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TRANSACTIONS OTHER THAN EXCHANGES OF EQUAL VALUE

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DISCUSSION PAPER

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Foreword

This Discussion Paper is issued by the European Financial Reporting Advisory Group (EFRAG) as part of its Research activity. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. EFRAG carries out this research work in partnership with National Standard Setters in Europe to ensure resources are used efficiently and to promote stronger coordination at the European level. Four strategic aims underpin proactive work:

- engaging with European constituents to ensure we understand their issues and how financial reporting affects them;
- influencing the development of global financial reporting standards;
- providing thought leadership in developing the principles and practices that underpin financial reporting; and
- promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our research activities and current projects is available on the EFRAG website [add link].

DISCLAIMER

EFRAG, while encouraging debate on the issues presented in the paper, does not express any opinion on those matters at this stage.

Copies of the Discussion Paper are available from the websites of those bodies issuing it. A limited number of copies of the Discussion Paper will also be made available in printed form, and can be obtained from EFRAG.

The paper invites comment on its proposals via the 'Questions for Respondents' contained in pages [XX].

Such comments should be submitted by [DATE] using the 'Express your views' page on EFRAG website by clicking [here-insert hyperlink] or should be sent by post to:

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All comments received will be placed on the public record unless confidentiality is requested.

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Executive Summary

1 [To be completed after the TEG discussion]

QUESTIONS TO CONSTITUENTS

EFRAG invite comments on all matters in this Discussion Paper, particularly in relation to the questions set out below. Comments are more helpful if they:

a) address the question as stated;

b) indicate the specific paragraph reference, to which the comments relate; and/or

c) describe any alternative approaches EFRAG, [other National Standard Setters] should consider.

All comments should be received by [Submission date].

[To be completed]

Chapter 1: Objective of the project

The project is based on the premise that certain transactions pursue a 'societal objective' which could justify an accounting treatment different from the treatment applied to purely commercial transactions. In some cases, the accounting outcome could be the same as under the current requirements, but the approach in the paper attempts to provide a conceptual approach for the outcome.

Why is this research undertaken?

1.1 The *Conceptual Framework for Financial Reporting ('Conceptual Framework')* does not contain concepts that specifically address 'non-reciprocal' transactions – transactions in which an entity gives (or receives) value from another entity without directly receiving (or giving) approximately equal value in exchange. In its deliberations on the revised *Conceptual Framework*, the IASB confirmed that it was not its intention to develop such concepts. The *Conceptual Framework* is based on the implicit notion that reporting entities are market participants that take rational decisions in order to maximise their benefits. Therefore, the *Conceptual Framework* may not be fit to provide guidance on transactions within the scope of this project.

1.2 During the IASB 2016 Agenda Consultation, some constituents identified non-reciprocal transactions as an area requiring attention by the IASB. These constituents identified different transactions, including income taxes, levies, and government grants as examples of transactions in which the non-reciprocal nature of the transactions contributed to the difficulties in accounting for them. They noted that these transactions may have characteristics that could warrant a specific accounting treatment. The IASB finally decided not to add this project to its agenda as it was not persuaded that grouping these topics would allow to find a common solution.

1.3 A vast array of such transactions exist and a number of IFRS Standards deal with them on a particular basis. For instance:

a) IAS 12 *Income Taxes* deals with the recognition and measurement of income taxes including tax incentives;

b) IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* deals with the accounting for grants, forgivable loans or low interest/interest-free loans;

c) IAS 41 *Agriculture* dealt with grants associated with biological assets;

d) IFRIC 21 *Levies* and IFRIC 6 *Liabilities Arising from Participating in a Specific Market* address the accounting for levies in the financial statement of the entity paying them.

1.4 A number of concerns could be raised in relation to the existing guidance. First, no all transactions with such characteristics are regulated under existing IFRS Standards. For instance, there is currently no explicit guidance for donations, grants and subsidies from other parties than Government or investment tax credits (excluded from both IAS 12 and IAS 20).

1.5 Furthermore, different recognition models coexist. For instance, IAS 20 essentially aims at matching the period in which a Government grant income is recognised in profit or loss with the related costs for which the grant is intended to compensate. In contrast, the model for grants in IAS 41 requires to recognise unconditional grant as income when the grant becomes receivable and conditional grant when the condition is satisfied. Therefore, investigating whether a comprehensive approach can be identified could be beneficial.

Understanding the problem

1.6 Transactions between independent parties normally have the following features: firstly, entities are willing to enter into the transaction; secondly, it is possible to identify what is exchanged and thirdly, it is assumed that transactions are carried out at arm's length.

1.7 In practice, however, it is possible that one or more of these features may not apply to certain transactions such as transactions other than exchanges of equal value. Transactions other than exchanges of equal value are characterised by the following features:

a) they are imposed, in the sense that entities do not freely elect to enter into the transactions, for example direct and indirect taxes;

b) it may not be possible to identify what good or services are exchanged between the entities involved in the transaction; or

c) the entities do not exchange equal value (or it may not be possible to determine if equal value has been exchanged).

1.8 The features mentioned in paragraph 1.7 may indicate how each of the characteristics could play a role to determine the accounting requirements for transactions other than exchanges of equal value.

1.9 First, the imposed nature of a transaction may justify a change in the timing of the recognition. When the entity does not have full discretion to avoid the outflow of resources, recognition of a future likely transaction does not create the risk of a future reversal (at least, not a reversal contingent only on the entity's decisions).

1.10 Secondly, the non-exchange nature of the transaction may justify a change in the way the cost of a transaction is allocated. Normally, cost is allocated to depict the consumption of the benefits from a transaction, although it may also reflect the reassessment of previously expected benefits (impairment). If the entity does not receive goods or services, or is unable to identify them, then a different approach to cost allocation is needed.

1.11 Thirdly, the exchange of non-equal values may justify a different approach in selecting a measurement basis. However, this discussion paper focuses on recognition issues only.

1.12 Consequently, the nature of transactions other than exchanges of equal value creates difficulties in accounting which could warrant for a specific accounting treatment. The objective of this discussion paper is to consider whether the characteristics of those transactions may justify a different accounting treatment.

