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DISCLOSURE IN FINANCIAL STATEMENTS OF POSSIBLE ADJUSTMENTS OF VAT ON CAPITAL GOODS

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ABSTRACT

In Estonia, initially deducted VAT on capital goods is subject to an adjustment from five to ten years, based on the actual use of an asset (KMS § 32). For a taxpayer, it means that he has to pay more VAT or return it as a result of VAT adjustment in periods following acquisition (KMS § 32; Nellen et al. 2016, 303-356). IFRS does not specify whether companies must disclose possible VAT adjustments on capital goods on financial statements. This thesis analyzes documents such as VAT regulations, accounting standards, IFRS, IFRIC interpretations, other normative acts, and related literature to find out if and when the potential amount of VAT adjustment on capital goods shall be disclosed on financial statements as a provision, contingent asset, or contingent liability.

This thesis shows that VAT adjustment on capital goods is a levy and possible VAT adjustments shall be disclosed on financial statements as contingencies because it is relevant information. Other than that, this thesis highlights the importance of the triggering event in the case of VAT adjustment on capital goods and emphasizes the fact that companies can recognize provisions or disclose contingent liabilities or contingent assets only after triggering event. When the company has the realistic alternatives to settle (avoid) the obligation to adjust VAT in some possible developments of the future, obligation qualifies only as a contingent asset or contingent liability. The thesis found that there is no regulation restricting disclosure of possible VAT adjustments on capital goods as provision, contingent asset, or contingent liability for all VAT adjustment periods.

Keywords: VAT adjustment, capital good, levy, triggering event, IFRS.

INTRODUCTION

The taxpayer is – in the economic sense– just a collector of value-added tax (hereinafter "VAT"), which is for accounting purposes a component of selling price and eventually paid by the end customer. Therefore, collection of VAT is just a duty for the taxpayer, rather than a "part of the essence of business transaction" (Marshal 2006, 186), that is imposed and regulated by the government. (Marshal 2006, 179-185) The right of deduction is an essential part of the VAT scheme, which is designed so that VAT is levied only on the value-added. This right ensures that VAT which was paid on acquired goods (hereinafter "input VAT") is subtracted from VAT payable (hereinafter "output VAT") due to the company's output transactions, during the same tax period. Based on what kind of activities the company is involved in, input VAT might be subject to full, partial, or no deduction at all. (Nellen et al. 2016, 303-356)

If VAT is subject to partial deduction, part of the input VAT is not deducted from output VAT, resulting in non-refundable VAT which in the case of capital goods becomes a cost component of an asset for the company (IASB 2001a, IAS 16 § 6). VAT adjustment directly affects the non-refundable portion of the VAT (Council directive 2006/112/EC art 173(1) & 184) which means that capitalized VAT portion of the capital goods might change as a result of VAT adjustment. In other words, if the company is not entitled to deduct VAT fully, initial VAT deduction, as well as VAT adjustment in the following periods, goes beyond simple duty of collection, while affecting the manager's decision-making process (Nellen et al. 2016, 305). Therefore, possible adjustments on capital goods might be useful information for decision-makers related to the cash flow of the company, with some links to the income statement, balance sheet, and other managerial decisions and raises the question of - if and when companies shall disclose possible VAT adjustments on capital goods in financial statements, to give full information to users of financial statements.

In Estonia, initially deducted VAT on capital goods is subject to an adjustment from five to ten years, based on the actual use of an asset (KMS § 32). For a taxpayer, it might mean that he has to pay more or less VAT for the current period when VAT payment is due (at the end of the calendar year) as a result of VAT adjustment on capital goods (KMS § 32; Nellen et al. 2016, 303-356).

While the right of VAT deduction is a "point transaction", in other words, while the right to deduct arises at the point of purchase (Marshal 2006, 173), VAT adjustment is directly related to periods following acquisition day (Nellen et al. 2016, 303-356). Hence, VAT adjustment carries characteristics of VAT and other levies related to operations in specific periods and can be interpreted as "VAT on operations". This situation gives space for interpretation about how we shall treat possible VAT adjustments on financial statements.

Since 2005, publicly-traded companies in the EU are required to apply a single set of internationally accepted financial reporting standards for the preparation of their financial statements (Regulation (EC) No 1606/2002 art 4). Namely, complying with IFRSs (Regulation (EC) No 1606/2002 art 2) is mandatory for all publicly traded companies in all EU member states (Regulation (EC) No 1606/2002 art 4).

All companies in Estonia are required to follow either international financial reporting standards (hereinafter "IFRS") or Estonian financial reporting standards (hereinafter "EFRS") (RPS § 17). EFRS are based on main principles provided in IFRS and IFRS for small and medium-sized enterprises (hereinafter "IFRS for SMEs") (RPS §17). IFRS for SMEs is a standalone standard designed for small and medium-sized enterprises, following the same principles as IFRS, but omitting some standards and requirements to make it more relevant and easier for SMEs to comply (IASB 2009, IFRS for SMEs). Recognition, measurement, presentation, and disclosure requirements are set in IFRS standards, which apply to the most important transactions of the companies. Though, not every transaction is covered completely by standards (IASB (2018), Preface to IFRS Standards).

According to IAS 8 Accounting policies, changes in accounting estimates and errors (hereinafter "IAS 8"), if no IFRSs address specific transactions, managers shall follow their judgment for developing policy, following other IFRSs dealing with similar or related topics and definitions in the conceptual framework for financial reporting (thereinafter "conceptual framework") (IASB 2003b, IAS 8 § 10). Other than that, managers can use other accounting literature and industry practices, while making sure that they do not go against IFRSs (IASB 2003b, IAS 8 § 12).

Throughout the thesis, opinions linking non-refundable VAT and levy are emphasized. There is a strong argument by most of the respondents of the IFRIC interpretations committee meeting in 2021 that "non-refundable VAT is in the scope of IFRIC 21 levies" (IFRS Interpretations

Committee 2021, § 18) but, accounting treatment of the non-refundable portion of VAT or adjustments to it is not explicitly addressed anywhere. It is obvious that IFRS and EFRS are based on an assumption that ultimately VAT is paid by the end customer and it is not a "part of the essence of business transaction" (Marshal 2006, 181) for the company. Accordingly, IFRS and EFRS do not address explicitly how we shall treat possible VAT adjustments on capital goods on financial statements. In order to answer research questions, this thesis concentrates on IFRS. This thesis aims to analyze documents such as VAT regulations, accounting standards, IFRS, IFRIC interpretations, and other normative acts and related literature to answer the research questions:

RQ1: Shall the potential amount of VAT adjustment on capital goods be disclosed on financial statements as a provision, contingent asset, or contingent liability?
RQ2 (If the answer to the RQ1 is positive): When the potential amount of VAT adjustment on capital goods shall be disclosed on financial statements as a provision, contingent asset, or contingent liability?

Hence, while looking for answers to the research questions, the author of this thesis follows hierarchy in paragraphs 10 to 12 of IAS 8. The author goes through definitions and recognition criteria in the conceptual framework and other IFRSs, IFRIC interpretations, EU regulations, Estonian regulations, and other related literature to the topic, while taking into account accounting treatment and details of VAT adjustment. The author of this thesis links other similar concepts, their treatment, interpretations, and definitions from the abovementioned sources while answering the research questions.

