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Update on the activity of the IFRS Interpretations Committee

Objective

1 The objective of this paper is to provide, for information purposes, a summary of the main open issues discussed by the IFRS Interpretations Committee (the 'IFRS IC').

2 The paper focuses on the issues that are still 'open' at the date of the summary, that is, matters that have not yet led to final decision by the IFRS IC.

3 The purpose of the presentation is to raise EFRAG TEG's and EFRAG CFSS's awareness on the issues being discussed at the IFRS IC and possible interactions with EFRAG's commenting activities and future standard setting. The session is not intended, however, to respond to the IFRS IC tentative decisions. Therefore, the paper does not contain EFRAG Secretariat's initial views on the issues and does not seek EFRAG TEG's nor EFRAG CFSS's technical assessment on the matters.

4 If EFRAG TEG or EFRAG CFSS express the wish to further discuss any of the presented issues, a session could be organised at a future meeting.

Overview of IFRS IC's current activity

5 The items marked in green were discussed by the IFRS IC since the last TEG CFSS meeting. The topics marked in orange are expected to be discussed in the next IFRS IC meeting.

Project **(including hyperlinks to the IASB project pages for each item)**	**Related Standards**	**Current status**	**Next milestone**	**Expected date**
Ongoing consultations regarding tentative agenda decisions				
Cash received via an electronic transfer system	IFRS 9	Consultation on tentative AD until 25 Nov	Tentative Agenda Decision Feedback	Q1/2022
Demand deposit with restrictions on use	IAS 1/IAS 7	Consultation on tentative AD until 25 Nov	Tentative Agenda Decision Feedback	Q1/2022
Tentative Agenda Decision Feedback				
Economic Benefits from Use of a Windfarm	IFRS 16	Consultation on tentative AD ended 16 August	Tentative Agenda Decision Feedback	Nov 2021

Project (including hyperlinks to the IASB project pages for each item)	**Related Standards**	**Current status**	**Next milestone**	**Expected date**
TLTRO III Transactions	IAS 20, IFRS 9	Consultation on tentative AD ended 16 August	Tentative Agenda Decision Feedback	Nov 2021
Finalised AD subject to IASB approval				
Accounting for Warrants that are Classified as Financial Liabilities on Initial Recognition Accounting for Warrants that are Classified as Financial Liabilities on Initial Recognition	IAS 32	Finalised Oct 21		
Non-refundable Value Added Tax on Lease Payments Non-refundable Value Added Tax on Lease Payments	IFRS 16	Finalised Oct 21		
Items for future consideration				
Principal versus agent: IT resellers	IFRS 15			Not specified
Accounting for rent concessions by lessors and lessees	IFRS 9 IFRS 16			Not specified
Deficits in low/new energy vehicle credits	IAS 37			Not specified

Ongoing consultations regarding tentative agenda decisions

Cash received via an electronic transfer system

6 There are diverse views on when to recognise cash received via electronic transfer as settlement for a financial asset, where the electronic transfer system has a formal automated settlement process which takes more than one day to complete.

Fact pattern

7 Entity A's year-end is 31 December 20X0. In November 20X0, Entity A sells goods to Entity B and recognises a trade receivable of CU100. On 31 December 20X0, Entity B notifies Entity A that it has initiated the payment of CU100 by the UK BACS payment system to settle the amount due. On 2 January 20X1, Entity A receives CU100 into its bank account as cleared funds.

8 The question raised is: Is it acceptable for Entity A to recognise cash of CU100 (and derecognise the trade receivable) on 31 December 20X0?

9 The IFRS Interpretations Committee confirmed the IASB Staff view and tentatively decided not to add a standard-setting project to the work plan. In the IASB Staff view, both the trade receivable settled and the cash received are financial assets in the scope of IFRS 9. As a consequence:

- Entity applies derecognition requirements in IFRS 9 in determining when to derecognise the trade receivable.

- Entity applies initial recognition requirements in IFRS 9 in determining when to recognise cash as a financial asset.