Expected effects of the revised Conceptual Framework

1.13 The IASB is expected to issue the revised the *Conceptual Framework* in the first quarter of 2018.

1.14 Under the revised *Conceptual Framework* an asset is defined as a 'present economic resource controlled by the entity as a result of past events'. An entity controls an economic resource if the economic benefits arising from that resource flow to the entity rather than another party. In the revised *Conceptual Framework* the aspect of control does not imply that the resource will produce economic benefits in all circumstances. Consequently, an asset is recognised even when there is a low probability that the asset will generate economic benefits for the entity.

1.15 The revised *Conceptual Framework* proposes a change in the definition of a liability. Under the current proposals, a liability is still recognised only if the entity has a present obligation, but the existence of a present obligation is identified when both the following conditions are met:

a) the entity has no practical ability to avoid the transfer; and

b) the entity has received the economic benefits or conducted the activities that establish the extent of the obligation.

1.16 The new articulation of the present obligation affects the timing and/or pattern of recognition of the liability in some but not all cases. This can be demonstrated with the following two examples for levies which may have different features to the date/period of activity and the date/period of calculation:

a) Example 1 - a levy is imposed to an entity for generating revenue during the year. In this example the measurement period is year 20X1, but the activity date is the date when revenues are first recognised in the following period year 20X2.

b) Example 2 – a levy is imposed to entities for being in operation on the last day of the year. In this case the activity date is the last day of the reporting period.

1.17 In both examples above, the entity does not have the practical ability to avoid the transfer, as the only way to do it would be to stop its operations and in both examples, it is not evident when the entity is receiving the economic benefits:

a) In Example 1, the activities that establish the extent of the obligation is the generation of revenues in the prior year. Therefore, it seems that under the proposals the liability to pay the levy would be progressively accrued during the prior year;

b) In Example 2, it is less clear. Since the amount to be paid is based on a net asset measure at the year-end, it may be argued that recognition would still be deferred until that date as under IFRIC 21. However, it could also be argued that the entity has conducted activities leading to that balance during the full year.

1.18 The forthcoming revised *Conceptual Framework* notes that a present obligation could accumulate over time if the economic benefits are received, or the activities are conducted, over time (if throughout that time, the entity has no practical ability to avoid the transfer).

1.19 Furthermore, it should be noted that the revised *Conceptual Framework:*

a) does not contain concepts that specifically address non-exchange transactions;

b) some types of transaction, an entity may have no practical ability to avoid a transfer if all avoiding actions would have economic consequences significantly more adverse than the transfer itself. However, it would never be sufficient that the management of the entity intends to make the transfer or that the transfer is probable; and

c) the enactment of a law (or the introduction of some other enforcement mechanism, policy or practice, or the making of a statement) is not in itself sufficient to give an entity a present obligation. The entity must have conducted an activity to which a present law (or other present enforcement mechanism, policy, practice or statement) applies.

1.20 This determination of the ‘activities conducted that will or may oblige the entity to transfer an economic resource’ and factors to conclude that an entity has 'no practical ability to avoid' a transfer are subject to interpretations that would depend on the type of transaction under consideration.

1.21 Consequently, the changes expected to be included in the forthcoming revised *Conceptual Framework* may not necessarily provide an obvious answer for the types of transactions considered in this discussion paper. It should be noted that the IASB has tentatively concluded that further guidance would be more appropriately developed if and when the IASB is developing an IFRS Standard for that type of transaction.

Chapter 2: Scope of the project

Scope definition

2.1 For the purposes of this Discussion Paper, Transactions Other than Exchanges of Equal Value (referred to as 'ToEEV') are defined as non-exchange transactions that are either:

a) non-voluntary transactions whereby the entity does not have the discretion to decide whether to enter into the transaction; or

b) voluntary transactions where the intended benefits are not primarily to maximise the proprietary benefits to the resource provider.

2.2 For the purposes of this paper, a non-exchange transactions are defined as transactions in which an entity either receives value from another entity without directly giving approximately equal value in exchange, or gives value to another entity without directly receiving approximately equal value in exchange.

2.3 Often, transactions other than exchanges of equal value involve governments or government bodies in their capacity as such. This characteristic is not essential, but the involvement of the government is an indication that the transaction is pursuing an objective of social welfare.

2.4 Non-voluntary transactions are usually required by law or regulation, and it is often the case that it is harder to determine what is being exchanged as the benefit received is in the form of a wider societal benefit. Types of transactions that would fall into this category are: income taxes, levies and other taxes such as consumption taxes, property taxes, social insurance taxes, emission rights etc.

2.5 Voluntary transaction are transactions into which the resource provider enters freely and are normally subject to stipulations (conditions or restrictions). Types of voluntary transactions are government grants, donations, forgivable or low-interest loans etc.

2.6 Possible indication of the existence of a wider objective is the tripartite nature of the arrangement. Under a grant transaction, the entity is generally receiving resources from one party and providing services to other parties, such as the General Public. In a levy, the entity may be paying consideration to a Government body and receiving services from another party.

2.7 The nature of both voluntary and non-voluntary transactions is such that the non-equal value exchange has an underlying wider objective to provide societal benefits to individuals, households or society. Such societal benefits can include social insurance, social security, social assistance, education, health, military services etc. Transactions other than exchanges of equal value can also be triggered by conducting certain government-imposed social or environmental policies which may not directly relate to the delivery of goods or services but rather observe a particular behaviour.

Scope exceptions

2.8 Majority shareholders have the legal right to direct the entity into a transaction, and for some of these transactions it may be difficult to assess if the consideration exchanged is at arms' length, although in many jurisdictions there may be limitations to the majority shareholders to carry out transactions that are not at arms' length.

2.9 EFRAG decided to exclude these transactions because in this paper the main focus is on the timing and pattern of recognition. The issues around transactions between an entity and its majority shareholders in their capacity, or transactions between entities under common control, are more around the measurement (and, assuming that fair value is selected as the measurement basis, the accounting of the difference between fair value and the consideration exchanged, if any).

2.10 Rate-regulated activities (RRA) as defined in the active IASB project may include some transactions that would fall within the proposed scope. This is because rate regulation may result in exchanges other than equal value, and the objectives may include a societal objective – i.e. regulation of tariffs for essential public goods and services. Considering the upcoming publication of a consultation document by the IASB, EFRAG has decided to exclude RRA from the proposed scope. EFRAG is following the development of the IASB project. Appendix 2 includes a high-level comparison between the model illustrated in this DP and the IASB model for RRA (based on tentative decisions to date).