The structure of the thesis follows a logical line starting with the discussion of VAT design, deduction, adjustment, and related regulations in the EU and Estonia, followed by an illustrative example. In the second part of the thesis, the accounting treatment of VAT deduction and adjustment is discussed. Discussion is continued about IFRS, fundamental concepts underlying IFRS, and liabilities and assets. It is followed with the analysis part where the author of this thesis cross-references to show that requirements in IFRS Standard and conceptual framework provide adequate bases to disclose possible VAT adjustment in financial statements and VAT adjustment is the levy. In the second part of the analysis, the author goes through definitions of provisions, contingent assets, contingent liabilities and explains when possible VAT adjustment meets recognition and disclosure criteria while linking related IFRIC interpretations, IFRSs definitions, accounting, and legal treatment of VAT adjustment.

1. VAT LAW

The right of deduction is an essential part of the VAT scheme, which ensures that VAT is only levied on the value-added. It is meant to relieve the trader of the burden of the VAT, by transferring the burden to the end customer. (Nellen et al, 2016; Rompelman and E.A. Rompelman-Van Deelen v Minister van Financiën (1985); Gabalfrisa S.L. and Others v Agencia Estatal de Administracion Tributaria (AEAT) (2000))

One of the main principles underlying the VAT is that it is a tax on consumption. Its key effect is that it shifts the burden of the tax to the final customer. Though, the real burden is not necessarily borne only by customers. The owners, staff, and/or financiers of the companies whose production is being taxed may also feel the real loss of income. (Ebrill et al. 2001, 16–85) The EU VAT system would be easier if the input VAT deductions were always full and immediate. Council Directive 2006/112/EC of 28 November 2006 on the common system of value-added tax (hereinafter "VAT directive") includes restrictions and guidelines for the right of deduction, making calculations of deductible VAT difficult. The basic principle of the EU VAT system is that the input VAT is subtracted from the output VAT due to the company's output transactions, during the same taxable period. (Nellen et al. 2016, 303-356; Council directive 2006/112/EC art 179) Consequently, the deduction concept is directly linked to the collection of output VAT (Uudenkaupungin Kaupunki (2006)). Whether VAT is subject to deduction is in substantive sense (leaving aside the formalities) contingent on the following (Council directive 2006/112/EC art 2 & 168):

a) an input supply by a taxable person;
b) the input supply is taxable;
c) the input supply is used for the purposes of a taxable output supply;
d) the person seeking to deduct (viz., receiving the input supply and making the output supply) is taxable.

In other words, paragraph 168 of the VAT directive lists input goods and services, purchased from the taxable person (supplier), on which VAT can be deducted, if a taxable person (consumer) seeking to deduct input VAT uses those goods and services for taxable output supply (Council

directive 2006/112/EC art 2 & 168). In addition to taxed output supply, the VAT directive lists other activities which are not taxed but give rise to VAT deduction (Council directive 2006/112/EC art 169). Input VAT is deducted fully (assuming that criteria a), b), and d) from the list above are satisfied) if it is used solely for activities listed in paragraphs 168 & 169 of VAT directive, which qualify for VAT deduction (hereinafter "taxed transactions"). Input VAT is not deducted if goods and services are used only for transactions that do not qualify for deduction (hereinafter "exempt transactions"). (Nellen et al. 2016, 303-356)

1.1. Proportional deduction of input VAT

The proportional deduction or "pro-rate deduction" (Nellen et al. 2016, 330), based on the proportion of taxed and total output transactions, takes place when a business is involved in a different type of economic activities, some of which are exempt transactions (Council directive 2006/112/EC art 173(1)). In paragraph 173(2), the VAT directive offers member states different methods for calculating proportional deduction (Council directive 2006/112/EC art 173(2)). In the same paragraph, we see that the VAT directive distinguishes two types of costs; direct costs, which can be directly linked to a specific activity, and general costs, which take the form of overhead and contribute to overall economic activities (Nellen et al. 2016, 330). As a general rule, the deductible proportion is calculated with a formula where, as a numerator, we have the total amount of taxed transactions without VAT, and as a denominator total amount of all transactions (taxed plus exempt transactions) without VAT (Council directive 2006/112/EC art 174(1)). Normally VAT calculation with this formula is made based on the preceding year's turnover (Council directive 2006/112/EC art 175(2)), and it is subject to adjustment at the end of the year based on actual use when "final proportion is fixed" (Council directive 2006/112/EC art 175(3)). If there does not exist data from the previous year, VAT is calculated based on estimations (Council directive 2006/112/EC art 175(2)), this approach is called "Pre-pro Rata Mechanism" (Nellen et al. 2016, 333).

1.2. Adjustment of VAT

The system of adjustment establishes procedures to adjust initially deducted VAT if "some change occurs in the factors used to determine the amount to be deducted" (Council directive 2006/112/EC art 184 & 185). Mainly adjustment happens when there are "changes in the ratios of use for taxed and exempt transactions" (Nellen et al. 2016, 334), changes in legislation (Nellen et al. 2016, 338),

and when an asset for which input VAT has been deducted is transferred (unless it's in the context of a taxable transaction)(Nellen et al. 2016, 338). For a taxpayer, it means that (KMS § 32; Nellen et al. 2016, 303-356);

a) He has to pay more VAT when payment is due (at the end of the calendar year) as a result of VAT adjustment on capital goods, which is the case when initially attributed VAT to each adjustment year is more than actual deductible VAT attributable to the adjustment year; or
b) He has to pay less VAT when VAT payment is due (at the end of the calendar year) as a result of VAT adjustment on capital goods, which is the case when initially attributed VAT to each adjustment year is less than actual deductible VAT attributable to the adjustment year; or
c) VAT due is not effected with VAT adjustment on capital goods because initially attributed VAT to each adjustment year and actual deductible VAT attributable to the adjustment year are same. (for definitions of "initially attributed VAT to each adjustment year" and "actual deductible VAT attributable to the adjustment year" see section 1.4 of this thesis).

1.2.1. VAT adjustment on capital goods

While articles 184 and 185 of the VAT directive, describe when adjustment shall be done, VAT directive states that member states shall lay down more detailed rules for implementation (Council directive 2006/112/EC art 186). The VAT directive classifies capital goods as movable and immovable properties, which member states might not treat the same way (Nellen et al. 2016, 303-356). Therefore, VAT Directive gives the right to define the concept of capital goods to member states (Council directive 2006/112/EC art 189). VAT directive spreads VAT adjustments for movable properties over five years and for immovable property up to twenty years, with a precise regime (Council directive 2006/112/EC art 187). In most cases, the adjustment period starts from the acquisition or manufacturing year, though the member state may decide to start the period from the time when the goods are first used (Council directive 2006/112/EC art 187). At the end of each year (Council directive 2006/112/EC art 175), the actual deductible VAT attributable to the adjustment year is compared to the initially attributed VAT to each adjustment year, and the difference is adjusted (Council directive 2006/112/EC art 184 & 185).

1.3. Estonian regulations

Estonian regulations classify capital goods as immovable and fixed assets, where immovable assets (same as immovable property in VAT directive) are defined as delimited part of the land, and fixed assets (same as movables property in VAT directive) all the rest (TsÜS § 50). Estonian value-added tax act treats immovable and fixed assets differently, giving ten and five years for adjustment respectively (KMS § 32(4)). Principles of calculating VAT are following VAT directive, providing more details about conditions, exceptions, calculations, and time frames.

