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International Accounting Standards Board

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Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **July 2008, London**

Project: **Compliance Costs for REACH (Agenda Paper 6D)**

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1. The IFRIC has received a request to add an item to its agenda to provide guidance on the treatment of costs incurred to comply with the requirements of the European Regulation concerning the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH). The Regulation came into force in part on 1 June 2007 and companies have begun to account for the first costs incurred to comply.

Submission

2. Background information on the provisions of the Regulation and more detail on the approaches currently found in practice are set out in the submission, which is attached as the Appendix to this agenda paper.

3. The submission notes that different types of costs are incurred due to the Regulation. It also notes that a variety of treatments for the costs have been observed in practice, including:

a) the expense as incurred approach

b) the separate right approach, including both separate acquisition costs and internally generated intangible asset considerations

c) the 'part of registered chemical' approach.

In addition, entities are beginning to develop accounting policies which are a mixture of these approaches.

Staff Analysis

4. The submission notes that the Regulation will apply to a large number of European entities reporting in accordance with IFRSs. In addition, the staff observes that the Regulation also applies to all entities doing business in Europe. Thus, it will apply to the European operations of entities reporting in accordance with IFRS in other jurisdictions. Therefore, the issue is both practical and of widespread application.

5. Given the large number of entities affected, the staff agrees with the submission that financial reporting would be improved if diversity in practice in the treatment of these costs did not exist. Ideally, diversity should be prevented from developing but if it has already begun to emerge, timely action could prevent it from becoming entrenched.

6. In some respects this issue is similar to the questions considered by the IFRIC in IFRIC 6 *Liabilities Arising from Participating in a Specific Market — Waste Electrical and Electronic Equipment.* In the staff's view, similar considerations apply to the IFRIC's decision whether to add the issue to its agenda.

Staff recommendation

7. The staff recommends that the IFRIC tentatively add this issue to its agenda. More research will be necessary on the precise nature of the requirements. In addition, the staff needs to confirm the conclusion in the submission that diversity exists in practice more generally than in the jurisdiction submitting the issue.

8. The staff would also like to investigate the opportunity of working with other interpretive bodies whose entities may be affected by the Regulation to determine whether a response to the issues identified could be developed collaboratively.

Question for the IFRIC

9. Does the IFRIC agree with the staff recommendation tentatively to add the issue to its agenda?

APPENDIX

IFRIC Agenda Item Request

The issue: Treatment of Compliance Costs in regards to REACH

I. Background Information

The regulation (EC) No 1907/2006 of the European Parliament and of the Council of December 18, 2006 concerning the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH), which entered into force in part on June 1, 2007, has certain impact on many businesses - namely the chemical industry.

Under the regulation all manufacturers and importers of chemicals must identify and manage risks linked to the substances they manufacture and market. For substances produced or imported in quantities of 1 tonne or more per year per company, manufacturers and importers need to demonstrate that they have appropriately done so by means of a registration dossier, which must be submitted to the European Chemicals Agency (ECHA). The **registration** will start on June 1, 2008 – however, many companies have stared to account for the first costs incurred in respect to REACH and to set up their respective accounting policies.

The Agency may then check that the registration dossier complies with the Regulation and must evaluate testing proposals to ensure that the assessment of the chemical substances will not result in unnecessary testing, especially on animals. Where appropriate, authorities may also select substances for a broader substance evaluation to further investigate substances of concern. REACH also foresees an authorisation system aiming to ensure that substances of very high concern are properly controlled, and progressively replaced by suitable alternative substances or technologies where these are economically and technically viable. Where this is not possible, the use of substances may only be authorized where there is an overall benefit for society of using the substance. In addition, EU authorities may impose restrictions on the manufacture, use or placing on the market of substances causing an unacceptable risk to human health or the environment. The Member States authorities are responsible for enforcing REACH through inspections as well as penalties in case of non-compliance.

Thus, the following steps need to be taken by both producers and importers of chemical substances:

- Identification of substances (to be differentiated between “non-phase-in” substances, which are broadly substances which have not previously been placed on the EU market and “phase-in” substances, which have been on the EU market for a longer time),
- Pre-Registration of “phase-in” substances, and
- Registration of “phase-in” and “non-phase-in” substances with possible subsequent update of registration.

Multiple companies will be able to register the same or similar substance(s) either individually or by forming a registration consortium (“cost sharing considerations”).

In case of such registration consortiums, costs need to be shared with other parties involved.

For substances of very high concern, an **authorisation** is required rather than registration for their use and their placing on the market. Those using or making available such a substance will need to apply for an authorisation for each use of the substance including an analysis of possible substitutes. An authorisation will be granted if the applicant can demonstrate that the risk from the use of the substance is adequately controlled. If not, then it may also be granted if the socioeconomic benefits outweigh the risks and there are no suitable alternative substances or processes.