10 This is different from the assumption underlying both views set out in the submission that no IFRS Standard specifically applies to the transaction, and consequently that the entity would develop an accounting policy applying paragraphs 10–11 of IAS 8.

11 The IASB Staff further provides the following analysis:

- Apply paragraphs 3.2.3 and 3.1.1 of IFRS 9 to determine when to derecognise the trade receivable and recognise cash as a financial asset, respectively. 3.1.2 of IFRS 9 is not applicable as there is no financial asset sale or purchase.
- Derecognise trade receivable on the date on which its contractual rights to the cash flows from the trade receivable expire and recognises the cash (or another financial asset) received as settlement for that trade receivable on that same date.
- Consider particular facts and circumstances—including the applicable laws and regulations and the characteristics of the electronic transfer system—in determining whether its contractual rights to the cash flows from the trade receivable expire on receipt of cash on the transfer settlement date, or earlier upon initiation of the cash transfer by the customer (or any date in between).

Demand deposit with restrictions on use

12 There are diverse views on whether amounts held in a demand deposit should be presented as cash in the statement of financial position and the statement of cash flows when the entity is prevented from using the amounts to meet short-term cash commitments. The preliminary agenda decision on the topic of "Demand deposit with restrictions on use" is likely to be of high practical relevance.

Fact pattern

13 This submission considers a situation where the entity is required as a condition of the sale of a business to keep a specified amount of cash on deposit to indemnify the purchaser for potential warranty claims extending over several years. The entity (seller) has deposited the specified amount in a separate demand deposit account. The terms of the demand deposit account itself do not impose conditions restricting its use (i.e., if the entity requested the amount from the bank, it would obtain the amount immediately).

14 The question raised is: Should the specified amount in a separate demand deposit account be presented as cash and cash equivalents on the statement of financial position (IAS 1.54(i)) and on the statement of cash flows?

15 The IFRS Interpretations Committee tentatively decided not to add a standard-setting project to the work plan.

Inclusion as cash and cash equivalents in the statement of cash flows:

16 IAS 7 *Statement of Cash Flows* paragraph 6 includes a definition of cash. Cash ‘comprises cash on hand and demand deposits.’ IAS 7 includes no other requirements on whether an item qualifies as cash beyond the definition itself. As indicated in IAS 7 and IAS 1 *Presentation of Financial Statements* amounts included in cash and cash equivalents may be subject to restrictions.

17 The IFRS IC concluded that restrictions on use of a demand deposit arising from a contract with a third party do not result in the deposit no longer being cash, unless those restrictions change the nature of the deposit in a way that it would no longer meet the definition of cash in IAS 7.

18 Entity holds amounts in a demand deposit (see fact pattern), which meets the definition of 'cash' in paragraph 6 of IAS 7. The entity has a contractual obligation to use the amounts held in that demand deposit only for the purpose of indemnifying the buyer for future potential warranty claims. That contractual obligation does not change the nature of the asset the entity holds: the asset is a demand deposit because there are no restrictions on the entity's ability to access—on demand—amounts held in the deposit account.

19 The contractual obligation restricts only the purpose for which the entity can use that asset. Therefore, the entity would include the demand deposit as a component of 'cash and cash equivalents' in its statement of cash flows.

Presentation in the statement of financial position:

20 Applying paragraphs 54(i)1 and 55 of IAS 1, the entity presents the demand deposit with restrictions on use as cash and cash equivalents in its statement of financial position, unless presenting it separately in an additional line item is relevant to an understanding of the entity's financial position.

21 However, if the demand deposit is restricted from being used to settle a liability for at least twelve months after the reporting period, then it would be presented as a non-current asset.

Disclosures

22 Applying paragraphs 45 and 48 of IAS 7, the entity discloses the components of cash and cash equivalents and—together with a commentary by management—the amount of significant cash and cash equivalent balances held by the entity that are not available for use by the group.