If the taxable person uses capital goods for both, taxed and exempt transactions, he has a right to a partial deduction which shall be based on "proportion of taxable supply to total supply" (KMS § 32(1) & 33(1) & 33(2)), calculated with a proportional deduction formula discussed in section 1.1 of this thesis or by combining direct calculation method with a proportional deduction (KMS § 33(1)). Though in cases where the partial deduction is based on the direct calculation method combined with proportional deduction the taxpayer shall keep separate accounts for taxed and exempt transactions, otherwise, additional permissions from tax authority are required (KMS § 33(3)). In the case of partial deduction, the proportion is calculated based on the previous year's transactions. If data from the previous year is not available, proportion shall be calculated by the tax authority, based on the taxpayer's application and estimations. (KMS § 33(3))

Input VAT adjustment for capital goods shall happen immediately in case of transfer, with some exceptions (KMS § 32(5)). If a taxable person sells capital goods during the adjustment period, adjustment shall be done based on the purposes of the supply in the following adjustable periods (KMS § 32(51)). VAT from goods and services which are destined for capital goods can be deducted only if they increase the book value of the asset. (KMS § 32(4))

Input VAT is adjusted at the end of each calendar year based on actual use (KMS § 32(42) & 33(2)). All entities in Estonia are required to make annual financial statements at the end of the financial year (RPS § 14). The financial year normally is a calendar year, unless otherwise provided by different regulations (RPS § 13). Therefore, preparation of annual financial statements and VAT adjustments take place approximately at the same time.

1.4. Example

Company in Estonia which is involved in taxed and exempt transactions, purchased a building, with 100,000 Euro input VAT. The proportion of taxed transactions out of all transactions in the previous year was 60%, respectively 60,000 Euros from input VAT is subject to deduction. The amount of deducted VAT attributable to each period is 6000 Euro (initially attributed VAT to each adjustment year) = 60% (intended use for taxed transactions) x 1/10 (the portion of total VAT attributable to each adjustment year) x 100,000 (amount of total input VAT). Any deviation from the initial proportion would require adjustment. Let's assume that the second-year taxed transactions portion increased from 60% to 70%. In this scenario, the actual deductible VAT attributable to the second year would be 7,000 Euros (actual deductible VAT attributable to the adjustment year) = 70% (actual use for taxed transactions) x 1/10 (the portion of total VAT attributable to each adjustment year) x 100,000 (amount of total input VAT). The difference between actual and already deducted input VAT is 1,000 Euros, since the actual right exceeds already deducted VAT, 1000 Euro more is subject to deduction in the current year. At the end of the year, the company will adjust VAT by putting 1000 Euros on the debit side of the VAT summary account while crediting capitalized nonrecoverable VAT portion of the capital good. The same rules apply to the following years.

2. ACCOUNTING TREATMENT OF VAT

The taxpayer is – in the economic sense – just a collector of VAT, which is for accounting purposes a component of selling price and eventually paid by the end customer. There is a huge difference between VAT and income tax. While income tax is claimed at the point of income, VAT is claimed at the point of purchase (Marshal 2006, 173). Collection of VAT is just a duty for the taxpayer, rather than a "part of the essence of business transaction" (Marshal 2006, 181). Accordingly, VAT is not directly reflected and reported in the profits and losses of a company, neither in the income statement (Marshal 2006, 181). VAT is excluded from revenue/transaction amount since it is collected on behalf of third parties (IASB, FASB 2014, IFRS 15 § 47). But a VAT account is an essential part of a balance sheet and it certainly has some balance at the date of the balance sheet (Marshal 2006, 181).

IFRS defines property, plant, and equipment as "tangible items that are…expected to be used during more than one period" (IASB 2001a, IAS 16 § 6), in other words, capital goods. IFRS emphasizes the fact that items that qualify as capital goods shall be recorded on the balance sheet at its cost (IASB 2001a, IAS 16 § 15). Cost can be an amount of cash or equivalent paid for the acquisition of an asset, and it includes purchase price, including non-refundable purchase taxes (IASB 2001a, IAS 16 § 16). Hence, when it comes to capital goods, nonrecoverable VAT shall be capitalized as the cost of the asset. Respectively any VAT adjustment shall be reflected on the cost of the capital item, specifically on the nonrecoverable portion of the VAT which shall be capitalized (Council directive 2006/112/EC art 173(1) & 184). Accordingly, partial deduction of VAT and adjustments for the following periods, slightly changes the situation for companies, while absorbing a portion of VAT as cost. The company is not just a collector anymore and VAT is not paid only by the end customer. On that account different opinions arise about the nature of non-refundable VAT, and how we shall treat them in IFRIC 21 levies, which is discussed later in section 4.1. of this thesis.

3. FINANCIAL REPORTING STANDARDS

3.1. International financial reporting standards

IFRS is a collection of accounting and financial reporting standards and interpretations developed by the IFRS Foundation, which are designed for preparing general-purpose financial statements and other financial reports. General-purpose financial statements are a main source of information for existing and potential investors, lenders, and other stakeholders. Other financial reports provide pieces of information that are not included in financial statements but might be useful for some stakeholders to make better decisions. (IASB 2018, Preface to IFRS Standards)

While promoting transparency, accountability, and efficiency of financial statements one of the objectives of the conceptual framework is to develop consistent accounting policies when no standard applies to a particular transaction (IASB 2018, Conceptual framework § SP 1(1) & SP 1(5)). Though, if a board adopts some particular standard that does not follow the conceptual framework completely, the conceptual framework does not have the power to override it, in other words, “the Conceptual framework is not a standard” (IASB 2018, Conceptual framework § SP 1(2)) but underlies main concepts as guidelines (IASB 2018, Conceptual framework § 1(11); Greuning et al. 2011, 3).

“The objective of general-purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity” (IASB 2018, Conceptual framework § 1(2)). Those decisions might depend on a lot of information including assessment of future net cash flows to the entity, income statement, balance sheet (IASB 2018, Conceptual framework § 1(3)), which is obviously affected by payment of VAT and capitalization of non-refundable VAT on capital goods on the due date. To estimate the value of the entity and make a more reliable assessment of the entity’s financial position, stakeholders need information about the resources of the entity, claims against it, and any transaction that might change any resource or claim (IASB 2018, Conceptual framework § 1(4) & 1(12)). Changes not resulting from financial performance also contribute to give a complete understanding of the entity’s financial position (IASB 2018, Conceptual framework § 1(21)).

The conceptual framework describes two fundamental qualitative characteristics of useful financial information, which are relevance (same as materiality in Accounting act) and faithful representation (same as objectivity and disclosure in Accounting act) (RPS §16; IASB 2018, Conceptual framework § 2(4)). Relevant information can be described as financial information, with qualitative or predictive value, which can affect stakeholders' decisions (RPS §16; IASB 2018, Conceptual framework § 2(7)). Faithful representation is described as disclosing all the relevant information about the substance of economic phenomena (RPS §16; IASB 2018, Conceptual framework § 2(12)).

"Financial statements shall present fairly the financial position, financial performance, and cash flows of an entity"(IASB 2003a, IAS 1 § 15). A Fair presentation can be achieved by following all applicable IFRSs to specific transactions. Though, when no IFRS address to specific transactions, companies shall follow a hierarchy of authoritative guidance set out in IAS 8. (IASB 2003a, IAS 1 § 17) If that is the case, managers shall follow its judgment for developing policy, while making sure that they provide relevant and reliable information to users of financial statements (IASB 2003b, IAS 8 § 11), and follow other IFRSs dealing with similar or related topics and definitions set out in conceptual framework (IASB 2003b, IAS 8 § 11). Other than that, managers can use other accounting literature and industry practices, while making sure that they do not go against IFRSs (IASB 2003b, IAS 8 § 12).