2.11 EFRAG has also considered the possible interactions of its approach with Income Tax. The application of the proposed approach could change the measurement of income tax, in interim periods compared to the current requirements in IAS 34 *Interim Financial Reporting*. IAS 34 requires an entity to apply the effective income tax rate expected for the year to the result before tax at the interim reporting date.

2.12 Under the proposed approach, income tax would presumably fall in Step 3 (see below) and be recognised in a progressive straight-line pattern over the year. It is difficult to argue that income tax is a transaction-based levy; the taxable basis is profit and it results from an aggregation of transactions. It would be extremely complex to allocate components to specific transactions.

2.13 Having a similar outcome for income tax and recurring levies does not seem conceptually erroneous, since both fund public services provided by governments. However, EFRAG notes that a change to the requirements for interim reporting should probably be considered as part of a broader revision to IAS 12*.* Moreover, it can be argued that current issues around income taxes are more related to measurement – especially for deferred taxes. Appendix 2 considers the possible interactions between the proposed ToEEV model and the current Income Tax accounting.

Chapter 3: The 4-step model

3.1 This chapter includes a description of the proposed accounting approach for ToEEV. In general, the model is based on the following notions:

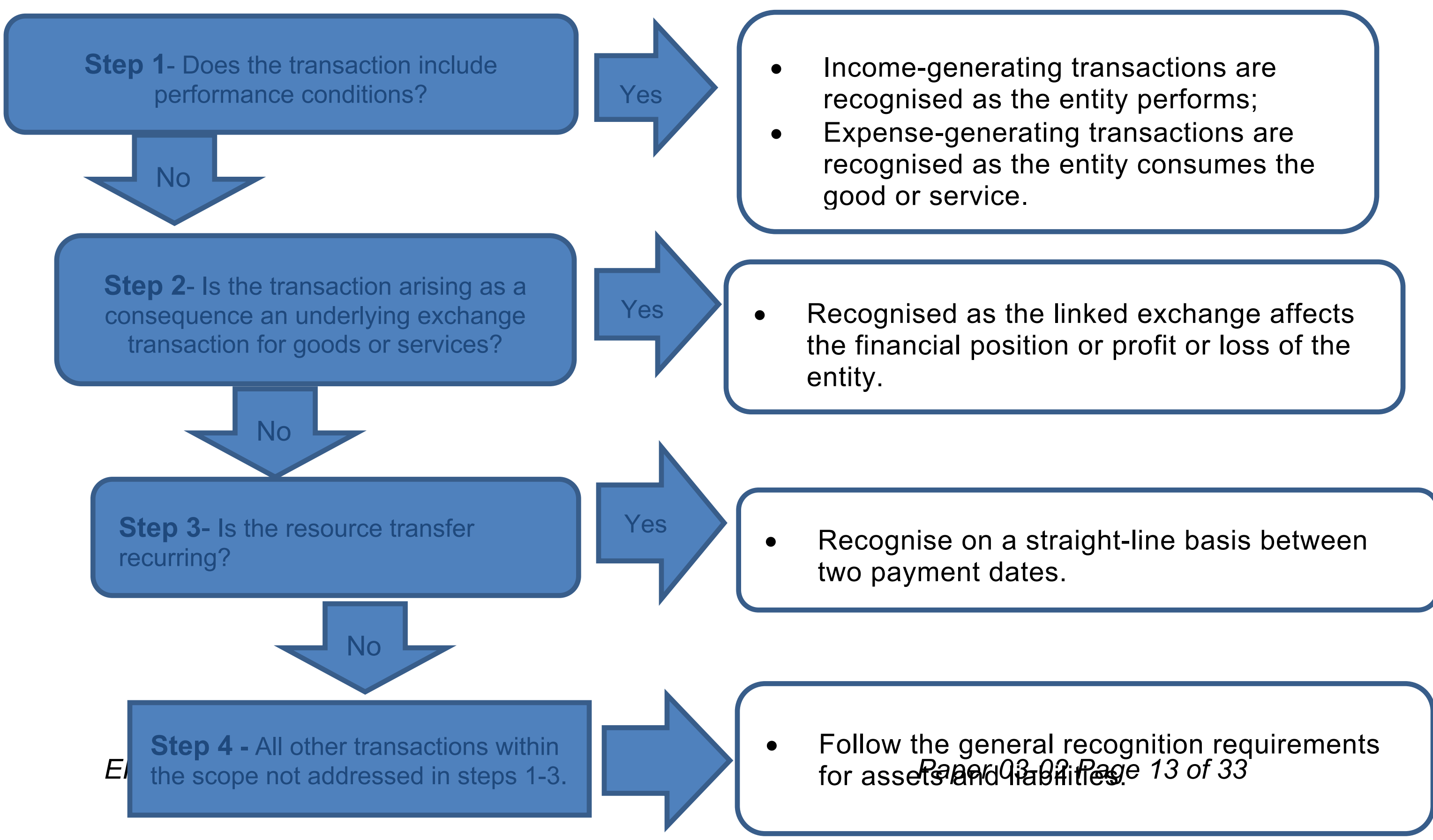
a) Transactions may fall within the proposed scope in full or partially. See paragraph 3.7 below for a discussion on whether a transaction that includes both a ToEEV and a non-ToEEV component should be separated;

b) For transactions within the proposed scope that contain performance conditions or that arises as a consequence of an underlying exchange transaction, the ToEEV transaction is recognised when the performance condition is being satisfied or the underlying transaction occurs – see paragraph 3.15 below for a discussion of the recognition pattern when the underlying exchange affects the financial position and the financial performance differently;

c) For other transactions within the proposed scope that occur on a recurring basis the purpose of 'societal benefit' is used to support a progressive recognition over time.

3.2 Appendix 1 presents a number of examples to illustrate the application of the model – its scope, scope exceptions and proposals. For each fact pattern, EFRAG has also described the existing accounting treatment and how it may change under the forthcoming revised *Conceptual Framework*.

3.3 For clarity, the steps are presented in successive order. For instance, a transaction that meets the characteristics of both the first and second step shall be treated as described under the first step.



First Step

3.4 The first step of the approach applies to those transactions where it is possible to identify performance conditions . In that case, the entity is either paying for an identified good or service, or being compensated to provide one. These transactions are recognised following the usual requirements:

a) income-generating transactions are recognised as the entity performs;

b) expense-generating transactions are recognised as the entity consumes the good or service.