23 The entity would also consider whether to disclose additional information in the context of the requirements in IFRS 7 about liquidity risk arising from financial instruments and how an entity manages that risk.

Tentative Agenda Decision Feedback

24 Both topics were not discussed in the IFRS IC September meeting. They are included here as they will be discussed in the upcoming IFRS IC Meeting in November.

Economic Benefits from Use of a Windfarm (IFRS 16)

What is the issue?

25 The IFRS IC received a request as to whether a power purchase agreement (PPA) in a gross pool electricity market is, or contains, a lease as defined in IFRS 16 Leases that is whether applying paragraph B9(a) of IFRS 16 Leases, the customer has the right to obtain substantially all the economic benefits from use of an identified asset.

26 In the specific submission, a windfarm generator (supplier) enters into a PPA with a customer, both of which are registered participants in a gross pool electricity market.

27 The PPA identifies a windfarm owned by the supplier that will be used to supply all the produced electricity to the grid in a gross pool electricity market; over a 20-year period. The customer has agreed to pay a fixed price per megawatt for the volume of electricity produced and supplied by the windfarm over the term of the PPA and is exposed to the price risk.

28 In the gross pool electricity market, a market operator determines the spot price for each 30-minute interval during the trading day and calculates for each participant (suppliers and customers) the amount receivable and payable, by applying the relevant spot price to the metered amount for each 30-minute interval.

29 The PPA swaps the spot price per megawatt of electricity supplied by the windfarm to the grid for a fixed price per megawatt and is settled net in cash. This means that the supplier receives a fixed price per megawatt for the electricity it supplies to the grid and the customer settles with the supplier the difference between that fixed price and the spot price per megawatt for that volume of electricity.

30 The customer also expects to purchase at least the volume of electricity the windfarm produces.

31 The PPA also transfers to the customer all renewable energy credits related to the production of electricity by the windfarm.

32 The submitter asks IFRS IC to clarify whether the retailer obtains substantially all the economic benefits from the use of the asset (windfarm) as part of the assessment under IFRS 16.

IFRS IC tentative conclusions (June 2021)

33 The IFRS IC concluded that, in the fact pattern described in the request, the customer does not have the right to obtain substantially all the economic benefits from use of the windfarm (e.g., the electricity generated). Consequently, the contract does not contain a lease.

34 The IFRS IC concluded that the principles and requirements in IFRS Standards provide an adequate basis for a customer that enters into an agreement as described in the request to determine whether it has the right to obtain substantially all the economic benefits from use of an identified asset. Consequently, the IFRS IC [decided] not to add a standard-setting project to the work plan.

TLTRO III Transactions (IFRS 9 and IAS 20)

What is the issue?

35 The IFRS IC received a request from the European Securities and Markets Authority on the accounting for the European Central Bank's (ECB) provision of financing to credit institutions under the ECB's third targeted longer-term refinancing operations (TLTROs) programme.

36 The amount that banks can borrow under the TLTRO programme is linked to their loans to non-financial corporations and households. By offering banks long-term funding at attractive conditions, they stimulate bank lending to the real economy. Upon meeting certain lending performance thresholds bank can receive loan at reduced interest rates. Also, during 2020, some of the transaction parameters were modified due to disruptions and temporary funding shortages associated with the COVID-19 pandemic.

37 Two views are expressed:

(a) View 1: TLTRO III transactions are loans at a below-market interest rate and include benefits which are treated as government grants according to IAS 20;

(b) View 2: TLTRO III transactions are accounted for as loans at a market interest rate according to IFRS 9.

38 ESMA observes a diversity in practice regarding the accounting for a variety of issues that accompany such a transaction (i.e., accounting for below market interest rates using IFRS 9 or IAS 20) and invites the IFRS IC to clarify the applicable requirements.

IFRS IC tentative conclusions (June 2021)

39 The IFRS IC concluded that if the bank determines that the TLTRO III tranches contain a government grant in the scope of IAS 20, the requirements in IAS 20 provide an adequate basis for an entity to determine how to account for that government grant.

