

POSITION PAPER



ESBG response to EFRAG draft comment letter on the proposed amendments regarding the accounting for provisions

ESBG (European Savings and Retail Banking Group)

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February 2025



EFRAG Questions:

Question 1 – Criteria on when an obligation is present

First of all, this question can only be read in conjunction with the examples provided in the exposure draft application guidance. The principle of separating the analysis of (i) the existence or non-existence of an obligation on one hand, and (ii) the assessment of whether it results from a past event on the other hand is an improvement. However, and considering certain examples provided, particularly for the taxes treated by IFRIC 21, the application made does not clearly distinguish the triggering event of the obligation from the calculation base of the provision to consider that an obligation exists. We oppose the recognition of bank taxes and similar levies in a period which comes earlier than the period to which they relate (i.e. in which they are chargeable). In this regard, we strongly support the critical arguments developed in the EFRAG response (§8 and §11).

The IASB proposes to amend the requirements in IAS 37 on when an entity has a present obligation by specifying when the past event condition is met in the following two scenarios:

- o when an entity has an obligation to transfer an economic resource only if it takes two (or more) separate actions. In such situations, the past event condition is met when the entity has taken the first action (or any of the actions) and has no practical ability to avoid taking the second action (or all the remaining actions); and
- o when an entity has an obligation to transfer an economic resource only if a measure of its activity in a period (the assessment period) exceeds a threshold. In such situations, the action that meets the past event condition is the activity that contributes to the total activity on which the amount of the transfer is assessed. At any date within the assessment period, the present obligation is a portion of the total expected obligation for the assessment period. It is the portion attributable to the activity carried out to date.

In relation to the first scenario, the IASB determines that executing the first action can be participating in a certain market, for example, in the banking market. However, the definition of a levy does not always identify two separate actions as clearly as indicated by the IASB. For example, a levy can impose a payment on financial institutions in a certain territory that meet the banking market condition at a specific point in time and whose taxable base corresponds to the revenues generated in a previous financial year. In this case, there is only one action that is the condition of financial entity on the date legally established by the levy, and the income would not be considered an initial action but rather, the calculation basis determined for the measurement of the obligation. Drawing a line between two



separate actions and one action together with a measurement reference to determine the levy could be challenging and a grey area for companies.

The payment of the levy is not something that entails additional resources to the entity and therefore is not directly related to obtaining income, whose counterpart is also different as they are not reciprocal transactions. As a result, ESBG does not agree with those that propose recording both the obtention of income and the levy simultaneously in the PL progressively but rather evaluate the accrual of each of transaction separately depending on their nature, as many banks have done since the application of IFRIC 21 in 2014.

Another amendment that ESBG does not agree with is the new requirement in paragraph 14R, which establishes: "A decision to prepare an entity's financial statements on a going concern basis implies that the entity has no practical ability to avoid taking an action it could avoid only by liquidating the entity or by ceasing to trade. "This statement, which is intended to be based on an accounting principle such as the preparation of the financial statements under going concern, directly requires all those commitments and obligations to be recorded in advance, even if the legal obligation has not already emerged for the company. Undergoing concern situations, in very rare cases companies will have the practical ability to avoid discharging the responsibility. In addition, non-adjusting subsequent events such as a merger between two banks, may occur after the reporting period. From a legal perspective, the acquired bank may not have to pay the levy whose taxable base is determined considering previous income; however, the application of 14R would lead to recognising at the end of a reporting period of an obligation that will be subsequently reversed. The application of this new requirement requires greater judgment in making estimates by preparers of the information, increasing subjectivity, and decreasing comparability between entities, while ESBG has the impression that under the current requirements of IAS 37 there is not a shortfall of provisions being recognised and not significant relevant issues have been identified by enforcers and supervisors.

As indicated in EFRAGs Draft Comment Letter in paragraph 8.b (ii), the application of the proposals may entail recording obligations at a point in time that do not yet exist, mainly in those levies which are non-reciprocal transactions, whose trigger is legal. The determination of the time point in the law itself is clear, understandable for all users, effective and mandatory for all entities that are under its scope, generating legal and accounting certainty in its application, avoiding subjectivity on the part of the preparers of the information as well as improving comparability between the entities that must apply such legal figure. In addition, recognising in advance the legal obligation before the legal trigger is met increases the risk of recording obligations that may not be subsequently completed, forcing entities to correct later their financial statements. In ESBG view, for non-reciprocal transactions, liabilities should only be recognised when



they are due based on the legal triggering event for that liability and when there is no other meaningful alternative.

ESBG impression is that the changes made in the 2018 Conceptual Framework have not been fully re-assessed by users because they have never been implemented in practice. Since 2014 we have been applying IFRIC 21 and analysts understand it well and have adjusted their models. A practice that was new under IFRIC 21 is currently well understood by users and broadly applied to different concepts of levies, now changing it again will be disruptive.

