash flows should reflect consistent assumptions – e.g. a nominal discount rate is applied to discount cash flows which include the effects of inflation.
- **Negative risk-free rates:** It is common for entities to determine an appropriate discount rate by reference to the yield on a low-risk government bond in a currency consistent with that of the provision. There have been times when such yields have been negative and questions have been raised whether the discount rate should be floored at zero in such cases.
- **Presentation:** Questions have been raised about how to present the unwinding of the discount in the statement or profit or loss and the statement of cash flows.

(b) We agree with the proposed disclosure requirements. We believe that they respond to feedback from investors.

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?

4(a) Transition requirements

We support the overall proposal for the retrospective approach to transition with simplifying exceptions. However, we have specific concerns relating to the transition approach for changes in accounting policies for discount rates.

- **Transition approach:** The transition proposals suggest that changes in discount rates represent changes in accounting policies. We note that changes in discount rates are generally treated as changes in accounting estimates. Therefore, we question whether requiring a retrospective approach in this case is appropriate.

- **Provisions in the scope of IFRIC 1:** The basis for apportioning the adjustment between the related asset and retained earnings at the transition date (paragraph 94E(b)) is not clear. This requires clarification, and an example would be useful.

4(b) Effective date

We expect that the implementation of the proposals related to the present obligation criterion and costs will require time to prepare for. Entities will need to educate themselves on the changes and in some cases develop new processes and controls to implement them.

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?

We agree with the proposals.

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?

(a) We think that decision trees are generally helpful in illustrating the application of the requirements in IAS 37 and the proposed decision trees are more comprehensive than what is currently included in the Implementation Guidance accompanying IAS 37. However, some find them overly complex and containing unnecessary details. We believe that they would be easier to use if combined into one decision tree rather than being three separate decision trees. KPMG's Provisions – Major accounting changes on the horizon talkbook on the proposals includes an alternative decision tree which may be easier to navigate (see slide 11).

(b) / (c) We acknowledge that some of the illustrative examples are based on the existing examples in IAS 37, IFRIC 6 and IFRIC 21, and some would be introduced through the proposals. We generally believe that the illustrative examples are helpful in illustrating the application of the requirements; however, we have specific comments and concerns about the proposed examples.

Critical comment

- **Single trigger vs multiple actions:** Examples 13A–13C are intended to illustrate the application of the guidance in paragraph 14Q on multiple separate actions. However, it is unclear how to distinguish between these examples. For example, it is unclear what the defining factor is which results in the conclusion that there is only a single trigger and not multiple actions in Example 13C. There is a risk of diversity in application based on the current drafting, particularly given there are various complex levies and property taxes. For example, when assessing a property tax, it is unclear whether an entity needs to consider if:
  - the law takes into account the ownership of the asset throughout the year;
  - there is an existing practice of negotiations between the seller and the buyer for compensation relating to the property tax if the law does not take the duration of ownership into account;
  - the tax is due on the first vs last day of the assessment period;
  - the tax is based on a value of the asset in a previous period(s); and
  - the amount of tax reflects the condition of the asset throughout the year – e.g. if the tax is due on the first day of the annual period but the asset is damaged subsequently, then the amount of tax is reduced.

We recommend enhancing the analysis in Examples 13A–13C to clarify the assessment of whether there are multiple actions which result in an obligation to transfer an economic resource (see our response to Question 1).

We also think that there is a risk that Example 13C will be misinterpreted as indicating that a property tax will always be recognised at a point in time. We recommend adding an example illustrating a property tax that would be recognised over time.

Other comments

- **Interaction with other accounting standards:**
  - Example 11B addresses a scenario involving a legislative requirement for an airline to overhaul its own aircraft. We note that paragraph 14 of IAS 16 *Property, Plant and Equipment* provides specific guidance for major inspections of owned assets – i.e. within the authoritative text of that accounting standard. Although the conclusion in Example 11B is consistent with the requirements of IAS 16, it is unclear why Example 11B does not reference IAS 16.

