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Re: ED/2024/6 Climate-related and Other Uncertainties in the Financial Statements – Proposed illustrative examples

Dear Andreas,

On behalf of the DRSC's Financial Reporting Technical Committee (FR TC) I am writing to comment on the IASB's Exposure Draft on Climate-related and Other Uncertainties in the Financial Statements – Proposed illustrative examples (ED/2024/6). Thank you for the opportunity to comment on the ED/2024/6.

1 The FR TC has supported the IASB project on climate-related risks in the financial statements early on. We therefore agree with the objective of this project and also see the need to enhance information on climate-related risks in financial statements. Moreover, we support the IASB's decision to generalize the project's objective to cover not only climate-related risks but (long-term) uncertainties in general. We agree that it is in line with the principle-based nature of the IFRS to address uncertainties in general rather than a particular aspect (here: climate-related) of uncertainties only.

2 However, while the illustrative examples proposed in ED/2024/6 are an important step into the right direction, we are not convinced that they will allow to fully achieve the objective of this IASB

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project. Though the proposed illustrative examples address issues in relation to reporting on climate-related risks and – in one example – on other uncertainties we are afraid that they will not result in the desired outcome. For one, the examples mainly touch on climate-related risks only. Secondly, illustrative examples are – by its very meaning – illustrating the existing IFRS requirements but do not alter or even enhance the existing understanding of reporting about uncertainties under IFRS. Furthermore, naturally, examples can only depict a simplified fact pattern highlighting one specific aspect, but not the complexity of fact patterns in practice. As a result, the examples can be expected to affirm current (good) practice and highlight – once more – specific aspects of climate-related and other uncertainties. Due to the lack of changes in the IFRS itself, the examples are likely to also reaffirm poorer practice which have been viewed as in line with IFRS in the past. Therefore, significant improvements or changes in reporting on climate-related and other uncertainties in IFRS financial statements is not likely to occur.

3 We understand that the IASB focuses on actions that could be completed in a timely manner (BC7) and we believe the examples are a helpful first step to identify relevant areas for the reporting of uncertainties. We would nevertheless like to encourage the IASB to build on the current discussion and further explore options to address clarifications or enhancements within the IFRS as suggested by the IASB in BC9(a). See our suggestions further down below (Section (II)).

4 We further suggest that the IASB clarifies its concept regarding the boundaries of IFRS financial statements compared to other reporting instruments such as the management commentary (management report) or the sustainability statement. The examples presented in ED/2024/6 do not further explain these important aspects of reporting about climate-related and other uncertainties. As a result, they raise questions as to where the IASB expects the information to be placed. For example, ED/2024/6.BC32 states that Examples 1 and 2 assume that the entity does not apply IFRS SDS and that otherwise the information would be required to be disclosed under IFRS SDS. The IASB does not explain, however, the consequences of any information (mandatorily) provided under the IFRS SDS in a sustainability report or elsewhere and whether these disclosures would make disclosures in the IFRS financial statements superfluous.

5 ED/2024/6.BC23-BC25 point out that entities might be required to provide similar information under IFRS for its IFRS financial statements as under IFRS SDS. BC25 points out that for purposes of adhering to IFRS SDS the reporting entities could refer to the IFRS financial statements. This suggests that the information is necessary in IFRS financial statements irrespective of the same information provided elsewhere in the entities' reporting.

6 Until now, the IFRS concept has provided for only limited information on risks and uncertainties that relate to the business operations in general. The conclusion that the IFRS IC recently drew regarding the criteria of a past event for recognizing a provision for a constructive obligation for net-zero commitments in the financial statements confirms the familiar concept under IFRS. The existence of a present obligation as a condition for recognizing liabilities (including climate-related liabilities) substantially limits the extent to which the risks associated with the reporting entity's business model are depicted in the financial statements. In short: risks associated with the reporting entity's business model are essentially left out of or very limited in the financial statements.

7 To address this issue (among other) for many years the EU has required certain entities to prepare a management report. One important section of that report and arguably the section that is of great importance to capital providers is the risk report section. Entities are required to disclose and discuss all material risks and opportunities that the reporting entity is exposed to. This risk report section serves the purpose of compensating the shortfall of information in the financial statements.

8 It would appear that the IASB is now aiming at highlighting how risk related disclosures should be subsumed under IFRS (for example by referencing to IAS 1.31 in Example 1 and 2). This blurs the currently existing line between the financial statements (with limited information on risks due to, among others, the restrictive present obligation criterion) and other reporting instruments (mandated) in addition to financial statements. We therefore encourage the IASB to consider the boundaries between the financial statements and other (mandated) reports in the context of their respective distinct objectives.