3.5 In step one, some transactions may have an exchange of good or service but the transaction price is not arm's length (because, for instance, the transaction is with a Government), and that would be in the scope of the project. However, since there was a performance obligation in the transaction, the relevant accounting model would be IFRS 15 *Revenue from Contracts with Customers*.

3.6 Further, a lot of income-generating non-exchange transactions such as Government grants are subject to conditions and stipulations. Some may argue that all conditions represent a sort of performance-related obligation. EFRAG considers that not all conditions or stipulations constitutes performance conditions. Paragraphs 3.25 to 3.39, hereafter, include a discussion on the characteristics that could be considered to determine whether conditions or stipulations attached to transactions can be considered as creating performance conditions

3.7 Transactions with performance conditions are within the scope of this project when the consideration exchanged does not equal in value the performance-related obligation. EFRAG has considered three possible alternatives for these cases:

a) The entity should always allocate the full amount to the performance-related condition(s). This solution would result in more transactions being treated the same as commercial transaction at arms' length. It also reduces complexity. However, if the transaction is the purchase of an asset and the entity is paying more than fair value, this creates a potential impairment issue;

b) The entity should allocate the full amount to the predominant component of the transaction. The entity would need to identify the predominant component, which may be possible to do with a qualitative assessment. If the ToEEV component was predominant the entity would then apply the following steps in the approach. However, this would imply that the entity may not recognise an exchange transaction or may still create a potential impairment issue;

c) The entity should allocate the amount to the different components using the guidance in IFRS 15. Since the ToEEV component could not be measured directly, the entity would apply the residual method. The entity would then apply the following steps of the approach to the ToEEV component. This solution would provide the most relevant information but would also increase complexity.

Question to EFRAG TEG

3.8 Does EFRAG TEG want to express a preferred position on the alternatives in paragraph 3.7?

Second Step

3.9 The second step of the approach applies to those transactions that arises as a consequence of an underlying exchange of the entity that affects its financial position or profit or loss.

3.10 In some transactions, an entity becomes liable to pay a levy or receive a grant because an underlying exchange transaction has occurred. Examples of this are taxes on sales or due on cash receipts from suppliers. In most cases, the party involved in the ToEEV is different from the parties with which the reporting entity conducts the underlying exchange activity.

3.11 The proposed approach rely on the premise that the underlying exchange transaction is the main objective for the resource provider to enter the transaction and therefore the model suggests to 'anchor' the accounting of the non-exchange transaction on that underlying exchange transaction.

3.12 Some underlying exchanges affect immediately profit or loss or only the balance sheet (like the receipt of a payment) and in that case the timing of the recognition of the ToEEV income or expense would occur at the same time. However, underlying exchanges involve the recognition of assets, in which case the question arises as whether the recognition of the ToEEV income or expense should occur at the time the underlying exchange affects the financial position of the entity or its profit or loss.

3.13 For instance, we examine below the case in Appendix 1 of a levy imposed on receipt of payment from customers. While the obligating event is the collection, the transaction generating the benefit to the entity is the sale. At that moment, the entity has also lost the practical ability to avoid the payment, as the only way to achieve this would be to forfeit the collection.

3.14 Similarly, an entity may receive a grant to invest in energy-saving equipment. The ToEEV income would fall in the second step if the condition is not deemed to be a performance condition, because the income is arising from on underlying exchange. The question arises as to whether the entity recognises the grant income when the asset is recognised (impact in the financial position) or as the asset is depreciated (impact on the profit or loss)?

3.15 EFRAG has identified two possible alternatives:

a) the recognition of the ToEEV income or expense should be strictly based on the terms of the transaction. In the example, if the terms refer to 'purchase' the income should be recognised in full at that moment, while if the terms refer to 'purchase and use' the income should be recognised as the asset is depreciated;

b) when the underlying exchange affects financial position and profit or loss in different times, the recognition of the ToEEV income or expense should give prominence to the latter. This approach would be based on the notion that the ToEEV income or expense is consideration for a 'societal' component (not directly identifiable) that the entity receives or provides over a period of time. Under this alternative, Step 2 and 3 are substantially similar: the difference is that the date of the underlying transaction is used at the place of the payment (or measurement) date.

Third Step

3.16 The third step of the approach applies to those transactions where no identifiable performance condition can be identified, either directly (Step one) or indirectly (step 2). For these transactions in which non-equal values are exchanged value (such as some levies or grants from Governments) the proposed approach considers that the notion of 'societal benefit' can play a significant role and take precedence for the accounting

3.17 It is, of course, not possible to identify the pattern in which entities receive and consume the benefits of the general activity of the Government or contribute to them. However, it seems reasonable that many of these are rendered continuously: education, security, infrastructures, judicial system.

3.18 For these transactions the model therefore suggests that, for transactions with recurring payments, a straight-line recognition over the period between two payment dates would be appropriate. In those cases where the actual amount to be paid (or received) is known only at or after the payment date, an entity would need to accrue based on the best estimate of the liability and true-up at the payment date.

3.19 Conversely, when the entity receives resources at regular intervals and is not required to act in a specific way, it may be argued that the transfer is intended to compensate the benefit created by the entity's activity to the public at large.

3.20 EFRAG observes that for these transactions progressive recognition of the cost between two subsequent payment (or measurement) dates is considered by many the appropriate outcome, however this cannot be linked to the pattern of receipt or consumption of an identifiable asset or service.

3.21 EFRAG however observes that a similar straight-line allocation over a period when there is no clear evidence of a better or different pattern of consumption would not be a new concept as it is already allowed under some IFRS for instance:

a) IAS 38 *Intangible Assets* requires to amortise using a straight-line method, if that pattern cannot be determined reliably;

b) When dealing with payments conditional on a service condition, IFRS 2 *Share-based Payment* requires to presume that the services will be received on a straight-line basis over the vesting period.

3.22 On that basis, the approach would result in a progressive recognition over a period:

a) between two payment (or measurement) dates for cost-generating transactions;

b) over the period designated by the applicable law or regulation, for income-generating transactions.

Fourth Step

3.23 The fourth step applies to the other transactions in scope. Although the 'societal benefit' notion could be relevant also for these, it is not possible to define a reference period and recognition of the income/expense shall follow the recognition of the asset/liability under the normal requirements.