    In addition, we note that entities sometimes incur obligations to maintain assets that they operate but do not own – e.g. lessees and operators in service concession arrangements in the scope of IFRIC 12 *Service Concession Arrangements*. Paragraph 21 of IFRIC 12 discusses the application of IAS 37 to such obligations. This is illustrated in Examples 2 and 3 in IFRIC 12 (IFRIC 12.IE11–IE38) in which an operator recognises a provision for a resurfacing obligation. It would be helpful to explain how the three conditions in IAS 37 apply to such obligations, either by expanding Example 11 in IAS 37 or making consequential amendments to the examples in IFRIC 12.
  - Examples 6(a), 6(b) and 11B explain that there is no past event for the obligation to pay for smoke filters and overhaul services respectively. Executory contracts are outside of the scope of IAS 37 unless onerous, therefore any contract for the purchase of these assets/services would not be in the scope of IAS 37 unless onerous, and upon these assets/services being received a financial liability in the scope of IFRS 9 *Financial instruments* would arise. We recommend either removing the 2nd paragraphs from the past-event condition analysis in these examples or adding a sentence that in this scenario the contract is executory and not onerous – i.e. it is not in the scope of IAS 37.
  - Paragraphs 165–168 of IAS 19 *Employee Benefits* contain specific requirements to recognise a liability for termination benefits. We recommend referring to this guidance from Examples 5A and 5B because it is also relevant to the timing of recognising a liability for the obligation to pay termination benefits. As proposed, there is a risk that users misunderstand

that IAS 37 recognition requirements apply in isolation to termination benefits. See also our comments regarding paragraph 80A under Question 7.

- The IFRS Interpretation Committee's (IFRIC) September 2019 decision *Compensation for Delays or Cancellations* (IFRS 15 *Revenue from Contracts with Customers*) concludes that compensation for delays or cancellations, as described in the request, is variable consideration in the contract under IFRS 15. We recommend removing all reference to termination penalties due to customers from Example 5B and making clarifications to paragraph 80A(b) such that 'executory supply contracts' do not include customer contracts.

- **Obligation being analysed unclear:** The 'obligation condition' analysis in Example 7 refers to the responsibility to comply with a financial services regulation, providing training services and a contract with a provider of training services. We believe that the intent is to analyse whether there is an obligation to provide training services and recommend clarifying the introduction and analysis of the three conditions accordingly. We also recommend either removing any analysis relating to a contract for training services not yet entered into because any such contract would be an executory contract outside of the scope of IAS 37 unless it is onerous, or adding a sentence that in this scenario the contract is executory and not onerous – i.e. it is not in the scope of IAS 37.

- **Past-event condition met over time:** It appears that in Example 14 the past-event condition is met over time because the entity manufactured cars with average fuel emissions higher than the government target over the annual reporting period. Other examples – e.g. 13A and 13B – specifically state in the past-event condition analysis the period that the present obligation accumulates over and refer to paragraph 14O. We recommend Example 14 should do the same.

- **Interim periods:** The conclusions for Examples 13A–13C and 14 focus on the accounting at the annual reporting period end. A key consideration for levies is the accounting at interim reporting periods. We recommend adding analysis to these examples which addresses interim reporting periods.

- **Inconsistent approach to past-event condition analysis:** We note that Examples 6(a), 6(b), 7, 11A and 11B include analysis of all three conditions even when the obligation and/or transfer conditions are not met. In contrast, Example 15 does not analyse whether the past-event condition is met for the obligation to reduce emissions which does not meet the transfer condition. We recommend adding analysis of the past-event condition for the obligation to reduce emissions to Example 15 such that a consistent approach is taken for all examples.

- **Scope of IAS 37:** Paragraph 1(a) of IAS 37 excludes from its scope executory contracts, unless they are onerous. We acknowledge that Example 11A is currently in IAS 37, but question whether it should remain given it would only be in the scope of IAS 37 if the entity had a contract to replace the liner and that contract were onerous. We recommend removing this example or adding a sentence that in this scenario the contract is executory and not onerous – i.e. it is not in the scope of IAS 37.

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

Yes. We make the following recommendations.

- IAS 1 *Presentation of Financial Statements* provides guidance on going concern assessments. IAS 1 does not refer to an entity's decision in the context of this assessment. To avoid any confusion, we suggest replacing 'A decision to prepare' in paragraph 14R with 'Preparing'.
- Cross-reference from paragraph 80A in IAS 37 to the requirements in paragraphs 165–168 of IAS 19 which contain guidance on when to recognise termination benefits. This would mitigate the risk that users misunderstand that IAS 37 recognition requirements apply in isolation to termination benefits.