STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Negative Low Emission Vehicle Credits (IAS 37)**
Paper topic	Supplementary analysis—reconciliation to IFRIC 6, IFRIC 21 and Illustrative Examples 6 and 11B

CONTACTS	Syamsul Hidayah	shidayah@ifrs.org
	Joan Brown	jbrown@ifrs.org

Introduction

Purpose of appendix

A1 This appendix provides additional analysis to support staff conclusions and drafting suggestions in Agenda Paper 4 *Negative Low Emission Vehicle Credits (IAS 37)—Comments on Tentative Agenda Decision*.

Background

Tentative agenda decision

A2 In February 2022, the IFRS Interpretations Committee (Committee) published a tentative agenda decision in response to a submission about IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

A3 A question raised by the submission was whether an entity has a liability for an outflow of resources embodying economic benefits (economic resources) if the entity can avoid the outflow through its future actions. The tentative agenda decision reported the Committee's conclusion that, in the fact pattern described in the submission, an entity has a liability unless the future actions required to avoid the outflow are a realistic alternative for the entity.

Comments on tentative agenda decision

A4 IAS 37 and its Interpretations illustrate other fact patterns in which an entity could avoid an outflow of economic resources through its future actions. For these other fact patterns, the conclusion is that the entity does *not* have a liability—even if the future actions required to avoid the outflow are not a realistic alternative for the entity.

A5 As reported in paragraphs 18–21 of Agenda Paper 4, some respondents to the tentative agenda decision express concern that the logic the Committee has applied in reaching its conclusions is (or might appear to be) inconsistent with that applied in other examples that interpret or illustrate the application of IAS 37, especially:

(a) IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*;

(b) IFRIC 21 *Levies*; and

(c) Illustrative Examples accompanying IAS 37:

(i) Example 6—Legal requirement to fit smoke filters; and

(ii) Example 11B—Refurbishment costs – legislative requirement.

A6 A few respondents suggest that if the logic the Committee has applied in the tentative agenda decision is (or appears to be) different from that applied in other examples that interpret or illustrate the application of IAS 37, there is a risk that entities will account for economically equivalent fact patterns differently, depending on which examples an entity refers to for guidance. PwC includes within its comment letter a description of three fact patterns that it suggests illustrate this risk.

Staff conclusions and drafting suggestions

A7 In paragraph 25 of Agenda Paper 4, the staff:

(a) conclude that the conclusions in the tentative agenda decision are consistent with those in IFRIC 6, IFRIC 21 and Illustrative Examples 6 and 11B accompanying IAS 37; and

(b) suggest changes to the drafting of the agenda decision to make the consistency clearer.

A8 Additionally, in paragraph 44 of Agenda Paper 4, the staff suggest refinements to the drafting of the agenda decision to identify the two actions required for an entity to have a constructive obligation.

A9 This appendix provides staff analysis to support these conclusions and drafting suggestions.

Structure of staff analysis

A10 The staff analysis in this appendix comprises:

		Paragraphs
(a)	a reconciliation of the conclusions in the tentative agenda decision to those in IFRIC 6 and IFRIC 21.	A11–A18
(b)	a reconciliation of the conclusions in the tentative agenda decision to those in Illustrative Examples 6 and 11B accompanying IAS 37.	A19–A25
(c)	an analysis of other fact patterns described in comment letters.	A26–A30

Staff analysis

Reconciliation to IFRIC 6 and IFRIC 21

A11 We think the key to reconciling the conclusions in the tentative agenda decision to those in IFRIC 6 and IFRIC 21 is to distinguish two types of actions that an entity might take:

(a) actions that *create* an obligation; and

(b) actions that *settle* the obligation.

A12 An entity could avoid an outflow of economic resources by avoiding either the actions that create an obligation or the actions that settle the obligation.

A13 We think the distinction between the two types of actions is important because, in determining whether an entity has a liability, actions that create an obligation are treated differently from actions that settle the obligation. For an entity to have a liability at the reporting date:

(a) the entity must *have taken* the actions necessary to *create* an obligation:

> IAS 37 defines a liability as a 'present obligation … arising from past events' and paragraph 19 of IAS 37 clarifies that 'it is only those obligations arising from past events existing independently of an entity's future actions' that meet the definition of a liability.