All financial statements are prepared, *inter alia*, on two main assumptions, the accrual basis of accounting and going concern. Following the accrual basis of accounting, the effect of a particular event on an entity's financial position is reflected in the period when these events take place, even if resulting cash transactions take place in the later period (RPS §16; IASB 2018, Conceptual framework § 1(17); Greuning et al. 2011, 5). "Financial statements are normally prepared on the assumption that the reporting entity is a going concern and will continue in operation for the foreseeable future" (IASB 2018, Conceptual framework § 3(9)). In other words, even if the company has an intention to stop operating after the reporting period it shall not affect the financial statement for the current period (Greuning et al. 2011, 5).

Disclosing assets and liabilities is one of the relevant topics for stakeholders (IASB 2018, Conceptual framework § 5(12)). Though, the classification, recognition, and disclosure requirement of liabilities and assets are more complicated and covered in more detail in the following section of this thesis. While providing information about equity's current assets,

liabilities, equity, income, and expenses, financial statements also disclose and/or recognize some possible future transactions if they include useful information for users of financial statements (IASB 2018, Conceptual framework § 3(6)).

3.2. Liabilities and assets

In order to accurately represent a reporting entity's financial position, we have to accurately account for its liabilities and assets. On that account, recognition and measurement of liabilities and assets can have a huge impact on the way a company's financial position is viewed. IFRS requires companies to disclose such information to financial statements, immediately following the matching principle (Alibhai et al. 2018, 417–418).

According to IFRS, liabilities are defined as the "present obligation of the entity to transfer an economic resource as a result of past events." (IASB 2018, Conceptual Framework § 4(26)). The past event which leads to obligation is called obligating event (IASB 2001c, IAS 37 § 16). Standard further emphasizes that there are three criteria to recognize almost all types of liabilities (IASB 2018, Conceptual Framework § 4(27)):

a) there shall be a present obligation;
b) the obligation shall exist as a result of a past event;
c) the obligation shall result in the transfer of economic resources;

With the liquidity principle, we classify liabilities and assets as current and long-term liabilities and assets. Normally, for current liabilities and assets, we know who is payee, what is the amount owed to the payee or owed by the payee, and what is the due date. However, in some situations, one or more of these components may be unknown, but following basic principles of accrual accounting, we have to match expenses and incomes with periods they were born. Respectively, not knowing the amount of liability or asset, due date or payee is not a justification for not accounting and reporting. Therefore, some flexibility measures are taken to account for these uncertainties and recognize possible liabilities and assets on financial statements, specifically different types or levels of liabilities and assets are proposed. (Alibhai et al. 2018, 410-425) The main objective of IAS 37 provisions, contingent assets, and contingent liabilities (hereinafter "IAS 37") is to guide when to recognize provisions and disclose contingent liabilities and contingent assets. Provisions are recognized and reported on financial statements separately, while contingent

liabilities are disclosed in notes. (IASB 2001c, IAS 37 § 11; Greuning et al. 2011, 239) IAS 37 also lists disclosure requirements and conditions (Greuning et al. 2011, 239-247).

3.2.1. Provisions

IFRS distinguishes provisions from other liabilities because of uncertain timing or the amount of future outflow of economic resources. (IASB 2001c, IAS 37 § 11; Greuning et al. 2011, 239) IAS 37 sets strict criteria for recognition of provisions and explains them to some extent. Criteria are as follows (IASB 2001c, IAS 37 § 14; Greuning et al. 2011, 239-247):

a) an entity has a present obligation (legal or constructive) as a result of a past event;
b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
c) a reliable estimate can be made of the amount of the obligation.

3.2.2. Contingent liabilities

Paragraph 10 of IAS 37 gives two definitions of contingent liability (IASB 2001c, IAS 37 § 10):

a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
b) a present obligation that arises from past events but is not recognised because:
    - it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
    - the amount of the obligation cannot be measured with sufficient reliability.

In essence, all provisions are contingent because we do not know the exact timing or amount. Though, in IAS 37, “contingent” is used for possible liabilities that arise from a past event and whose existence is dependent on some events in the future, which are not fully under the company’s control (IASB 2001c, IAS 37 § 10). Other than that, a contingent liability is used for present liabilities that arise from a past event and did not qualify as provisions, because it is not probable that outflow of economic resources will be required or amount cannot be estimated with sufficient reliability (IASB 2001c, IAS 37 § 10 & 12) Contingent liabilities shall not be recognized on financial statements, but disclosed on notes, unless the possibility of an outflow of economic resources is remote (IASB 2001c, IAS 37 § 28). Contingent liabilities shall be reassessed

continuously, and if the outflow of resources becomes probable, it shall be recognized as a provision (IASB 2001c, IAS 37 § 30).

3.2.3. Contingent assets

Paragraph 10 of IAS 37 defines contingent assets as "a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity" (IASB 2001c, IAS 37 § 10).

Contingent assets shall not be recognized on the financial statement (IASB 2001c, IAS 37 § 31). If the contingent asset is probable, it is disclosed in notes (IASB 2001c, IAS 37 § 34). Contingent assets usually arise from unplanned or unexpected events which gives a rise to the inflow of economic benefits (IASB 2001c, IAS 37 § 32). Contingent assets shall be reassessed continuously, and if the inflow of resources becomes virtually certain, income shall be recognized in financial statements (IASB 2001c, IAS 37 § 35).

4. ANALYSIS

4.1. Possible VAT adjustment on capital goods as levies

IFRIC interpretations committee talks about levies in IFRIC 21 levies (thereinafter "IFRIC 21"), addressing a lot of topics that are relevant for this thesis. Specifically, timeline, obligating event, progressive nature of some levies, constructive obligation, going concern are discussed in IFRIC 21 which provides somewhat directive answers towards our research questions. Paragraph 4 of the IFRIC 21 defines levy as: "an outflow of resources embodying economic benefits that are imposed by governments on entities in accordance with legislation" (IFRS Interpretations Committee 2013a, § 4). According to paragraph BC6 of the basis for conclusions on IFRIC Interpretation 21 Levies, "for the purposes of… [IFRIC 21] amounts that are collected by entities on behalf of governments (such as value-added taxes) and remitted to governments are not outflows of resources embodying economic benefits for the entities that collect and remit those amounts" (IFRS Interpretations Committee 2013b, § BC6). One of the reasons behind assuming that VAT does not fall under the scope of EFRIC 21 might be that "the non-refundable VAT portion is not within the scope of IFRIC 21 as it does not meet the definition of a levy, given that the VAT is imposed by government on the [end customer, not the entity]" (IFRS Interpretations Committee 2021, 12). In other words, the taxpayer is just a collector of VAT, which is just a duty for the taxpayer, rather than a business transaction, and the real burden of VAT is borne by the end customer, not the company (Marshal 2006, 181). Consequently, the nature of VAT as an outflow of economic resources as a levy that is imposed by the government on the company is challenged.

Though, as we discussed before, the real burden of VAT is not necessarily borne only by customers, since owners, staff, and/or financiers of the companies whose production is being taxed may also feel the real loss of income (Ebrill et al. 2001, 16–85), especially if we are talking about non-refundable VAT. In 2021 IFRS Interpretations Committee received the question related to non-refundable VAT and sent a questionnaire to the International Forum of Accounting Standard-Setters, securities regulators, and large accounting firms while making the questionnaire available on their website as well (IFRS Interpretations Committee 2021, § 8). They received 17 responses, eight from national standard-setters, six from large accounting firms, and three from securities regulators or organizations representing a group of securities regulators (IFRS Interpretations Committee 2021, § 10). "Most respondents said… non-refundable VAT is in the scope of IFRIC

21 Levies" (IFRS Interpretations Committee 2021, § 10). These respondents said that, in their view, "The non-refundable VAT portion does meet the definition of a levy per IFRIC 21, as the payment thereof relates to an outflow of economic resources in accordance with legislation imposed on entities by local government" (IFRS Interpretations Committee 2021, 15). In interpretation notes, we see an explanation which says: "VAT essentially compensates the relevant local authority for the shared services and infrastructure provided and is funded by its taxpayers that were utilized in the elaboration of that product or service" (IFRS Interpretations Committee 2021, 9). In other words, VAT is imposed by the government on the company, and it is compensation for an increase in the value of a product or service, which happened within the government's jurisdiction. In other words, VAT adjustment can be interpreted as cost for operations of the company for a specific period. Because non-refundable VAT shall be recorded as a cost of capital goods (IASB 2001a, IAS 16 § 6 & 15), adjustment to it can be considered as an outflow, or inflow of economic resources as well.