3.24 Typically this category will encompass transactions such as some one-off levies, penalties and fines, donations etc…

Performance condition

3.25 Step one of the proposed approach refer to the notion of performance condition.

3.26 EFRAG observes that IAS 20 and IAS 41 provide little guidance about what is meant by unconditional or conditional in the context of grants and similar transactions. Further guidance can be found in Public Sector Accounting Standards such as IPSAS 23 *Revenue From Non-Exchange Transactions (Taxes And Transfers)* which operates a distinction between two forms of stipulations contained in grant and similar government assistance:

a) Restrictions' that limit or direct the purposes for which a transferred asset may be used, but do not specify that future economic benefits or service potential is required to be returned to the transferor if not deployed as specified. Where a recipient is in breach of a restriction, the transferor, or another party, may have the option of seeking a penalty against the recipient, by, for example, taking the matter to a court or other tribunal, or through an administrative process;

b) 'Conditions' that require that the future economic benefits or service potential embodied in the asset is consumed by the recipient as specified or future economic benefits or service potential must be returned to the transferor.

3.27 The recipient of grants and similar benefits subject to conditions, as above defined, incurs a present obligation when it initially gains control of the transferred resource. This is because the recipient must either deliver particular goods or services to third parties or return to the transferor future economic benefits or service potential.

3.28 Some conditions are linked to the operations of the entity (e.g. receiving a grant to do research in a specified area). Such conditions are conceptually similar to the notion of performance obligation in IFRS 15, and therefore it may be argued that the requirements in that Standard could apply to such transactions.

3.29 However, a 'performance obligation' in IFRS 15 is defined as a promise to transfer goods or services to the customer, which is the party that has contracted with the entity and is committed to pay consideration. For ToEEV transactions, the entity may be required to perform to a party other than the party paying the consideration. So, the definition of performance obligation is narrow than 'performance condition'.

3.30 In this regard, EFRAG observes, that both the International Public Sector Accounting Standard Board - IPSASB and the Government Accountant Standard Board - GASB have ongoing projects exploring how a performance obligation approach could be applied to transactions with Government, using IFRS 15 definition as the starting point with appropriate modifications made for the public sector.

3.31 The following paragraphs consider characteristics which could be considered to assess whether conditions attached to a transaction include performance conditions.

The conditions must have substance.

3.32 A term in a transfer agreement that requires the entity to perform an action that it has anyway no alternative but to perform, may lead to conclude that the term is in substance neither a condition nor a restriction and does not impose on the recipient entity a performance obligation. An example of that would be a general condition of compliance with applicable laws.

The conditions must have economic effects for the grantee if not complied with.

3.33 The recipient must incur a present obligation to transfer future economic benefits or service potential to third parties (including the general public) when it initially gains control of an asset subject to a condition. As such the recipient is unable to avoid the outflow of resources (not complying with the conditions also has economic effects for the recipient). An example of that would be a condition that obliges the recipient to either use the funds to provide services within a certain period or return them to the grantor. If the recipient is not required to either consume the future economic benefits or service potential embodied in the transferred asset in the delivery of particular goods or services to third parties or else to return to the transferor future economic benefits or service potential, then the stipulation fails to meet the definition of a condition and would not create any performance condition.

The conditions must be sufficiently specific

3.34 Government assistance to entities can be aimed at encouragement or long-term support of business activities either in certain regions or industry sectors. Conditions to receive such assistance may not be specifically related to the operating activities of the entity. Conversely some grants are more closely related to specific actions by the recipient, such as purchasing an asset or hiring a certain number of employees.

3.35 Conditions can vary greatly, from general promises that resources received will be used for the ongoing activities of a resource recipient to specific promises about the type, quantity and/or quality of services to be delivered. Sometimes the specificity of services promised to be delivered by a resource recipient and agreed by the resource provider are implied rather than explicitly stated.

3.36 There might be agreements where delivery of services may not be specific or distinct so as to identify a performance obligation (e.g. where the resource recipient promises to a resource provider that it will use transferred resources to finance a range of possible activities). In such agreements, it might be difficult to know what services have been transferred and if and when any performance conditions are fulfilled.

Fulfilment of the conditions must be liable to be assessed

3.37 Linked to the point above, the recipient should be able to assess if the condition has been fulfilled. There needs to be a minimum level of details and specification of such matters as the nature or quantity of the goods and services to be provided or the nature of assets to be acquired as appropriate and, if relevant, the periods within which performance is to occur.

3.38 Performance is generally monitored by, or on behalf of, the transferor on an ongoing basis. This is particularly the case when a condition a stipulation provides for a proportionate return of the equivalent value of the asset if the entity partially performs the requirements of the condition.

The realisation of the condition must be within the control of the entity

3.39 A condition such as an event outside the control of the entity would not create performance condition (e.g. a grant repayable if global market conditions or global economy improves).

Chapter 4: Practical issues

The role of uncertainty

4.1 The application of the second and third step of the model may result in assets and liabilities starting to be recognised at an earlier stage than under the normal requirements. This is because normal requirements result in assets being recognised only when the entity has acquired control, and liabilities being recognised only when an obligation has been incurred.

4.2 Contribution or receipt of a societal benefit has a connotation of duration, while control or obligation may arise at a point in time – so the advantage of using the 'societal benefit' notion is to enable a progressive recognition. The implication is however that the role of 'control' and 'obligation' in recognition could be weakened.

4.3 If there was no uncertainty about the eventual occurrence of the transaction – in other words, if the entity was certain to pay or receive the resources – the alternative model proposed in this paper would only affect the timing and/or pattern of recognition. However, as noted above, the transactions in scope are often conditional on future events, such as the entity being in operation at a certain date, keep operating over a defined period of time or achieving certain thresholds. In such conditions of uncertainty, the alternative model proposed in this paper could cause an entity to start recognising a transaction that ultimately fails to occur.

4.4 The implication of this would be the need to reverse the accounting entry. Such reversals have a negative informative value because they create accounting noise in the performance of the entity and lower the predictive value of information,

4.5 Two questions arise around how to treat uncertainty in the proposed model for ToEEV:

a) should this conditional uncertainty play a role in reference to the recognition or should it be incorporated in the measurement of the transaction?

b) should the answer be same for expense-generating transactions (such as levies) and income-generating transactions (such as grants)?