9 Furthermore, the FR TC believes it necessary to thoroughly review the examples presented in ED/2024/6 in order to build on more realistic and hence more relatable fact patterns. It seems, for example, unlikely for an entity in a capital-intensive industry and exposed to climate-related risks to have in place a transition plan which has no effect on the recognition or measurement of its assets and liabilities and related income and expense (see Example 1). Other fact patterns, especially for Example 7, need to be clarified to determine those cases (fact patterns) that effect recognition and/or measurement in contrast to cases that call for (additional) disclosures.

10 In addition, the proposed Illustrative Examples focus on climate-related uncertainties. The project, however, was widened by the IASB to address longer-term uncertainties in general. The examples should therefore address not only climate-related uncertainties but the general issues of

depicting long-term uncertainties in IFRS financial statements. Some additional examples could be drafted to mirror more general considerations of long-term uncertainties.

11 To summarize, in our view, the Illustrative Examples would benefit from a revision and the project in general would also benefit from (re-)considering narrow-scope amendments to the IFRS. It seems to us that the IASB would otherwise miss an opportunity to more generally address the issues around accounting for (long term) uncertainties and to improve the decision usefulness of the information provided for the economic decisions of the users.

12 Below we lay out our comments regarding the Illustrative Examples as suggested in ED/2024/6 (I) and our suggestions regarding further explorations of amendments to IFRS (II).

(I) Illustrative Examples

Example 1 and 2 – Materiality judgements (not) leading to additional disclosure

13 The FR TC supports laying out examples on how entities are expected to consider aspects of qualitative materiality. However, the FR TC disagrees with the general notion to have to include a negative confirmation depending on expectations of stakeholders which are based on criteria such as the industry that the entity operates in. Examples 1 and 2 foster the general expectation of disclosures beyond specific requirements in IFRS Accounting Standards and respective negative confirmation depending on the entity's financial position and performance compared to its industry and the economic environment.

14 PS2 *Materiality Assessment* addresses external qualitative factors (such as geographical location, industry sector, state of the economy/economies an entity operates in) to be considered by an entity for determining "material information". It also points out negative confirmation disclosures based on those external qualitative factors (Example K of PS2). However, PS 2 is not an integral part of the IFRS and has, to our knowledge, not yet significantly informed reporting practice with regard to "negative confirmation" disclosures.

15 In our understanding, despite PS 2 and other IFRS literature, the IFRS itself are not widely or consistently understood to currently require negative confirmations. They are rather understood to emphasize the need for clarity of information (to not obscure material information with non-material information).

16 While Examples 1 and 2 might be clear cut regarding the reasonable expectation of stakeholders and therefore the need for negative confirmations a general notion of "negative confirmations" will be more difficult to apply in a more complex practice environment. In addition to the practical challenges of monitoring and assessing the completeness of information in the light of the need for negative confirmations there are currently no established boundaries or limits for such negative confirmations.

17 Furthermore, these examples bring to light just how critical it is that the boundaries of the IFRS financial statements are clarified, as also explained above (paras 4-7). ED/2024/6.BC32 states that Examples 1 and 2 assume that the entity does not apply IFRS SDS. It goes on by stating that "If those Standards were applied, the entity would be required to disclose in its sustainability-related financial disclosures information about the effects of climate-related risks and opportunities on its financial position, financial performance and cash flows for the reporting period." This implies that it is sufficient if the information in question were described under the IFRS SDS. However, the IFRS SDS do not prescribe where to locate the information. Therefore, it would seem acceptable if the information is provided elsewhere, e.g. in the management commentary (management report) or a separate sustainability statement. The information would therefore not necessarily be required to be disclosed within the IFRS financial statements. Furthermore, as stated in ED/2024/6.BC22, these considerations are not limited to IFRS SDS. Hence, entities might instead also be reporting under ESRS or other frameworks, placing the information in question elsewhere in the various entity reporting instruments.

18 Without consideration of BC32 the Example 1 seems to have to be read as a requirement resulting from the understanding of IAS 1/ IFRS 18, hence resulting in a necessary disclosure in the IFRS financial statements (regardless of any further information in other sources of the entity's reporting). If it were the case that the information can be provided elsewhere, there is a need for clarification (including on any conditions for this) within the examples rather than a brief reference to this aspect in the BC.

19 But more generally, as already laid out in paras 4-7 above, this example touches on the fundamental question of the boundaries of as well as the connections between the different reporting instruments with their distinct respective objectives. In view of the importance of this question it should therefore in general be explored in more detail by the IASB.