40 With respect to the question of whether conditions attached to the interest rate should be reflected in the estimates and revisions of expected future cash flows when determining the effective interest rate, the IFRS IC concluded that the matters described in the request are part of a broader matter that, in isolation, are not possible to address in a cost-effective manner and should be reported to the IASB Board. The IASB Board should consider this matter as part of the post-implementation review of the classification and measurement requirements in IFRS 9.

41 For these reasons, the IFRS IC [decided] not to add a standard-setting project to the work plan.

Finalised AD approved by the IASB

Accounting for Warrants that are Classified as Financial Liabilities on Initial Recognition

What is the issue?

42 In the fact pattern a warrant provides the holder with the right to buy a fixed number of equity instruments (of the issuer) for an exercise price that will be fixed at a future date. There are three views in practice.

43 Applying IAS 32.16 at initial recognition, the variability in the exercise price results in the issuer classifying these instruments as financial liabilities. That is, it does not meet the fixed-for-fixed condition. This request asked whether it is possible for the issuer to reclassify a warrant as an equity instrument following the fixing of its exercise price after initial recognition –given that the fixed-for-fixed condition would be met at that stage.

IFRS IC conclusions

44 The IFRS IC tentatively decided that the matter, in isolation, is too narrow to be answered. On the other hand, they believe that the broader issues of reclassifying financial instruments are better addressed as part of the IASB's *Financial Instruments with Characteristics of Equity* (FICE) project.

45 Eight comment letters were received.

46 Six respondents (Deloitte, the Malaysian Accounting Standards Board, the Institute of Chartered Accountants of India, the Institute of Chartered Accountants of Nigeria, David Hardidge and Petrobras) agree with the IFRS IC's decision for similar reasons to those of the IFRS IC.

47 Two respondents, the Group of Latin American Standards Setters and Consejo Mexicano de Normas de Información Financiera (Mexican Standard Setter), agree with the decision as they consider that IAS 32 already adequately address the fact pattern as described by referring to paragraphs 16E to 16F (paragraphs relating to 'puttable instruments' that are not allowed to be applied by analogy per IAS 32).

48 The IFRS IC considered feedback on the tentative agenda decision and confirmed the decision. The IASB did not object to this agenda decision.

Non-refundable Value Added Tax on Lease Payments

What is the issue?

49 The submission received addresses how to account for non-refundable value-added tax (VAT) charged on lease payment: does a lessee include non-refundable VAT as part of the lease payments for a lease under IFRS 16 Leases?

50 In the fact pattern present local VAT legislation requires sellers to collect VAT and remit amounts to the government. In addition, purchasers are generally allowed to recover from the government VAT charged on payments for goods or services, including leases. Because of the nature of the lessee's operations the entity is unable to recover all of the VAT charged.

IFRS IC conclusions

51 The IASB Staff concluded that the non-refundable VAT should be excluded from the measurement of the lease liability. The staff suggested not explaining the accounting treatment lessees apply to it because its impact is not material nor widespread. Most of the IFRS IC members tentatively agreed with the accounting conclusion but some of the members were not convinced that the matter is not material nor widespread based on the limited outreach performed by the staff.

52 Based on the feedback received, the IASB Staff analysed although many respondents stated that fact patterns in the tentative agenda decision is widespread, they did not report observing significant diversity in the accounting lessees apply, nor do they report that the matter is generally material for affected lessees. Most respondents agreed with the IFRS IC's tentative agenda decision not to add a standard-setting project to the work plan. However, some of them expressed different views on the accounting treatment and suggested the agenda decision should explain it. The IASB Staff concluded that little additional evidence exist that the issue under consideration has widespread effect and has, or is expected to have, a material effect on those affected.

53 The IASB Staff considers that it is not the role of the IFRS IC to undertake technical analysis and provide explanatory material in ADs when the Committee has obtained insufficient evidence that the matter has widespread effect and has, or is expected to have, a material effect on those affected.