During the IASB emerging economies group 8th meeting in December 2014, it was emphasized that "an entity should recognise as assets refundable or overpaid taxes and contributions (including VAT)" (National Organization for Financial Accounting and Reporting Standards, Russia 2014, 11) if an entity has a current right to reimburse asset which can be measure reliably and used in foreseeable future (National Organization for Financial Accounting and Reporting Standards, Russia 2014, 11). This scenario or criteria during which entities should recognize assets/overpaid taxes is similar to criteria for recognition of assets as defined in the conceptual framework and is covered throughout this thesis. Comparably, while talking about deposits relating to taxes, the IFRS interpretations "committee concluded that the requirements in IFRS Standards and concepts in the Conceptual Framework for Financial Reporting (Conceptual Framework) provide an adequate basis for an entity to account for deposits relating to taxes other than income tax" (IFRS Interpretations Committee 2019, § 2). Also, the committee concluded that tax deposit meets the definition of the asset since "the tax deposit gives the entity a right to obtain future economic benefits, either by receiving a cash refund or by using the payment to settle the tax liability" (IFRS Interpretations Committee 2019, 10).

VAT adjustment implies that VAT might be overpaid for a specific period due to changes in calculation bases, and companies might pay less VAT after adjustment or get some of the overpaid VAT back as cash, depending on the legislation in the country. In other words, VAT adjustment might give companies the right to "future economic benefits" (IFRS Interpretations Committee

2019, 10) as discussed in the case of tax deposits above. Therefore, the author of this thesis thinks that the word "future economic benefit" (IFRS Interpretations Committee 2019, 10) is inclusive of VAT adjustment when VAT is refundable. On the other hand, we might have an opposite situation when VAT is payable after adjustment. If following the interpretation committee decision in 2019 we have an "adequate basis for an entity to account for deposits" (IFRS Interpretations Committee 2019, § 2), we shall assume the existence of the same basis for situations when VAT is payable after adjustment. Hence, we can conclude that possible VAT adjustment on capital goods is relevant information for the users of financial statements when as a result company has to pay more or less VAT on the due date.

Since VAT adjustment is the correction of initially deducted VAT, which increases or decreases the non-refundable VAT portion of the cost of the capital good in each period (Council directive 2006/112/EC art 173(1) & 184), we can conclude that VAT which is subject to an adjustment shall be treated as a levy and falls under the scope of IFRIC 21. Since VAT adjustment is not an income tax it is within the scope of IAS 37 (IFRS Interpretations Committee 2019, 1). While in IAS 37, recognition criteria are listed for each contingency, in IFRIC 21 we find somewhat directive answers to how we shall interpret these criteria while talking about VAT adjustment. In the following sections, the author of this thesis checks when VAT adjustments meet recognition and disclosure requirements while making sure that answers follow definitions in the conceptual framework.

4.2. Past event

Paragraph 8 of IFRIC 21 states that "the obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation" (IFRIC 21 § 8). "In other words, the liability to pay a levy is recognised when the activity that triggers the payment of the levy occurs, as identified by the legislation" (IFRS Interpretations Committee 2013b, § BC13). Consequently, it is crucial to take into account what is the event which triggers the obligation according to law.

One of the elements in recognition criteria for provisions, contingent assets, and contingent liabilities (collectively "contingencies") is that they are linked to certain past events (IASB 2018, Conceptual Framework § 4.2; IASB 2001c, IAS 37 § 10 & 14). The concept of the past event is

explicitly addressed and explained only under the provision section of IAS 37, paragraphs 17 to 22. Following subsection 4.2.1 of this thesis and references in it explicitly address past events from a liability perspective while answering the question: from/after what point in time company is allowed to recognize or disclose possible VAT adjustment on capital goods in financial statements. In the opinion of the author of this thesis, because the nature of the link between all contingencies (including contingent assets) and past events are the same, the approach for choosing the point in time shall be uniform for all contingencies and conclusion of the following subsection 4.2.1 of this thesis applies to all contingencies. Respectively, while using the phrase "obligating event", the author means a past event that gives rise to/triggers all contingencies (not only liabilities).

4.2.1. Obligating event

In essence, provision cannot be recognized if there is no obligating event in the past, or while expecting obligating event to occur in the future (Alibhai et al. 2018. 426). Paragraph 8 of IFRIC 21 brings an example and emphasizes the fact that there might be several necessary activities leading to present obligation, while none of them alone are "sufficient to create a present obligation" (IFRIC 21 § 8). Paragraph BC12 of Basis for Conclusions on IFRIC Interpretation 21 levies emphasizes the fact "that there can be only one single obligating event" (IFRS Interpretations Committee 2013b, § BC12), even though activities undertaken in the previous year are necessary to create present obligation (IFRS Interpretations Committee 2013b, § BC12). Therefore, companies shall be careful when deciding what is an actual obligating event that triggers obligation, taking into account concepts described above, which are:

a) existence of obligating event in past;
b) the possible existence of several necessary activities in past leading to an obligation;
c) existence of only one single obligating event.

Perhaps one of the most important topics the author of this thesis wants to highlight, considering concepts described above, is the timeline and flow of VAT on capital goods, in case it is subject to adjustment, from the company's perspective. After the company decides to buy capital goods it might take the following steps:

a) acquisition of property and (not necessarily) Pro-rate calculation/Pre pro-rate calculation and payment of the consideration (together with the VAT thereon) to the seller;
b) payment of VAT for the relevant month, less the deductible portion of input VAT on the consideration for the property, to authority;
c) the event that triggers an adjustment;

d) adjustment.

For illustrative purposes, we assume that all of these steps take place. In the case of VAT on capital goods, we have a series of chained events which are necessary for the adjustment of VAT, from step a) to step c), though step a) or b) alone or together are not sufficient to give rise to adjustment. Accordingly, step c is triggering activity or obligating event. This timeline makes clear that initial VAT deduction alone, without following triggering even, is not enough for provisions, contingent liabilities, or contingent assets to exist. The author of this thesis thinks that obligating event at least shall make clear whether the company has possible liability or possible asset.

4.3. Realistic alternative

For an event to be an obligating event, the entity shall "have no realistic alternative to settle the obligation" (IASB 2001c, IAS 37 § 17; Alibhai et al. 2018, 426). This is a case when a company has legal or constructive obligations (IASB 2001c, IAS 37 § 17). A Realistic alternative is discussed in this section to answer the question: what obligating event shall result so that possible VAT adjustment on capital goods meets recognition criteria for provisions?