20 Furthermore, Example 1 does not specify the time period for which the reporting entity does not expect effects of its transition plan to reduce GHG emissions over the next 10 years. It should be

clarified in the example that the entity does not expect effects of its climate-related transition plan at any point in time. Currently, while Example 1 does not specify a time horizon para BC23 refers to the IFRS SDS disclosures providing information about how sustainability related risks and opportunities have affected the entity's financial position and financial performance for the reporting period [emphasis added]. Therefore, the time horizon for which the entity is expected to assess (possible) financial effects should be clarified in the example.

21 Furthermore, it is questionable whether Example 1 depicts a realistic and hence relatable fact pattern. While it is inherent that examples simplify fact patterns to highlight specific aspects it seems highly unlikely that an entity operating in a capital-intensive industry, and which is exposed to climate-related transition risks has in place a transition plan for the next 10 years which will not affect the financial position and financial performance of the entity. The FR TC therefore suggests reconsidering the fact pattern laid out in Example 1.

22 Finally, we would like to note that we understand the fact pattern to address possible incremental financial effects of a transition plan, i.e. that the reporting entity is asked to evaluate any incremental financial effect resulting from the transition plan instead of the total costs for the operations of the business. In practice, it does not always seem straight forward to assess which are the incremental costs that are resulting from a transition plan compared to costs connected with the general business operations.

Example 3 – Disclosure of assumptions: specific requirements (IAS 36)

23 The FR TC suggests highlighting the importance of IAS 1.31 by including a reference to this paragraph also in this example. Even though IAS 1.31 is explicitly the subject of Example 5 we suggest considering a reference in Example 3 as well as to illustrate other circumstances in which IAS 1.31 should be considered.

Example 4 – Disclosure of assumptions: general requirements (IAS 1/IAS 8)

24 In our view Example 4 reiterates the current understanding of the use of IAS 1.125 and therefore confirms exiting practice.

25 The FR TC notes, however, that the example further suggests that entities should report on the aspects that are laid out in IAS 36.130 but which are not explicitly applicable as the CGU in the

fact pattern does not include goodwill or intangible assets with indefinite lives. Currently these disclosures are not required to be presented according to IAS 36.132, but are merely "encouraged". Instead of referring to IAS 1.125 which in turn results in disclosures about the assumptions (as encouraged in IAS 36.132) the FR TC suggests that the IASB considers amending IAS 36 instead. This would result in the disclosure outcome the IASB seems to intend as illustrated in this example. See Section II of this comment letter for suggestions to amend IFRS.

Example 5 – Disclosure of assumptions: additional disclosures (IAS 1/IFRS 18)

26 As the example before, Example 5 also seems to reiterate the current understanding of the use of IAS 1.31 and therefore it confirms exiting practice.

27 In addition, the FR TC notes that the example does not seem to depict a real-life fact pattern. It again seems highly unlikely that a government announces a regulation restricting an entity's ability to operate and generate profits in that jurisdiction in the future but at the same time that government does not provide an indication of when that regulation would be effective. The FR TC suggests redrafting this example to depict a more relatable example.

Example 6 – Disclosure about credit risk (IFRS 7)

28 The FR TC supports including an example on how to take climate-related risks into account for credit risk disclosures under IFRS 7. Climate related risks are a risk driver for credit risk. Therefore, their impact is of relevance to users of financial statements.

29 The example is based on explanations. We think this is a good way of giving information on the one hand and of reflecting the risk management in banks on the other hand.

30 Climate-related risks are often not assessed separately when determining expected credit losses. Instead, climate-related risks are risk drivers which are implicit in the models used in banks. For example, this is the case in financing collateralized by assets like corporate real estate. The expected credit loss largely depends on the market values of these collaterals determined based on comparative market transactions. These market values implicitly include climate-related risk factors. However, the climate risk factor effect cannot be separated from the residual market values. Therefore, the impairment cannot be split in effects from climate-related risk and other effects.

Example 7 – Disclosure about decommissioning and restoration provisions (IAS 37)

31 Decommissioning and restoration provisions are a core aspect of financial accounting for including climate-related and other uncertainties. The FR TC therefore welcomes an example on decommissioning and restoration provisions. Nevertheless, we again would like to suggest redrafting this example in order to clarify the fact pattern which would then allow a clearer distinction between aspects that relate to questions of recognition and/or measurement on the one side and questions of disclosures on the other side.

32 The fact pattern in Example 7 refers to a petrochemical manufacture who has plant decommissioning and site restoration obligations for its petrochemical facilities. The entity assumes that it will continue to maintain and operate the facilities for an extremely long time. Consequently, the provision for settling the obligation is immaterial due to the discounting to the present value of the obligation. The example further states that "the costs to settle the obligation will be high and there is an increasing risk that the entity might be required to close some of its petrochemical facilities earlier than it expects because of efforts to transition to a lower-carbon economy". Disclosures are required because information about the obligation is material despite the related provision being immaterial.