(b) the entity must have *no realistic alternative to taking* the actions necessary to *settle* the obligation:

> Paragraph 10 of IAS 37 defines an obligating event as 'an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation'.

A14 The important feature of the requirements is that the ‘no realistic alternative’ criterion applies only to the actions necessary to *settle* an obligation, not to the actions necessary to *create* an obligation. In other words, ‘no realistic alternative’ is a factor to consider in assessing the enforceability of an obligation, not in assessing the timing of its creation. If, at the reporting date, an entity has not yet taken the actions necessary to create an obligation, it does not yet have a liability—even if it has no realistic alternative to taking these actions in the future.

A15 Both IFRIC 6 and IFRIC 21 address government-imposed charges. In both cases:

(a) the charge is ‘linked to’ (IFRIC 6) or ‘triggered by’ (IFRIC 21) an activity specified in legislation—an entity becomes obliged to pay the charge only if and when it conducts the linked or triggering activity specified in that legislation;

(b) that activity specified in the legislation might occur later than the revenue- or profit-generating activity that is the underlying reason for imposing the charge;

(c) the purpose of the Interpretation is to clarify which of an entity’s activities (the linked/triggering activity or the earlier revenue- or profit-generating activity) creates an obligation; and

(d) the consensus applies paragraph 19 of IAS 37 to conclude that the obligating event is the linked/triggering activity—before then there is no obligation existing independently of the entity’s future actions.

A16 For the fact patterns in both IFRIC 6 and IFRIC 21, the questions raised by the legislation and answered by the consensus relate to the timing of the creation of an obligation, not the entity’s ability to avoid settling any obligation that arises. In the absence of any information to the contrary, we assume the legislation is enforceable in the conventional way—the government has the power to take legal proceedings to enforce settlement—so an entity that has incurred an obligation will have no realistic alternative to settling it. For this reason, there is no need for IFRIC 6 or IFRIC 21 to discuss realistic alternatives to settlement.

A17 We think the conclusions in the tentative agenda decision are consistent with those in IFRIC 6 and IFRIC 21. The government measures described in the submission give rise to an obligation to eliminate negative credits. The measures link that obligation to an activity of an entity—the production or import of vehicles with average fuel emissions higher than a government target. The tentative agenda decision identifies this linked activity as the activity that creates a present obligation.

A18 However, in the fact pattern described in the submission, there is a second step to consider. We cannot assume that an entity with an obligation to eliminate negative credits has no realistic alternative to settling that obligation. The measures do not give the government the power to take legal proceedings to enforce settlement. Instead, the measures give the government the power to place restrictions on the future activities of an entity that fails to settle the obligation. For some entities, accepting these restrictions might be a realistic alternative to settling the obligation. Accordingly, the tentative agenda decision discusses not only the activities that create an obligation, but also the need to assess whether the entity has a realistic alternative to settling an obligation once it has been created.

Reconciliation to Illustrative Examples 6 and 11B accompanying IAS 37

A19 All entities face constraints on the way in which they operate. These constraints are typically legal—that is, they derive from the legal system of the jurisdiction in which the entity operates. But constraints can instead be constructive—that is, they derive from actions of the entity that create a valid expectation in other parties that the entity will behave in a particular way.

A20 The constraints might oblige an entity to conduct its operations in accordance with specified environmental, health and safety, or social standards—for example, to:

(a) limit its emissions of pollutants or greenhouse gases to a specified amount;

(b) maintain equipment used to provide services to customers to a specified condition; or

(c) pay a specified minimum wage to its employees.

A21 Such constraints do not necessarily give rise to liabilities because operating within a constraint does not necessarily require an outflow of economic resources. For example, to comply with environmental or health and safety regulations, an entity might need to purchase equipment (for example, smoke filters for its factories) or to enhance its existing equipment (for example, overhaul aircraft). In these cases, compliance does not require an outflow of economic resources—the entity exchanges one resource (cash) for another resource (equipment) and there is no net outflow. As illustrated in Illustrative Example 11B accompanying IAS 37, a requirement to overhaul aircraft every three years is accounted for by attributing part of the cost of an aircraft to components that need to be overhauled every three years, and depreciating that part of the cost over three years—not by recognising a provision for future overhaul costs.