II. General Accounting Treatments noted

In respect to the different types of costs being incurred due to REACH (REACH costs) as detailed above, the question has come up, how to treat the costs incurred since in practice a wide variety of treatments has been observed as follows:

1. "Expense as incurred" approach

Some reporting entities consider all REACH costs as "compliance" costs and expense these costs as incurred following the guidance in *Framework* paragraphs78-80. These reporting entities believe that all respective costs do not meet the requirements for recognition of an asset as laid out in *Framework* paragraphs 53-59 and IAS 38.

Especially in the case of studies to be carried out for registration / authorisation of new products it is argued that the costs incurred are being part of the research rather than the development phase (or part of the very early development phase), which normally do not qualify for recognition.

2. "Separate Right" approach

Some reporting entities do consider the REACH costs as separate rights in line with IAS 38.9. These entities argue that REACH costs, whether charged by external parties or incurred internally, qualify for recognition as separate acquisition costs or internally generated intangible assets respectively. With regard to the latter it is considered that:

- the resulting intangible assets will meet the identifiability criterion (IAS 38.12) as well as
- the "control" requirement (IAS 38.13).

a) Separate Acquisition Costs

It is considered probable that the expected future economic benefits that are attributable to the asset will flow to the entity and the costs of the asset can be measured reliably (IAS 38.21 and IAS 38.25-32).

b) Internally generated intangible assets

The REACH costs incurred internally are considered to be intangible assets arising from development and are therefore recognized if the entity can demonstrate that the criteria listed in IAS 38.57 (a) – (f) are met. To demonstrate that these intangible assets will generate probable future economic benefits (IAS 38.60), the reporting entities argue that such benefits will be generated by either sale of the registered chemicals in the normal course of business or by sale of these rights.

3. "Part of registered chemical" approach

Some reporting entities argue that the REACH registration / authorisation costs represent part of the cost incurred for the registered chemical internally generated (thus, the registration / authorization itself is not considered to be a separate intangible asset / a separate right). Rather the chemical internally generated represents an intangible asset and the cost of it includes the cost for the registration / authorization. According to this approach the internally generated intangible asset (including the cost of the registration / authorization) is being accounted for considering the guidance in IAS 38.51-67.

A specific issue to be considered in this context is the fact, that the registration / authorisation in the majority of the instances is required for chemicals which have been in the market for years. For these chemicals the requirements for costs incurred subsequently to add to the intangible asset (IAS 38.18) need to be met. More specifically IAS 38.20 states that the nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it. Accordingly, most subsequent expenditures are likely to just maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria in this Standard.

4. Mixed approaches

Finally, there are reporting entities that are in the course of establishing accounting policies which represent a mixture of above approaches 1. to 3.

III. Type of costs considered to qualify for Capitalization

In order to determine which (type of) costs are to be capitalized the individual facts and circumstances need to be reviewed thoroughly by each reporting entity whether the costs incurred are directly attributable to registration / authorisation and are reliably measurable – in general this may comprise internal and external costs. The individual reporting entity must also determine from which point in time these costs are to be capitalised.

Forming a consortium as a cost sharing vehicle is supported by REACH. One of the general accounting treatments as outlined out above and as deemed appropriate should be applied irrespective of how registration has been obtained.

As with registration, upon authorisation a manufacturer / importer obtains the right to manufacture / import a specific chemical substance. The main difference to registration is that the authorisation will be reviewed after a certain time and this may lead to an amendment or withdrawal of the authorisation for the use of the substance. Nevertheless the costs incurred in achieving authorisation should be reviewed in accordance with the conclusions as laid out above to determine which need to be capitalised.

Current Practice: Diversity in practice

Based on our knowledge of actual accounting practice we have thorough support for the fact that currently there is diversity in practice which is expected to continue or even increase in the future without respective guidance.

In addition, based on the information as disclosed by some chemical companies in respect to how they intend to account for costs incurred by REACH, diversity in practice appears to be evidenced.

Reasons for the IFRIC to address the issue:

a) Is the issue widespread and practical?

As outlined in the above section “current practice” – yes.

b) Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?

As outlined in the above section “current practice” – yes.

c) Would financial reporting be improved through elimination of the diversity?

Financial reporting will be improved through elimination of the diversity since the chemical industry is a rather large one in Europe (it had been estimated that the total cost to be incurred by REACH will amount to €2.3 Billion (estimate of ECHA); figures estimated by the European chemical industry are ranging from €4.3 Billion to €9.7 Billion.

d) Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and *Framework for the Preparation and Presentation of Financial Statements*, but not so narrow that it is inefficient to apply the interpretation process?

We are of the opinion that the issue is sufficiently narrow since it is related to the specific regulation (EC) No 1907/2006 of the European Parliament and of the Council of December 18, 2006 (REACH).

On the other hand, it is not so narrow that it will be inefficient to apply the interpretation process since a large industry (chemical industry – mainly in Europe) will benefit from a clarifying interpretation by IFRIC. Also, in the mid- or long-run it is not improbable that other countries or regions introduce comparable or at least similar monitoring procedures for chemical substances.

e) If the issue relates to current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC would require to complete its due process).

N.A.