4.6 We will illustrate the first question with an example. Under the proposed model, an entity accrues the liability for a levy recurring on an annual basis between two payment dates. Assume that the payment of the annual levy is depending on the entity meeting a certain threshold in its net assets at the end of the period – in that case there is a condition of uncertainty[*].

[*] Currently, IFRS 23 par.12 indicates that if the obligating event is the reaching of a minimum threshold, the liability is recognised only after reaching the threshold.

4.7 If this condition is incorporated in the recognition, the entity would not start recognising the liability until the threshold is reached – in that case the outcome would differ from the proposed treatment of the ‘certain’ levy. If instead the uncertainty is incorporated in the measurement, the entity would still start recognising the levy from the same date and would reflect the likelihood of meeting the threshold in the amount of the provision.

4.8 EFRAG suggests that for the expense-generating transactions in scope of this project, this conditional uncertainty would play a role in measurement, not in recognition. This implies that, in certain circumstances, the initial accrual could be reversed.

4.9 In relation to the expense-generating transactions, the risk of reversal may be mitigated by the fact that they, for probably the most part, are non-voluntary.

4.10 In relation to the income-generating transactions, EFRAG understands that some have a preference for asymmetrical recognition of assets and liabilities. This asymmetrical recognition would follow from the application of prudence. The implication would be to maintain an essential role for control in relation to the recognition of asset.

4.11 On the other side, control of the resource may occur at any moment, and earlier than the payment date - in the absence of an identifiable performance-condition, a model based only on control as the sole driver of recognition would lead to an immediate recognition of the income. This outcome occurs under IPSAS 23 and has raised concerns. The IPSAS has published a Consultation Document where it is suggesting - as one possible alternative - that all stipulations are considered to be like performance-condition. EFRAG observes that this option would result in practice to apply IFRS 15 requirements to ToEEV income-generating transactions.

4.12 EFRAG has identified two possible alternatives:

a) the first one is to apply a symmetrical approach under which the societal benefit takes precedence over the control notion. Under this alternative, in some circumstances entities would start to recognise income (and assets) at an earlier date than under normal requirements. In this alternative, the uncertainty about receiving the resource would be incorporated in the measurement;

b) the second is to require a certain probability threshold as a condition to recognise income (and assets) for income-generating transactions under step two and three. This would introduce an element of asymmetry in the model which would reflect a notion of asymmetrical prudence. The threshold could be more or less high - 'probable', 'more likely than not' or 'not unlikely' - and would introduce an element of judgment and a risk of inconsistent application.

Question to EFRAG TEG

4.13 Does EFRAG TEG want to express a preference among the two alternatives in paragraph 4.12 above?

Limitations and implications

4.14 EFRAG acknowledges that the application of the model described above involves a certain degree of judgment.

4.15 The proposed approach requires to distinguish between transactions where a performance-related obligation can be identified (for which normal recognition requirements would apply) and those where it does not. This requires identifying if the payer is obtaining an identifiable good or service in exchange for the consideration paid. There is an unavoidable element of judgment required in this.

4.16 For instance, in Australia oil and gas companies pay a levy to finance the National Offshore Petroleum Safety and Environmental Management Authority (NOPSEMA), Australia's independent expert regulator for health and safety, environmental management, structural and well integrity for offshore petroleum facilities and activities in Commonwealth waters.

4.17 Given the nature of activities of the regulator, it may be argued that the entity paying the levy is receiving an independent expert advice on their risk management plans. Alternatively, the regulations could have imposed that entities have these plans audited. If this interpretation is retained, the transaction would qualify for Step Two in the above model and the liability would be recognised as the entity receives the advice. If instead, it is concluded that there is no identifiable service received (and the entity is simply paying to fund the regulator, but not in exchange for something specific), then the transaction would qualify for Step Three and be recognised between two settlement dates.

4.18 If income taxes were included in the scope of application of the model, this would change the measurement of income tax in interim periods compared to the current requirements in IAS 34 recognition in interim periods of income tax. Currently income tax in interim periods is computed by applying the effective tax rate expected at year-end on the interim result. Income tax is therefore allocated to the interim periods not on a straight-line *pro-rata temporis* basis, but in proportion to the earnings before tax.

4.19 The application of the model would instead result in a linear allocation over time. This seems to be an unavoidable consequence, because both income tax and levies fund public services provided by governments. It is difficult to argue that income tax is a transaction-based levy; the taxable basis is profit and it results from an aggregation of transactions. It would not be possible to allocate components to specific transactions.

Chapter 5: Presentation and disclosures

[To be completed]

Appendix 1 – Illustrative examples

IE 1. EFRAG has considered in this Chapter the effects of the proposed approach to some of transactions that would be included in the scope of our Research project. For each fact pattern, EFRAG has also described the existing accounting treatment and how it may change under the forthcoming revised *Conceptual Framework*.

a) **Example 1** – Scope: Commercial transaction with Government;

b) **Example 2** – Scope exception: Transaction with shareholders;

c) **Example 3** – Levies arising from participating in a specific market;

d) **Example 4** – Taxation arising as consequence to credit movements on bank accounts;

e) **Example 5** – Capital grant: government grant paid to an entity under the condition that the entity purchases a specified asset;

f) **Example 6** – Income grant - government grant paid to an entity under the condition that the entity operates for three years (grants related to income with service condition); and

g) **Example 7** - Research grant

Example 1 – Scope : Commercial transaction with Government

Fact pattern

IE 2. An entity enters into a service agreement to provide monthly payroll processing services to a Government body for one year. The transaction is made at commercial conditions (arm's length);

Accounting under current IFRS

IE 3. Exchange transactions with Governments as customers are within the scope of IFRS 15. The fact that the customer is a Government does not change the principles applicable to determine when revenue is recognised.

IE 4. Under the above fact pattern (derived from Example 13 of IFRS 15):

a) The promised payroll processing services are accounted for as a single performance-related condition which is satisfied over time in accordance with paragraph 35(a) of IFRS 15 because the customer simultaneously receives and consumes the benefits of the entity's performance in processing each payroll transaction as and when each transaction is processed.

b) The entity recognises revenue over time by measuring its progress towards complete satisfaction of that performance condition in accordance with paragraphs 39–45 and B14–B19 of IFRS 15.

Revised Conceptual Framework

IE 1. No difference expected. Assets are defined as 'present economic resource controlled by the entity as a result of past events'.