4.3.1. Realistic alternative for provisions

According to the first part of paragraph 19 of IAS 37, "It is only those obligations…existing independently of an entity's future actions (ie the future conduct of its business) that are recognized as provisions (IASB 2001c, IAS 37 § 19). In the second part of paragraph 19 of IAS 37, we read that "because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation, it has no present obligation for that future expenditure and no provision is recognized." (IASB 2001c, IAS 37 § 19). In other words, provision is recognized under the assumption that:

a) All the necessary steps (including triggering event) leading to obligation already took place (as we discussed in subsection 4.2.1).
b) Obligation already exists independently of an entity's future actions. All the things which are controllable by the company will stay the same because the "entity has no realistic alternative to settling [or avoid] the obligation created by the [obligating] event" (IASB 2001c, IAS 37 § 17).

c) Though, the existence of obligation depends on some factors. If these are not the entity's future actions, then we can assume that they are some external factors, causing some degree of uncertainty, which might change the situation.

Paragraph 19 of IAS 37 is somewhat straightforward, but how the company shall determine if the company has a realistic alternative? As it is described in IAS 37 company has no realistic alternative only (IASB 2001c, IAS 37 § 17):

a) where the settlement of the obligation can be enforced by law; or
b) in the case of a constructive obligation, where the event (which may be an action of the entity) creates valid expectations in other parties that the entity will discharge the obligation.

As a conclusion of this subsection, we can answer the question: what obligating event shall result so that possible VAT adjustment on capital goods meets recognition criteria for provisions? (contingent liability and contingent assets are discussed in the following subsection)? For possible VAT adjustment to qualify as a provision the following is required:

a) All the necessary steps (including triggering event) leading to the obligation to adjust VAT already took place. Therefore, the obligation to adjust VAT already exists.
b) The obligation exists independently of an entity's future actions and obligation cannot be avoided because:
    - it is enforced by law; and/or
    - there is a constructive obligation.
c) There are some external factors, causing some degree of uncertainty, which might change the situation.

4.3.2. Realistic alternative for contingent assets and contingent liabilities

One of the definitions (definition b)) of the contingent liability, mentioned in section 3.2.2 of this thesis, says that in essence, a contingent liability is an obligation that does not qualify as a provision because it is not probable that outflow of resources will be required to settle the obligation or because obligation cannot be measured reliably. In other words, criteria for contingent liability are lower.

Another definition of contingent liabilities and definition of contingent assets in paragraph 10 of IAS 37 is as follows: "a possible obligation [or asset, in case of contingent asset] that arises from

past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity" (IASB 2001c, IAS 37 § 10). We see a clear connection between obligation/asset, which arises from a past obligating event like in the case of provision. Unlike criteria for provision which says that provision exists "independently of an entity's future actions" (IASB 2001c, IAS 37 § 19) while depending on external factors, the existence of contingent liabilities and assets are dependent on some future events "not wholly within the control of the entity" (IASB 2001c, IAS 37 § 10). The author of this thesis thinks that words "not wholly within the control of the entity" (IASB 2001c, IAS 37 § 10) can be interpreted as within the control of the entity to some extent and within the control of external factors to some extent. In other words, the author thinks that words "not wholly within the control of the entity" can be interpreted as hypothetical situations or as "if, then scenario". In other words, in the case of contingent liabilities, it is obvious that: the existence of obligation which might lead to VAT adjustment is certain as in the case of provisions, but for some possible development of scenarios controlled by external factors, the company has realistic alternatives to settle (avoid) the obligation.

Following this logic, the author of this thesis thinks that for possible VAT adjustment to qualify as a contingent liability the following is required (the same logic applies to contingent assets, and the list would look alike with some minor changes):

a) All the necessary steps (including triggering event) leading to the obligation to adjust VAT already took place. Therefore, the obligation to adjust VAT already exists; but
b) The entity has realistic alternatives to settle the obligation, depending on scenarios developed under external factors (criteria c) of this list). Thus, the part of the obligation could be avoided because:
    - it is enforced by law but the means of execution is up to the company; and/or
    - there is a constructive obligation but the means of execution is up to the company.
c) There are some external factors, causing some degree of uncertainty, which might change the situation so that company has realistic alternatives to settle the obligation.

Respectively, when the company has the realistic alternatives to settle (avoid) the obligation to adjust VAT in some possible developments of the future, obligation qualifies only as a contingent asset or contingent liability. In other words, it can be understood as: obligation to do something which might trigger VAT adjustment already exists (is triggered) but VAT adjustment is not triggered yet. "For a liability to qualify for recognition there must be not only a present[existing]

obligation but also… [at least some] probability of an outflow of resources embodying economic benefits to settle that obligation" (IASB 2001c, IAS 37 § 23). In other words, the obligation shall result in the outflow of economic resources. The probability of outflow shall not be necessarily high (IASB 2001c, IAS 37 § 10 & 14; IASB 2018, Conceptual Framework § 4(37)). Obligation might be classified as a liability even if the probability of transfer is low, though this probably is one of the main determinants for the existence of obligation (IASB 2018, Conceptual Framework § 4(38)). Thus, probabilities work as criteria for recognition, measurement, and classification of liabilities and assets with minimum thresholds. In other words, if one is certain that obligation/asset exists but the related probability of outflow/inflow of economic resources is remote obligation/asset shall not be disclosed in financial statements (IASB 2001c, IAS 37 § 23).

4.4. Probability of an outflow of resources embodying economic benefits

When it comes to the outflow of resources embodying economic benefits word "probable" is defined in footnotes of IAS 37 as "more likely than not" (IASB 2001c, IAS 37 A1429), which most experts define as the probability of slightly more than 50% (Alibhai et al. 2018, 437), is explicitly linked to provisions (IASB 2001c, IAS 37 § 14). Probability of less than 50% (less than likely) is implicitly linked to contingent assets and contingent liabilities while saying "it is not probable that an outflow of…" (IASB 2001c, IAS 37 § 10) or "possible obligation" (IASB 2001c, IAS 37 § 10) which on its own implies that outflow of resources is less than likely.

EFRS in ASBG 8 – provisions, contingent liabilities, and contingent assets – offer comprehensive illustrations of when to recognize each type of liability or asset, which is presented in this thesis for illustrative purposes. These illustrations are presented below in figure 1 and figure 2. While the left column visualizes the probability of obligation at the end of the period vertically, the middle column links each type of liability or asset to probability. The respective treatment of each component is described in the last column. Though, probabilities of obligations expressed in percentages are approximations. Other than that assessment of the situation might depend on managers' decisions as well.

Probability	Category	Treatment
Certain realisation ***100%***	**Liability**	*Record on the balance sheet*
Probable	**Provision**	*Record on the balance sheet and describe in notes*
50% *Less than likely*	**Contingent Liability**	*Describe in notes*
Unlikely ***0%***	-	*Don't do anything*

Figure 1. liabilities, related probabilities, and respective treatment on financial statement.
Source: Ministry of finance 2019, 14

Probability	Category	Treatment
Certain realisation ***100%***	**Asset**	*Record on the balance sheet*
Probable	**Contingent Asset**	*Describe in notes*
50% *Less than likely*	-	*Don't do anything*
Unlikely ***0%***	-	*Don't do anything*

Figure 2. Assets, related probabilities and respective treatment on financial statement.
Source: Ministry of finance 2019, 14

The author of this thesis thinks that a realistic alternative to settle is a somewhat equal notion to probabilities when it comes to a realistic estimate of outflow/inflow of economic resources. In other words, in the case of liabilities, if the company has a realistic alternative to settle the obligation, the company might have more possibilities to avoid obligation completely or partially, therefore the overall expected value of outflow of resources might be lower. In other words, if there is a high probability to transfer economic resources in a certain scenario, but there exists a lot of other scenarios with really low probabilities, the expected value of outflow of economic resources would be relatively low (IASB 2001c, IAS 37 § 39). Therefore, in practice when it comes to a realistic estimate of outflow/inflow of economic resources realistic alternative to settle obligation or probabilities shall not be discussed separately.