54 The IFRS IC considered feedback on the tentative agenda decision and confirmed the decision. IASB Staff recommended to finalise the AD as published in March (with only minor editorial improvements); that is:

(a) Without including explanatory material as to how an entity accounts for non-refundable VAT.

(b) Indicating simply that the IFRS IC decided not to add a standard-setting project to the work plan because there was insufficient evidence that the matter has widespread effect and has, or is expected to have, a material effect on lessees affected.

55 The IASB did not object to this agenda decision.

Items for future consideration

Principal versus agent: IT resellers (IFRS 15)

56 The issue concerns all IT service providers worldwide who sell software licences to B2B customers under indirect contracts.

57 The submission deals with the question whether, when software licences are sold by third parties, i.e., by IT service providers or IT system houses, the respective third party is to be classified as principal or agent. Doubts arise especially with respect to contract models in which the third party is a value-added reseller and directly performs complex and extensive consulting services in advance within the scope of the contractually agreed performance (so-called indirect contract models).

58 The distinction made between the role of the principal and that of the agent of an entity has significant consequences for the presentation of the revenue in the income statement.

59 The question raised is: Should the value-added reseller in the indirect contract model be regarded as the principal or as the agent?

View 1: The Value-Added Reseller is the Principal

60 According to IFRS 15.24, the value-added reseller identifies the sale of a software licence as a promise in the customer contract. Moreover, the value-added reseller identifies the pre-sales consulting as an implicit promise to the customer pursuant to IFRS 15.24.

61 In summary, the following applies to the indirect contract model in the field of software licensing involving a value-added reseller (in accordance with IFRS 15 BC116J and the next paragraphs).

(a) The customer benefit only arises from the interaction or combination of the individual promises.

(b) From the perspective of the customer, the promise largely represents a single performance (= provision of a suitable and legally secure software solution).

(c) The consulting service directly and greatly influences the licence (and vice versa). Thus, consulting risks also give rise to licence risks. The value-added reseller bears the risk for the entire service package and may be held liable accordingly.

(d) The consulting thus has a significant impact on the customer benefit.

62 The value-added reseller comes to the conclusion that pre-sales consulting represents an implicit (significant) promise to the customer. The performance consists, not only of the sale of the standard software licence, but of a combined performance bundle comprising the standard software licence and the qualified consulting services of the value-added reseller.

View 2: The Value-Added Reseller is an Agent

63 This deviating interpretation of IFRS 15 does not assume the existence of a significant integration performance in the indirect business if the main purpose of the consulting service is to fulfil the licensing requirements of the software vendors.

64 The view that a pure agency activity is on hand is supported by the fact that in the context of the sale of standard software licences in the indirect business, a direct contractual relationship is instituted between the customer and the software vendor in addition to the contractual relationship between the customer and the value-added reseller and until then, the value-added reseller does not control the software licence. In this context, the pre-sales consulting would be regarded as a pure sales service on the part of the value-added reseller.

65 This reasoning can be supported as follows:

(a) The consulting service of the value-added reseller aims primarily at the software vendor’s interest in due licensing.

(b) Compared to the value of the standard software licence, the pre-sales consulting overhead and the gross margin usually accounts for a minor share.

(c) Pre-sales consulting is provided even in cases in which the sale ultimately does not materialise. Thus, pre-sales consulting services are offered even without remuneration.

(d) A customer who knows which contract model would be suitable and how many standard software licences he or she needs would not gain any added value from the pre-sales consulting.

Conclusion

66 After considering the two views, the submission summarises that the licence is not sold alone, but as a combined performance bundle consisting of the licence and the qualified advice of the value-added reseller (i.e., a customer-specific licensing

solution) for which the value-added reseller is responsible. The value-added reseller is the principal in the indirect contract model and presents the entire trading revenue.