IE 2. In this case, it could be argued that the entity gains control over the resource (i.e. contract revenue) as it performs its obligations under the contract

EFRAG's proposed approach

IE 3. Since the transaction is voluntary and occurs at normal commercial terms, the transaction is not within the proposed scope (see paragraph 2.1 above). The entity accounts for the transaction under the applicable IFRSs.

Example 2 – Scope exception – Transactions with shareholders

Fact pattern

IE 4. An entity enters into a CU 100 loan agreement with its majority shareholder at below-market rate.

Accounting under current IFRS

IE 5. IFRS 9 required financial instruments to be initially recognised at fair value (IFRS 9). Where a loan is not on normal commercial terms however, the 'below-market' element of the transaction needs to be evaluated and separately accounted for. The relevant guidance would have to be looked at to account for that separate element.

Revised Conceptual Framework

IE 6. The transaction could be non-voluntary and may fall within the proposed scope. As explained in paragraph 2.9 above, EFRAG decided to limit the scope of the project to exclude transactions between an entity and its majority shareholders. As a consequence the entity would not apply the proposals in this DP to the transaction.

Example 3 - Levies for participating in a specific market

Fact pattern

IE 7. A government charges an annual levy of 0.1% of total liabilities at the end of the reporting period. If the reporting period is longer or shorter than 12 months, the levy is increased or reduced proportionately.

Accounting under current IFRS

IE 8. The entity applies IFRIC 21 and identifies what is the obligating event. If the legislation identifies the obligating event as being in business at the reporting date, before the entity has no present obligation until that date, even if it is economically compelled to continue operating as a bank in the future.

IE 9. In that case, the liability is recognised in full at point in time at the end of the reporting period, if the entity is operating as a bank at that specific date.

Revised Conceptual Framework

IE 10. Both the following conditions must be fulfilled to recognise a liability:

a) The entity has no practical ability to avoid payment;

b) The entity has received economic benefits, or conducted the activities that will or may require transfer of resources.

Judgement needed to determine whether the entity has received benefits (authorisation to operate), or that it has taken an action (obtained the authorisation needed to operate in a particular market).

EFRAG's proposed approach

IE 11. The transaction is non-voluntary and therefore falls within the proposed scope. The entity applies the analysis in the DP:

a) Step 1 -The entity assesses if there an identifiable performance condition from the counterparty. It is assumed that there is no separately identifiable asset or service received in exchange for the levy payment;

b) Step 2 – The entity assesses if the obligation arises as a consequence of a specific underlying exchange. This is not the case under the scenario;

c) Step 3 – The entity assesses if the payments are recurring. The entity also assumes that that there is an indirect societal benefit underlying the transaction. Therefore, it recognises the liability progressively between two payment dates.

Example 4 - Levies on bank transfers

Fact pattern

IE9. The tax regulations in country X apply a transaction tax to all bank transfers. The tax is calculated based on 0.1% of the transfers and is payable the next month.

Accounting under current IFRS

IE 12. The entity applies IFRIC 21 and shall assess what is the obligating event under the legislation, the actual cash transfer or the original commercial transaction.

Revised Conceptual Framework

IE 13. No present obligation until the entity has received economic benefits, or taken action, that will or may require transfer of resources (even if no practical ability to avoid payment).

IE 14. Judgement is needed to assess whether what are the 'action' taken by the entity that required the transfer of resources: i.e. the actual cash transfer or the original commercial transaction. Based on that assessment the levy may be recognised either at the underlying transaction date or at the payment date.

EFRAG's proposed approach

IE 15. The transaction is non-voluntary and therefore falls within the proposed scope. The entity applies the analysis in the DP:

a) Step 1: The entity assesses if there an identifiable performance condition from the counterparty. It is assumed that there is no separately identifiable asset or service received in exchange for the levy payment;

b) Step 2: The obligation to pay arises as a consequence of an underlying exchange transaction. The entity recognises the liability as the underlying exchange occurs. Further guidance may be needed to assess if the underlying exchange is the original transaction or the settlement.

Example 5 - Capital grant

Fact pattern

IE 16. A Government provides a to an entity under the condition that the entity purchases a specified asset. The grant is fully payable when the qualifying asset is purchased. There are no additional conditions or stipulations.

Accounting under current IFRS

IE 17. The entity applies IAS 20. A grant subject to condition is recognised only when there is 'reasonable assurance that the entity will comply with the condition'; and

IE 18. Government grants related to assets can be either:

a) presented in the statement of financial position as deferred income and recognised in profit or loss on a systematic basis over the useful life of the asset; or

b) deducted from carrying amount of the asset. The grant is recognised in profit or loss over the life of a depreciable asset as a reduced depreciation charge.

Revised Conceptual Framework

IE 19. Assets are defined as when 'present economic resource controlled by the entity as a result of past events'. In this case, it could be argued that the entity does not control the resource (grant) until the purchase of the asset.

EFRAG's proposed approach

IE 20. The transaction is voluntary. The entity assesses that the objective of the grant is not to maximise of the proprietary benefits of the Government and therefore the transaction falls within the proposed scope. The entity applies the analysis in the DP:

a) Step 1: The entity concludes that there is no performance condition;

b) Step 2: the grant is arising as a consequence of an underlying exchange (the purchase of the asset). The grant is conditional only upon the purchase of the qualified asset which is an exchange transaction. The grant would be recognised when the asset is purchased because at that date the entity has performed with conditions under the grant agreement.

The model would need be to determine whether the grant is taken as a profit, deducted from the cost of the asset or spread over the depreciation period for the Asset (See alternatives considered in paragraph 3.15).

Example 6 - Income grant

Fact pattern

IE 21. An entity is entitled to receive a CU 300 Government grant under the condition that the entity operates for three years in a specific area of the country. The grant is paid through 3 instalments of CU 100 on 1st of January of the following year.

a) Permutation A: The grant is repayable in full to the Government if the entity fails to comply with the 3-year condition. No other conditions are stipulated.

b) Permutation B: If the entity stops operating in the area, the amounts already received for past periods are however kept and the entity loses the right to receive the grant for the current and future periods (if any). No other conditions are stipulated.