4.5. Realistic estimate of probable outflow/inflow of economic resources

Standard emphasizes that using estimations while preparing financial statements is essential, and in most cases, this estimate can be reliable to measure and recognize provisions. (Alibhai et al. 2018, 426). The best estimate is what entity rationally would have to pay or receive to settle the obligation at the end of the period (IASB 2001c, IAS 37 § 37), which can be assessed by managers of the entity (IASB 2001c, IAS 37 § 38). If the company is measuring a single obligation or asset, the "most likely outcome may be the best estimate of the liability [or asset]" (IASB 2001c, IAS 37 § 38). If measurement involves a lot of different possibilities, outcomes, or populations, it can be assessed with a statistical method called "expected value" (IASB 2001c, IAS 37 § 39). Though, in extreme cases where estimates cannot be made contingent liability shall be disclosed in notes (IASB 2001c, IAS 37 § 26).

4.6. Present and possible obligations

Like non-refundable VAT, VAT adjustment has an obvious effect on the cash flow of the company, it is linked to the income statement and balance sheet of the company and it might be inflow or outflow of economic resources (IFRS Interpretations Committee 2021, 15; IASB 2018, Conceptual framework § 1(3)). Though, it might not be always clear if an obligation exists (IASB 2001c, IAS 37 § 15) or in other words if the obligation to adjust VAT exists. Other than obligations arising from the contract and legal means there exists constructive obligation which can arise from company's practices, policies, or statements (IASB 2001c, IAS 37 § 10; IASB 2018, Conceptual Framework § 4(31)). These constructive obligations take the form of responsibility, because of promises and past practices from the company the other party expects to be fulfilled (Alibhai et al. 2018, 425–426).

Right to deduct input VAT is a point transaction, in other words, the company gets this right at the moment it purchases capital goods (Marshal 2006, 173). Though, the right/obligation to adjust VAT is related to undertaking an activity in periods following acquisition (KMS § 32). In other words, adjustment of VAT is based on actual business use of an asset in specific periods (KMS § 32; Nellen et al. 2016, 303-356). After input VAT for capital goods is deducted, it is subject to an adjustment from five to ten years (KMS § 32(41)). Therefore, the extent of obligating events in terms of affected periods where VAT might be subject to adjustment, we might think about it as:

a) Abligating events that might make deducted VAT subject to an adjustment only for the period when obligating event took place (thereinafter “current period”) and,
b) Obligating events that might make deducted VAT subject to an adjustment after the current period as well (thereinafter “future periods”).

Following the VAT adjustment system in Estonia, discussed in section 1.3 of this thesis, the legal obligation to adjust VAT for each period arises separately, once in each reporting year at the end of the period (KMS § 32). In other words, the company receives a VAT receipt payable to authority, which reflects the adjustable portion of VAT from capital goods once in a year, at the end of the period and only for the current period (KMS § 32; Nellen et al. 2016, 303-356). Hence, obligating event certainly can be the reason for a legal obligation for the current period. In this scenario, the situation is simple. As managers decide that there exists a present or possible obligation to adjust VAT at the end of the current period, they shall disclose this information on the financial statement as provision, contingent asset, or contingent liability depending on the situation. But what happens if managers are certain to some extent that because of obligating event initially deducted VAT will be subject to an adjustment in future period or periods as well (after the current period)? Shall companies recognize provisions or disclose contingent assets or contingent liabilities for all affected periods? In other words, as we assume that the company is going to operate in future periods for one or another reason, do we assume that the company has an obligation to adjust VAT for future periods which shall be disclosed in financial statements?

4.6.1. Obligation for future periods

As we discussed in section 4.1 of this thesis, we shall treat VAT adjustment as a levy. The same topic, obligation for future periods, though with the perspective of levies, is discussed in IFRIC 21, which says: “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” (IFRS Interpretations Committee 2013a, § 9). Paragraph 10 of IFRIC 21 addresses going concern and explains that "The preparation of financial statements under the going concern assumption does not imply that an entity has…[any]present obligation[legal or constructive] to pay a levy that will be triggered by operating in a future period“ (IFRS Interpretations Committee 2013a, § 10).

At first glance, all of these statements are restricting to disclose possible VAT adjustments for future periods. Though, if we pay close attention, we see the phrase “levy that will be triggered”

(IFRS Interpretations Committee 2013a, § 9 & 10). As we discussed in subsection 4.2.1, the company is allowed to recognize or disclose possible VAT adjustment in financial statements only after triggering event that leads to obligation. In other words, the company is allowed to recognize or disclose possible VAT adjustments in financial statements as provision, contingent asset, or contingent liability only after a liability to adjust VAT is already triggered and obligation already exists. In IAS 37 we read: “no provision is recognized for costs that need to be incurred to operate in the future. The only liabilities recognized in an entity’s statement of financial position are those that exist at the end of the reporting period” (IASB 2001c, IAS 37 § 18). Therefore, if the criteria in subsection 4.2.1 are met, in other words, if the obligation to adjust VAT for future periods is already triggered and it already exists, there is nothing forbiding disclosure of possible VAT adjustments for future periods as well. Following the accrual basis of accounting, the effect of a particular event on an entity’s financial position is reflected in the period when these events take place, even if resulting cash transactions take place in the later period (RPS §16; IASB 2018, Conceptual framework § 1(17); Greuning et al. 2011, 5). Financial statements disclose and/or recognize some possible future transactions if they include useful information for users of financial statements (IASB 2018, Conceptual framework § 3(6)). Respectively, if managers decide that there exists a present or possible obligation to adjust VAT in future periods as well, they shall disclose this information on the financial statement as provision, contingent asset, or contingent liability depending on the situation.

CONCLUSION

IFRS and EFRS do not provide specific guidance about how we shall treat the possible VAT adjustment on capital goods on financial statements. Considering the design of the VAT scheme, where the company is just a collector of the VAT for the local authority, VAT collection and payment is not considered as a business transaction (Marshal 2006, 179-185). When the company is involved in some exempt transactions, VAT might be subject to partial deduction (Nellen et al. 2016, 303-356). Following the IFRS, capital goods shall be recorded at their cost (IASB 2001a, IAS 16 § 15), which includes any nonrecoverable VAT (IASB 2001a, IAS 16 § 6), in other words, non-refundable VAT becomes a cost component for the company. This situation goes against one of the fundamental VAT principles of neutrality, which aims not to affect the company's decision making (Nellen et al. 2016, 303-356), and gives space for interpretation of how we shall treat possible VAT adjustments.

While the initial deduction of VAT is straightforward and is a "point transaction", in other words, the company gets this right at the moment it purchases capital goods (Marshal 2006, 173), VAT adjustment is directly related to periods following acquisition day. According to Estonian regulation, VAT on capital goods is subject to an adjustment from five to ten years (KMS § 32 (4.1)). This means that the VAT portion of the cost of the capital might change for respective periods, and the company might pay less or more VAT as a result of VAT adjustment based on the actual use of an asset (KMS § 32; Nellen et al. 2016, 303-356). This might be useful information for decision-makers related to the cash flow of the company, income statement, and balance sheet and raises a question if we shall disclose possible VAT adjustments on financial statements, to give full information to users of financial statements.

While analyzing if VAT adjustment qualifies as contingencies, the author of this thesis follows hierarchy in paragraphs 10– 11 of IAS 8. The author goes through VAT regulations, definitions, and criteria for recognizing contingencies, IFRS interpretations, accounting treatment of VAT adjustment and checks compliance with the conceptual framework and other IFRSs to find if possible VAT adjustments shall be reflected on financial statements.