Accounting for rent concessions by lessors and lessees (IFRS 9/16)

67 Reductions in lease payments (rent concessions) are sometimes granted to lessees by lessors without changing other terms of the lease contract. The number of such payment reductions has become increasingly common since the start of the covid-19 pandemic. There is currently diversity in the accounting for rent concessions for operating leases on the lessor's side and for all types of leases on the lessee's side.

Fact pattern

Lessor: Accounting treatment of a voluntary forgiveness of lease payments

68 The submitter has identified diversity as to how lessors account for rent concessions in case of a voluntarily forgiveness of lessees' past lease payments.

(a) Some lessors account for as lease modification applying paragraph 87 of IFRS 16 (modification as a new lease from the effective date of the modification). The loss resulting from the rent concession is allocated over the remainder of the lease term.

(b) Other lessors apply derecognition requirements of IFRS 9 to their lease receivables in these circumstances (recognition of an immediate loss equal to the receivable's carrying amount in the period when the concession is granted).

View 1: Treatment as lease modification under IFRS 16

69 A voluntary reduction of lease payments granted by the lessor – if material – meets the definition of a lease modification in IFRS 16 (lease modification is a change in the scope of a lease or the consideration for a lease, that was not part of the original terms and conditions of the lease). A forgiveness of the past lease payments (not required by law or foreseen in the contract) meets this definition.

70 Paragraph 87 of IFRS 16: contract modification is accounted for as a new lease from the effective date of the modification. Considering any prepaid or accrued lease payments relating to the original lease as part of the lease payments for the new lease, the granted concession is spread over the remaining term of the contract, reducing future lease payments.

71 Paragraph 81 of IFRS 16: lease payments from operating leases shall be recognised as income on a straight-line-basis (or other rational basis) which represents the pattern in which benefit from the use of the underlying asset is diminished.

72 In effect the effect of a rent concession will be spread over the remaining lease term reducing future lease income.

View 2: Derecognition of the operating lease receivable according to IFRS 9

73 While in accordance with paragraph 2.1(b) of IFRS 9 rights and obligations under leases to which IFRS 16 applies are in general excluded from the application scope of IFRS 9, subsection (i) of this paragraph states that operating lease receivables are subject to derecognition and impairment requirements of IFRS 9 (see also IASB's educational guidance "IFRS 16 and covid-19": "If a change in lease payments results in the extinguishment of a part of a lessee's obligation specified in the contract (for example, a lessee is legally released from its obligation to make specifically identified payments), the lessee would consider whether the requirements for derecognition of a part of the lease liability are met applying paragraph 3.3.1 of IFRS 9 Financial Instruments.").

74 Regarding lessors' lease receivables, paragraph 3.2.3 of IFRS 9 requires derecognition of a financial asset when the contractual rights to the cash flows from this financial asset expire. Paragraph 3.2.12 of IFRS 9 on derecognition of a financial asset states that the difference between the carrying amount (measured at the date of derecognition) and the consideration received shall be recognised in profit or loss. Under this accounting treatment, the concession would be recognised as a loss in the income statement, with a corresponding reduction to the lease receivable in the period in which the reduction is contractually agreed. The lessor will continue to recognise the unchanged amount of lease income over the lease term.

View 3: Accounting policy choice to apply IFRS 9 or IFRS 16

75 Given the uncertainty as to which requirements apply to a voluntary reduction of past lease payments, entities have an accounting policy choice to apply either the requirements of IFRS 9 or IFRS 16

Lessor: Calculation of an impairment allowance for the lease receivable when the lease liability is expected to be forgiven

76 The submitter has identified diversity as to how lessors estimate impairment losses when they expect to forgive part or all of the outstanding lease receivable after end of period. Diversity in how an expected future forgiveness of past lease payments is accounted for is also linked to issue beforementioned above.