The above comments are from a perspective of what we believe should be the accounting treatment that most faithfully reflects the financial situation of a company.

If we take into account only the technical aspects, we believe that the IASB's proposals are consistent with the latest changes that were made in 2018 to the Conceptual Framework (CF). Therefore, this leads us to question whether some parts of the definition of a liability in the CF should be reviewed again, in particular the one that assumes the non-practical ability in a situation of going concern will always occur.

Question 2 - Costs included in the estimation of the expenditure required to settle a provision

The clarification regarding 'the costs that relate directly to the obligation' provided by the Board is welcome as it reflects the transfer of economic resources.

We agree that these costs should consist of the incremental costs of settling the obligation, but we are not completely sure whether a reference to 'an allocation of other costs that relate directly to settling obligations of that type' is appropriate.

Not every corporation or bank has analytical systems or tools to identify an allocation of costs to each type of provisions as this proposed clarification covers all types of provisions. In a financial entity most likely these analytical systems are based on financial products or services being distributed; therefore, we could foresee complexity and both one-off and on-going costs in determining the other directly attributable costs. Also, one additional thought is whether an allocation of the depreciation charge for an item of property, plant or equipment should be considered when estimating the other costs related directly to settling the obligations. In our view, the allocation of costs of corporate assets and personnel working in general headquarters may lead to recognize in advance costs for contracts that are not onerous at the reporting date and, in our view, do not best portray the performance for that period.

ESBG agrees with EFRAG that it would be useful to include additional examples or application guidance on the type of costs an entity should include when



measuring a provision and illustrating the case where a company does not internally identify and allocate certain costs as the above referred.

Question 3 - The rate to be used to discount future expenditure to their present value and related disclosure requirements

The board's proposal not to include the risk of non-performance seems acceptable to us as it is a welcome simplification in practice given the complexity of evaluating these provisions in terms of time horizon.

Question 4 - Transition requirements and effective date

In principle, a retrospective application is the most suitable approach in this case. However, without the additional clarifications requested (see question 1), we are concerned that the initial application may result in inconsistencies among entities subject to the same levies.

Question 5 - Disclosure requirements for subsidiaries without public accountability

ESBG does not have comments on this question.

Question 6 - Guidance on implementing IAS 37

The examples provided (especially those related to IFRIC 21) require additional clarification on the normative reasoning adopted. Indeed, these examples refer only to the judgment of the entity that publishes the accounts without developing the underlying reasoning regarding the analyzed tax. Regarding the example 13B on banking tax, members arrive at different understandings on the point of time and the amount of the provisions that should be recognized under this guidance.

In particular, these examples do not address:

- Cases where there is a gap of more than one year between the tax base period (X-2 or more) and the levy due date (X)
- Cases where the IASB envisages the provisioning of several years of taxes in advance (e.g. for certain temporary levies that cover a number of years), and
- The consistency between different taxes:
 - For certain taxes (example 13C - property tax), the conjunction of owning the asset and the tax's due date could lead to the conclusion that it is the latter that triggers the need to provision.
 - For other taxes (example 13B - bank tax), the accounting primarily relies on having engaged in banking activity (action 1). Some banks are concerned this may lead to provisioning



several years of taxes if the same entity does not have the practical ability to avoid performing this same action (i.e., banking activity) in subsequent years (assuming the tax calculation bases are sufficiently stable and predictable). Other banks understand that the provision is recognized progressively from the start of the year so that, by year-end, the best estimate of the expected tax payment is fully recorded but only for that year

Finally, considering the diversity of taxes worldwide, a clarification on the treatment/reasoning to be adopted during interim closings should be systematically presented (existence of the obligation and whether to recognize a provision or not).

Question 7—Other comments

On our view, EFRAG's cover letter should be reviewed, once agreed with the main contents of the detailed letter. In particular, we note that currently it states that it is not a fundamental revision of IAS 37 but rather targeted improvements with the aim of clarifying current requirements, reducing diversity and changing the timing of recognition of some provisions.

We believe a better depiction would be to state that some of these amendments address the current inconsistency between the Conceptual Framework, IAS 37 and IFRIC 21 regarding the timing of recognition of some provisions, which could have a significant impact for certain sectors such as banking.



About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 20 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. Advocating for a proportionate approach to banking rules, ESBG unites at EU level some 873 banks, which together employ 610,000 people driven to innovate at 41,000 outlets. ESBG members have total assets of € 6,38 trillion, provide € 313 billion in loans to SMEs, and serve 163 million Europeans seeking retail banking services. ESBG members commit to further unleash the promise of sustainable, responsible 21st century banking.

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Published by ESBG. February 2025