33 In our view the fact pattern of this example raises various questions. For one, the reason for the increasing risk of the entity being required to settle the high obligation early is very vage. The fact pattern states this to be the case "*because of efforts to transition to a lower-carbon economy*".

34 However, it would seem that "efforts to transition to a lower-carbon economy" are indicative for necessary recognition and/or measurement considerations. Despite of "whose" efforts are addressed in the example the entity would at least have to consider possible consequences for recognition and/or measurement. In our view, these need to be addressed in the example as well.

If, for example, the government (source outside the control of the reporting entity) has decided to increase its efforts for a transition to a lower-carbon economy this will likely result in new regulation. Any (discussion of) new regulation is likely to have an impact on the assessment of the expected useful life of the facility and will therefore likely result in a reconsideration of the current accounting for the facility (including, but not limited to, the provision for the obligation for decommissioning and restoration). On the other side, any such effort on the side of the reporting entity itself should be expected to also result in a revaluation of the useful life of the facility and hence a likely different measurement of the facilities and a different measurement of the provision (due to shorter expected time to operate). It is not yet clear how any "efforts to transition to a lower-

carbon economy" merely result in a risk to settle the obligation earlier but would not result in a reconsideration of the assumptions underlying the recognition and/or measurement of the book value of the facilities as well as the provision. In our view the example should clarify why these efforts would only trigger disclosures but not a re-evaluation of the underlying measurements. Changes in the assumptions for the measurement of facilities and provisions would, nevertheless, have to be explained. Disclosures on the reasons for the changes in the underlying assumptions are required.

Example 8 – Disclosure of disaggregated information (IFRS 18)

35 In our view, Example 8 confirms current reporting practice.

(II) Suggestions for amendments to current IFRS

36 The FR TC generally agrees with the narrow scope of the project as pursued by the IASB. However, we assume that the desired effects regarding the improvement of disclosures about climate-related and other uncertainties as well as in regard to closing the expectation gap will not materialise with Illustrative Examples alone. Therefore, we strongly suggest that the IASB also considers specific amendments to IFRS.

37 The IASB could reconsider IAS 36 (par 35 in reference to IAS 36.33(b)) with regard to the statement of reliable future cash flows not generally being available for periods longer than five years and limiting management's estimates of future cash flows to a maximum of five years. While IAS 36.35 states that management may use cash flow projections based on financial budgets/forecasts over a period longer than five years if it is confident that these projections are reliable and it can demonstrate its ability, based on past experience, to forecast cash flows accurately over that longer period. In practice IAS 36.35 usually limits projections to five years despite a possibly longer-term consideration of uncertainties around future cash flows.

38 Furthermore, we suggest the IASB considers another amendment to IAS 36. Aligning the requirements in IAS 36.134 (for CGU with goodwill and/or intangible assets with indefinite useful life) with the voluntary disclosure under IAS 36.132 (for CGU without these particular assets). IAS 36.132 currently encourages [emphasis added] an entity to disclose assumptions used to determine the recoverable amount of assets (cash-generating units) during the period. It is,

however, required to disclose estimates used to measure the recoverable amount of a cash-generating unit when goodwill or an intangible asset with an indefinite useful life is included in the carrying amount of that unit (IAS 36.134). The disclosure is hence required for those assets that require annual impairment testing (for the CGU). To not only encourage but require similar information for other assets as well could improve and align disclosure on climate-related risks and other uncertainties for these assets. This seems to be the outcome of Example 4 anyway, which does not however argue with IAS 36.132 but with reference to IAS 1.125.

39 We also suggest exploring IAS 37, Illustrative Example 6 (*Legal requirement to fit smoke filters*) and the underlying concept of IAS 37 described in that example (obligation for the costs of fitting smoke filters depending on the occurrence of the obligating event which is the fitting of the filters itself). The concept of an unavoidable obligation laid out in this example typically results in questions regarding the practical relevance and suitability of this example (and of IAS 37).

40 Last but not least, IAS 1.125 could be reconsidered. Currently an entity shall disclose information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year [emphasis added]. The (potential) impact of significant long-term risks and long-term uncertainties on the carrying amounts of assets and liabilities does not typically unfold within the next financial year but over much longer time-horizons. Disclosures on those mid- and long-term impacts should therefore explicitly required in the IFRS.

41 On a more general note the IASB could build on the recent discussions regarding this project to connect this work on “climate-related and other uncertainties” with some of its other work-streams, especially the work on IAS 37 and Management Commentary.

If you have any questions regarding our comment letter please contact either Kati Beiersdorf (beiersdorf@drsc.de) or me.

Kind regards,

Sven