77 Supporter of view 1 argue that the application of IFRS 16 guidance on accounting for lease modifications precedes the application of the impairment requirements to the lease receivable due to paragraph 87 of IFRS 16 (modification from the effective date of the modification). The expected forgiveness of past payments will not be included in the assessment of the expected credit losses on the lease receivable. Hence, when calculating the expected credit losses on the lease receivable, it should not be assumed that the concession may be granted. This argumentation is also shared by some proponents of views 2 and 3.

78 Supporter of views 2 and 3 point out that the impairment requirements of IFRS 9, which are applicable to operating lease receivables according to paragraph 2.1(b)(i) of IFRS 9, stipulate the use of reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions (paragraph 5.5.17(c) of IFRS 9). In their opinion, expectations regarding forgiveness should be taken into account when calculating the impairment at the reporting date.

Lessee

79 The submitter notes that lessee accounting for a voluntary forgiveness of a lease liability granted by the lessor appears also results in diversity, if the lessee does not take advantage of the optional relief from applying IFRS 16 lease modification requirements for rent concessions arising as a direct consequence of the COVID-19 pandemic

View 1: Treatment as lease modification under IFRS 16

80 Proponents of view 1 support the application of the guidance in IFRS 16 on lease modification accounting. In accordance with paragraph 45(c) of IFRS 16, this leads to a remeasurement of the lease liability by discounting the revised lease payments using a revised discount rate on the modification date.

View 2: Derecognition of the lease liability according to IFRS 9

81 Since paragraph 2.1(b)(ii) of IFRS 9 requires the derecognition principles of IFRS 9 to be applied to lease liabilities recognised by the lessee, proponents of view 2 argue that applying paragraph 3.3.1 of IFRS 9 to the lessee's lease liability, it shall be

(partly) derecognised as a result of the voluntary forgiveness by the lessor and, therefore, no revision of the discount rate is required.

View 3: Accounting policy choice to apply IFRS 9 or IFRS 16

82 Proponents of view 3 believe that entities have an accounting policy choice to apply either IFRS 9 or IFRS 16

Deficits in low/new energy vehicle credits (IAS 37)

Fact pattern

83 In 2018 new regulatory measures to promote energy efficient and new energy cars (the "Measures") were introduced. Entities sign an annual commitment to reiterate that they will comply with the applicable laws and regulations, as well as the Measures.

84 A Passenger Vehicle Enterprise (PVE or entity) can

(a) either produce/import traditional energy cars more efficient than the standard set by government, or

(b) produce/imported a higher number of new energy vehicles than the target proportion of cars, receives positive credits, or

(c) otherwise receive negative credits.

85 Entities with net negative credits are required to purchase positive credits generated by other PVEs from the market to reduce the negative credits to zero. Those cannot be sold or carried over to subsequent years. If the credit balance is negative:

(a) The entity may potentially be impeded in any and all activities connected with government authorities (e.g., tax exemption applications, capacity expansion approvals, import inspections, etc.).

(b) The entity is required to submit a remedial plan for vehicle production/imports for the subsequent year to generate sufficient positive credits to offset the deficit for the year.

(c) The Government may disapprove the entity's applications for the launch of any new vehicle models.

86 Many of the PVEs that expected or faced actual deficits, have purchased credits from other PVEs via trading platform in order to offset the deficit.

87 The questions raised are: does a deficit position create a legal liability or constructive obligation under IFRS as of the end of a reporting period? If not, would a legal liability or constructive obligation under IFRS be created, if the PVE has entered into a binding contract with another PVE to purchase positive credits which will be settled after the end of the reporting period before the reporting end?

Legal liability or constructive obligation?

View 1: No, the deficit position is neither a legal liability nor a constructive obligation.

88 Criteria for the recognition of a provision under IAS 37.14(a) are not met as the entity can avoid the future expenditure by its future actions (no present obligation). According to IAS 37.19, only those obligations arising from past events existing independently of an entity's future actions (i.e., the future conduct of its business) should be recognised as provisions.