A22 However, some constraints can give rise to liabilities:

(a) if *compliance* will result in an outflow of economic resources—for example:

   (i) payment of a tax charge or levy;

   (ii) performance of asset decommissioning or environmental rehabilitation services; or

   (iii) surrender of credits like those described in the tentative agenda decision; or

(b) if *non-compliance* can result in an outflow of economic resources—for example:

   (i) payment of a fine or penalty for failure to comply with health and safety regulations; or

   (ii) payment of compensation to a party harmed by an act of wrongdoing by the entity; or

(c) if the imposition of a constraint means that contracts the entity has entered into become onerous (for example, because the entity will generate less revenue or incur additional costs).

A23 If a constraint could result in an outflow of economic resources from an entity, the existence of the constraint is not sufficient to create a liability. The constraint must exist *and* the entity must have conducted the activity that triggers an obligation for an outflow. This means that:

(a) enactment of legislation is not sufficient to create a legal obligation for an entity, unless the legislation applies retrospectively to the entity’s past activities or affects the entity’s existing contracts; and

(b) a public statement by an entity that it will behave in a particular way (for example, restore any land it damages) is not sufficient to create a constructive obligation for that entity, unless the statement applies retrospectively to the entity’s past activities (for example, land the entity has already damaged) or affects the entity’s existing contracts.

A24 The conclusions in Illustrative Example 6 accompanying IAS 37 are consistent with the analysis in paragraphs A21–A23. In Illustrative Example 6, new legislation in 20X0 requires an entity to fit smoke filters to its factories by 30 June 20X1, and non-compliant operation of a factory after that date may give rise to fines or penalties. The conclusions are that:

(a) the legislation does not give rise to a liability for the cost of fitting smoke filters;

(b) the only potential obligating event is non-compliant operation of a factory after 30 June 20X1. This is the activity that could trigger a charge for fines or penalties.

A25 The conclusions in the tentative agenda decision are consistent with those in Illustrative Examples 6 and 11B. In all the fact patterns, the only activity that is viewed as creating a liability is the activity that could trigger an outflow of economic resources.

Other fact patterns referred to in comment letters

'Net zero' and other environmental and social commitments

A26 Some respondents to the tentative agenda decision express concerns that the discussion of constructive obligations could be interpreted more broadly than intended and, in particular, could be applied to public statements that entities make in relation to environmental and social commitments—for example, 'net zero' commitments. We think that the analysis set out above could help entities identify whether and when such statements give rise to liabilities. In particular, it could clarify that:

(a) as discussed in paragraphs A19–A21, a constraint on the way in which an entity operates (whether legal or constructive) does not necessarily create liabilities for the entity, because operating within a constraint does not necessarily require an outflow of economic resources; and

(b) as discussed in paragraph A23, if a constraint could require an outflow of economic resources from an entity (for example, a penalty for failure to operate within specified limits), the existence of the constraint is not sufficient to create a liability. The constraint must exist *and* the entity must have conducted the activity that triggers an obligation for an outflow (for example, operated outside the specified limits).

Three fact patterns described by PwC

A27 In its response to the tentative agenda decision, PwC suggests that, unless the Committee clarifies how the fact pattern in the tentative agenda decisions differs from those in IFRIC 6, IFRIC 21 and Illustrative Examples 6 and 11 accompanying IAS 37, application of the tentative agenda decision could result in transactions with similar legislative objectives and economic substance being accounted for differently.

A28 The firm describes three fact patterns, and suggests that the conclusions that might be reached for those fact patterns applying the logic in the tentative agenda decision could be different from the conclusions that would be reached applying other requirements in IFRIC 6, IFRIC 21 or IAS 37.

A29 For each of these examples, we set out in the table below:

(a) the fact pattern described by PwC;

(b) PwC's concern about the implications of the tentative agenda decision; and

(c) our staff view.

A30 We use the analysis in paragraphs A11–A25 above to help explain our view that, for each of the three examples, the conclusions reached applying the logic in the tentative agenda decision would be the same as those reached applying other requirements in IFRIC 6, IFRIC 21 and IAS 37.