Throughout the thesis, opinions linking non-refundable VAT and levy are emphasized. There is a strong argument in IFRS interpretations that non-recoverable VAT is levy (IFRS Interpretations Committee 2021, 15) but, VAT adjustment is not explicitly addressed anywhere. While in IFRIC

21 interpretation committee, emphasizes the fact that for the purpose of the IFRIC 21, VAT is not levy (IFRS Interpretations Committee 2021, 12) later interpretations and bases for conclusion for interpretations, highlights a different aspect of VAT and says that non-recoverable VAT results in an outflow of economic resources, and it is imposed by government by legislation, consequently non-refundable VAT falls under IFRIC 21 (IFRS Interpretations Committee 2021, 15). Since VAT adjustment is not an income tax it is within the scope of IAS 37 (IFRS Interpretations Committee 2019, 9). The thesis emphasizes the periodic nature of VAT adjustment. We can argue that it takes the form of "VAT on operations". In other words, it is VAT but, directly related to the business practices of the company in specific periods. Following the interpretation committee decision in 2019 we have an "adequate basis for an entity to account for deposits" (IFRS Interpretations Committee 2019, § 2), we shall assume the existence of the same basis for situations when VAT is payable after adjustment. Hence, the author of this thesis concludes that possible VAT adjustment on capital goods is relevant information for the users of financial statements when as a result company has to pay more or less VAT on the due date and shall be disclosed in financial statements.

Discussion of the timeline of VAT adjustment makes it clear that initial VAT deduction alone, without following triggering even, is not enough for provisions, contingent liabilities, or contingent assets to exist. Paragraph BC12 of Basis for Conclusions on IFRIC Interpretation 21 levies emphasizes the fact "that there can be only one single obligating event" (IFRS Interpretations Committee 2013b, § BC12), even though activities undertaken in the previous year are necessary to create present obligation (IFRS Interpretations Committee 2013b, § BC12). Therefore, companies shall be careful when deciding what is an actual obligating event that triggers obligation, taking into account the concepts described in subsection 4.2.1:

a) existence of obligating event in past;
b) the possible existence of several necessary activities leading to an obligation;
c) existence of only one single obligating event.

For possible VAT adjustment to qualify as a provision the following is required:

a) All the necessary steps (including triggering event) leading to the obligation to adjust VAT already took place. Therefore, the obligation to adjust VAT already exists.
b) The obligation exists independently of an entity's future actions and obligation cannot be avoided because:
    - it is enforced by law; and/or
    - there is a constructive obligation.

c) There are some external factors, causing some degree of uncertainty, which might change the situation.

For possible VAT adjustment to qualify as a contingent liability the following is required (The same logic applies to contingent assets and the list would look alike with some minor changes):

a) All the necessary steps (including triggering event) leading to the obligation to adjust VAT already took place. Therefore, the obligation to adjust VAT already exists; but
b) The entity has realistic alternatives to settle the obligation, depending on scenarios developed under external factors (criteria c of this list). Thus, the part of the obligation could be avoided because:
    - it is enforced by law but the means of execution is up to the company; and/or
    - there is a constructive obligation but the means of execution is up to the company.
c) There are some external factors, causing some degree of uncertainty, which might change the situation so that company has realistic alternatives to settle the obligation

Possible VAT adjustment does not qualify as provisions but qualifies as contingent liabilities because it is not probable that outflow of resources will be required to settle the obligation or because obligation cannot be measured reliably (IASB 2001c, IAS 37 § 11; Greuning et al. 2011, 239). Following the criteria above, possible VAT adjustment does not qualify as provisions when an entity has realistic alternatives to settle the obligation, though it qualifies as a contingent liability.

"For a liability to qualify for recognition there must be not only a present [existing] obligation but also… [at least some] probability of an outflow of resources embodying economic benefits to settle that obligation" (IASB 2001c, IAS 37 § 23). In other words, the obligation shall result in an outflow of economic resources. The probability of outflow shall not be necessarily high (IASB 2001c, IAS 37 § 10 &14; IASB 2018, Conceptual Framework § 4(37)). Thus, probabilities work as criteria for recognition, measurement, and classification of liabilities and assets with minimum thresholds. In other words, if one is certain that obligation/asset exists but the related probability of outflow/inflow of economic resources is remote obligation/asset shall not be disclosed in financial statements (IASB 2001c, IAS 37 § 23).

In practice when it comes to a realistic estimate of outflow/inflow of economic resources realistic alternative to settle obligation or probabilities shall be discussed together. Considering the

probability of outflow or inflow of economic resources, the possibility to estimate the fair value of obligation companies shall follow disclosure requirements set down in paragraphs 84 to 92 of IAS 37, depending on what type of liability or asset there exist in managers opinion.

Considering EU and Estonian VAT law, the legal obligation to adjust VAT for each period arises separately, once in each reporting year at the end of the period (KMS § 32). Therefore, obligating event certainly can be the reason for a legal obligation for the current period. Hence, as managers decide that there exists a present or possible obligation to adjust VAT at the end of the current period, they shall disclose this information on the financial statement as provision, contingent asset, or contingent liability depending on the situation.

As we discussed in subsection 4.2.1, the company is allowed to recognize or disclose possible VAT adjustment in financial statements only after triggering event that leads to obligation. In other words, the company is allowed to recognize or disclose possible VAT adjustments in financial statements as provision, contingent asset, or contingent liability only after a liability to adjust VAT is already triggered and obligation already exists. In IAS 37 we read: “no provision is recognized for costs that need to be incurred to operate in the future. The only liabilities recognized in an entity’s statement of financial position are those that exist at the end of the reporting period” (IASB 2001c, IAS 37 § 18). Therefore, if the criteria in subsection 4.2.1 are met, in other words, if the obligation to adjust VAT for future periods is already triggered and it already exists, there is nothing forbidding disclosure of possible VAT adjustments for future periods as well. Following the accrual basis of accounting, the effect of a particular event on an entity’s financial position is reflected in the period when these events take place, even if resulting cash transactions take place in the later period (RPS §16; IASB 2018, Conceptual framework § 1(17); Greuning et al. 2011, 5). Financial statements disclose and/or recognize some possible future transactions if they include useful information for users of financial statements (IASB 2018, Conceptual framework § 3(6)). Respectively, if managers decide that there exists a present or possible obligation to adjust VAT in future periods as well, they shall disclose this information on the financial statement as provision, contingent asset, or contingent liability depending on the situation.

The answer to the RQ1 is as follows: VAT adjustment on capital goods is a levy and shall be disclosed on financial statements as contingencies before settlement because it is relevant information.

The answer to the RQ2 is as follows: possible VAT adjustment on capital goods shall be disclosed only after triggering the event. When it is not probable that outflow of resources will be required to settle the obligation to adjust VAT or because obligation cannot be measured reliably obligation qualifies only contingent liability. If the company has the realistic alternatives to settle (avoid) the obligation to adjust VAT in some possible developments of the future, obligation qualifies only as a contingent asset or contingent liability. Disclosing contingent liability, contingent assets, or recognizing provision is possible for all VAT adjustment periods.

We can reasonably argue that the existence of most of the possible VAT adjustments will not be apparent by the time of preparation of annual financial statements. Though if companies are preparing interim financial statements, which follow the same accounting policies as annual financial reports (IASB 2001b, IAS 34 § 28) they shall disclose this information in selected explanatory notes which is one of the required parts of the report (IASB 2001b, IAS 34 § 8). For further research, the same study can be done concentrated on EFRS.

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