Accounting under current IFRS

IE 22. Under IAS 20, a grant is not recognised in income until there is 'reasonable assurance' that both (i) the entity will comply with the conditions attaching to it and (ii) the grant will be received. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

IE 23. A grant that does not impose specified future performance conditions on the recipient is recognised in income when the grant proceeds are receivable;

IE 24. The grant is recognised in profit or loss 'on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate. If payments were received in advance, the recipient would recognise a liability.

IE 25. Therefore, in the considered fact patterns:

a) *Under Permutation A*, the entity would have first to make an assessment as to whether it has reasonable assurance to remain operating in the area until the end of the 3-year period. If the condition is met it will then have to recognise the cumulative grant over the period, it recognises expenses the related costs for which the grant is intended to compensate.

b) *Under Permutation B*, the entity would have to assess whether the 3-year period condition has real substance and economic effects since the entity is entitled to retain any grant received at the end of each period regardless of its obligation to operate for 3 years. It could be considered that the entity obtains controls of the CU 100 instalment at the end of each fiscal year as the amount received is not repayable. A CU 100 grant would therefore be recognised at the end of each period.

Revised Conceptual Framework

IE 26. In the revised *Conceptual Framework*, Assets are defined as 'present economic resource controlled by the entity as a result of past events'.

a) In the case of permutation, A, it could be argued that the entity does not control the resource (grant) until the end of the third year when it has performed its obligation to operate. As payment was received in advance, the recipient recognises a liability as it incurs a present obligation to transfer future economic benefits

b) In the case of permutation B, grants received for past period are not repayable and it could be considered that the 3-year activity period has no substance and no real economic effects for the entity. It could be considered that, at the end of each period

EFRAG's proposed approach

IE 27. Applying the proposed approach, the entity would have to determine whether the requirement to operate on the under-developed areas could create a form of performance condition that the entity fulfils over the 3 years. If so, the grant would be recognised in income on a straight-line basis over the 3-year period.

Example 7 – Research grant

Fact pattern

IE 28. A manufacturer of medical devices successfully applied for financial support from a government to fund research into a particular new type of technology that could lead to improvement in healthcare.

IE 29. The government agrees to reimburse entity 50% of specified project costs over a two-year period. In accordance with the agreement, the entity must meet specified targets with regards to testing of the technologies being developed. The entity must also prepare six-monthly progress reports for the government. Technologies developed under the agreement remain the property of the manufacturer.

Accounting under current IFRS

IE 30. Under IAS 20 a government grant is not recognised until there is reasonable assurance that:

a) the entity will comply with the conditions attaching to it; and that

b) the grant will be received. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled.

IE 31. The entity will first need to assess whether it has reasonable assurance to meet the specified targets before recognising the grant. If so, the grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

IE 32. In the considered case as the grant is meant to reimburse 50% of specified project costs over two years, grants will be recognised as the expenses they make up for are incurred.

Revised Conceptual Framework

IE 33. The revised *Conceptual Framework* defines assets as 'present economic resource controlled by the entity as a result of past events'.

IE 34. In the fact pattern described, it could be argued that the entity does not control the resource (grant) until it has performed its obligations. As payment was received in advance, the recipient recognises a liability as it incurs a present obligation to transfer future economic benefits.

EFRAG's proposed approach

IE 35. The transaction is voluntary. The entity assesses that the objective of the grant is not to maximise of the proprietary benefits of the Government and therefore the transaction falls within the proposed scope. The entity applies the analysis in the DP:

a) Step 1: The entity assesses if the requirements to do the research, meet specific targets and report back to the Government qualify as performance conditions (Step 1 of the proposed model). If this is the case, the receivable and grant revenue will be recognised as the entity fulfils its performance condition. This may not coincide, like under current accounting under IAS 20, with the way expenses are incurred over the project. See above in paragraph 4.12 for a discussion on the role of uncertainty.

Appendix 2 – Comparing the proposed ToEEV model with existing IFRS for related transactions

5.1 The objective of the IASB project on Rate-regulated Activities is to develop an accounting model to recognise the effects of the timing differences arising from the rate-adjustment mechanism established in the formal regulatory framework between the rate-regulated entity and the rate regulator in the entity's financial position and financial performance. The formal regulatory framework is materialised through a specific regulatory agreement between the rate-regulated entity and the rate regulator. The accounting model considers whether the rights and obligations created by the regulatory agreement meet the definitions of assets and liabilities under the revised *Conceptual Framework*.

5.2 The regulatory right is the right specified in the regulatory agreement to charge a rate increased by an incremental amount which is created when the entity fulfils or partially fulfils the services requirement, however, the regulated rate does not yet reflect the compensation that the entity is entitled to. The rate-regulated entity controls the regulatory right as it is the only party that can use the right and obtain benefits from it, regardless of whether the right will produce economic benefits in all circumstances.

5.3 A regulatory right arises as a result of past transactions, activities or events, such as:

a) The rate-regulated entity incurs expenses that the regulated rate is intended to recover through amounts billed to customers. In this case, a regulatory asset is recognised overtime when the expenses have been incurred by the entity.

b) Meeting a bonus target established in the regulatory agreement. Regulatory asset is recognised at a point in time when the bonus target has been reached.

c) Higher amount of actual allowable expenses than the estimated amount already included in the rate. Regulatory asset is recognised at a point in time when the overspending of allowable expenses is approved by the regulator.

5.4 The regulatory obligation is the obligation to provide goods and services at a rate reduced by an incremental amount which is created when an entity charges customers through the current rate for service requirements that it has not yet fulfilled.

5.5 A regulatory obligation could arise from a number of past events:

a) The rate-regulated entity receives amounts from customers in advance of carrying out activities or incurring expenses allowed under the regulatory agreement. In this case, a regulatory liability is recognised overtime when the amount has been received from the customers.

b) Failing to meet a target established in the regulatory agreement which results in a penalty. Regulatory liability would be recognised at a point in time when a breach of the regulatory commitment is established.

c) Lower amount of actual allowable expenses than the estimated amount included in the rate. Regulatory liability is recognised at a point in time when the underspending of allowable expenses is established.

5.6 The accounting model for rate-regulated activities requires the recognition of regulatory assets and regulatory liabilities if it is more likely than not that they exist and the recognition threshold is symmetrical for both assets and liabilities.

5.7 In general terms, the tentative direction of the RRA project results in the recognition of income (via an accrual or a deferral) as the performance condition is being satisfied. This is consistent with the accounting outcome under the model proposed in the DP under Step 1- that is, when then entity can identify a performance condition.

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