89 A past pattern of practice to purchase credits does not create any constructive obligation. As the measures allow an entity to submit a remedial plan and avoid purchasing credits, it is unreasonable for the Government or other parties to have a valid expectation that the entity will not use this avenue in the future. The

commitment letter reiterates that the entity will comply with the applicable laws and regulations as well as the Measures but it does not extend beyond these requirements.

90 IFRIC 21.9 specifies that “an entity does not have a constructive obligation to pay a levy that will be triggered by operating in a future period as a result of the entity being economically compelled to continue to operate in that future period”. The Interpretations Committee further clarified in IFRIC 21.BC17 that “when an entity is economically compelled to incur operating costs that relate to the future conduct of the business, that compulsion does not create a constructive obligation and, thus, does not lead to the entity recognising a liability”. (argumentation by analogy).

91 No financial penalty for the uncompensated negative credits, therefore the deficit balance is neither a legal liability nor a constructive obligation to the Government or another party for the PVE. The deficit will not directly result in an outflow or transfer of economic resources. Measures also allow other ways for remediation; thus the entity is not forced to pay penalties. The result of non-compliance will only impact the future operations of the entity.

View 2: Yes, the deficit is a constructive obligation.

92 The deficit has created a duty or responsibility that the PVE has to transfer economic resources which it has no realistic alternative to avoid. (indirect economic penalties such as economic losses from losing new car model business without government approval).

93 Adjusting (future) production/ importation plans is very costly and may take a longer period beyond the subsequent year which would not help to address the deficits in a timely manner. The economic penalties can only be avoided by purchasing credits to compensate negative credit balances which results in an outflow of economic resources.

94 Furthermore, closing down the business is not economically reasonable and not a realistic alternative. There is no guidance on assessing whether an alternative is realistic. In this fact pattern, given the high economic penalties potentially involved and the disruption resulting from adjustments to operations, submitting a remedial plan and adjusting the operation of the entity are considered unrealistic.

95 While the settlement of the obligation (negative credit balance) by purchasing positive credits cannot be enforced by law and it is therefore not a legal obligation, a constructive obligation would be created by past practice or sufficiently specific communication to affected parties.

96 The relevant party is the Government and the citizens together with the PVEs which have positive credits for sale. Such valid expectation to compensate existing deficits by purchasing credits from third parties has been created by the PVE’s purchases of credits to offset against the deficit. The signed commitment letter and the purchases of credits in previous years that have established a pattern of past practice give rise to a constructive obligation (similar to Example 2B of the implementation guidance in IAS 37 Provisions, Contingent Liabilities and Contingent Assets; published policy to clean up contamination it causes and there is a record of honouring it).

97 In measuring the obligation, the best estimate is determined considering the net negative credits created and, thus, the expected total number of positive credits to be purchased for a given year at each reporting date.

Legal liability or constructive obligation for binding contract

View 1: Yes, a liability is recognised

98 By entering into the binding contract (to purchase credits) with another party a present legal obligation is created.

99 As there are no future economic benefits associated with the credits other than to settle the deficit, the contract to purchase the credits in combination with the deficit meets the definition of a provision under IAS 37.14.

100 The entity has no possibility to avoid an outflow of economic resources caused by the past events, i.e. a deficit and the purchase of credits with no alternative use than to settle the deficit.

View 2: No, there is neither a legal liability nor a constructive obligation.

101 When the credits are not transferred to the entity prior to the reporting date, there is no direct accounting consequence, as the contract (to acquire credits) is executory at the reporting date.

102 Proponents of this view believe that the purchase of credits provides the economic benefits of maintaining the production/ import plans for the following year without changes. (onerous provision only to the extent the cost of fulfilling the contract exceed the cost of changing the production/import plans for the following year).

103 Purchased and received credits should be recognised as an acquired other asset/prepayment which will be derecognised through the income statement once the respective rights are used to settle the negative credit balances.

Questions for the EFRAG CFSS and EFRAG TEG members

104 Do you have any comments on the topics presented?

105 Do you wish to further discuss any of the presented issues at a future meeting?