Table—example fact patterns discussed in PwC comment letter

Example 1	
Fact pattern	The fact pattern is the same as that described in Illustrative Example 6 accompanying IAS 37 (see paragraph A24 above), except that: (a) the new legislation requires entities to fit smoke filters to kitchens by 1 January 2023; and (b) the legislation applies to any entity that operated as a restaurant in 2021.
PwC concern	The logic in the tentative agenda decision could imply that the obligating event that gives rise to a present obligation is operation as a restaurant during 2021. Hence, applying that logic, if an entity operated as a restaurant during 2021, it should recognise a provision in 2021.
Staff view	As discussed in paragraphs A21–A24 above, a requirement to operate with smoke filters is not an obligation that results in an outflow of economic resources. The only outflows would be the penalties or fines that could be triggered by non-compliant operation. The logic in the tentative agenda decision (the obligating event is the action required to trigger an obligation that results in an outflow of economic resources) would lead to the same conclusion as that in Example 6 accompanying IAS 37—the only obligating event would be non-compliant operation of a kitchen after 1 January 2023.

Example 2	
Fact pattern	The fact pattern is similar to that in Example 2 in IFRIC 21. Legislation imposes a levy to be paid on 1 June 2022 by an entity that both: (a) operated as a financial institution during 2021; and (b) continues to operate as a financial institution in 2022. The levy is calculated as a percentage of revenue recognised in 2021.
PwC concern	Applying IFRIC 21 would lead to a conclusion that the entity does not have a liability at 31 December 2021. The fact that an entity has operated as a financial institution in the past does not provide certainty that it will continue to do so in the future. The entity can avoid payment of the levy by discontinuing its financial services activities on 31 December 2021. Therefore, the liability arises in 2022, once the entity has triggered a requirement to pay by continuing to operate as a financial institution (paragraph 9 of IFRIC 21). In contrast, applying the logic in the tentative agenda decision could lead to a conclusion that the entity has a liability that arises progressively throughout 2021. Operating as a financial institution in 2021 gives rise to an obligation for the entity, because ceasing operations in December 2021 is not an economically realistic alternative course of action at 31 December 2021.
Staff view	The same conclusion would be reached applying either IFRIC 21 or the tentative agenda decision, for the reasons discussed in paragraphs A11–A18 above. Both IFRIC 21 and the tentative agenda decision identify as the obligating event the action of the entity that triggers the creation of an obligation under the legislation—operating as a financial institution in *both* 2021 and 2022. At 31 December 2021, the entity has not yet operated in 2022 and therefore has not conducted the activity that triggers the creation of an obligation. The 'no realistic alternative' criterion applies only to actions required to settle the obligation, not actions required to create an obligation.

Example 3 –>

Example 3	
Fact pattern	The fact pattern is a modified version of the fact pattern in the tentative agenda decision, but involving a levy instead of negative credits. Legislation requires entities to compare the average fuel emissions of vehicles produced or imported from 1 January 2023 to 30 June 2024 to a specified target. If the average fuel emissions exceed the target, a levy is paid; if they are below the target, no levy is paid. The payment will be triggered based on the calculation of the average emissions of all vehicles produced or imported during the period from 1 January 2023 to 30 June 2024 compared to the target.
PwC concern	Despite the substance of the legislation being similar to that described in the tentative agenda decision, the form of the legislation could drive a different outcome. The levy would be within the scope of IFRIC 21, and the conclusion reached applying IFRIC 21 would be that the entity does not have a liability at 31 December 2023. Before 30 June 2024, no obligation exists independently of the entity's future actions – the entity could avoid paying the levy, for example by producing or importing more vehicles that lower the average emissions, even if the average exceeds the target at certain times within the period.
Staff view	Applying IFRIC 21 would not necessarily lead to a conclusion that no obligation exists until 30 June 2024. IFRIC 21 states that the obligating event for a levy is 'the activity that triggers payment of the levy'. In this example, that activity is producing or importing vehicles whose average fuel emissions exceed the specified target. IFRIC 21 does not address situations in which the triggering activity occurs over a period and the levy depends on the average at the end of the period. Nothing in IFRIC 21 precludes a conclusion that, were the triggering activity to occur over a period, the obligation arises over that period, with the obligation at any date within the period reflecting the cumulative position at that date. Two examples accompanying IFRIC 21—Example 1 (in which a levy is triggered progressively) and Example 4 (in which a levy is triggered if revenue exceeds a threshold)—address triggering activities that occur over a period. Both of these examples suggest that a levy would be recognised at a date within the period by reference to the cumulative position at that date—ignoring any activity after that date.