Project **Item for continuing consideration**

Topic **IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*—Recognition of a liability**

Purpose of the paper

1. The objective of this paper is to:
   - (a) provide:
     - (i) an analysis of the use of IFRIC 6 by analogy and ask of the Committee its views on the applicability of IFRIC 6 to other situations than WE&EE; and
     - (ii) an analysis of the application of IAS 37 to examples of situations derived from the feedback received.
   - (b) suggest paths forward on how identified tensions in applying IAS 37 could be solved;
   - (c) evaluate the issue by reference to the Committee's criteria for taking an issue onto its agenda;
   - (d) provide a recommendation to the Committee that it should take the issue onto its agenda; and
   - (e) ask whether the Committee agrees with the staff's recommendation.
2. The objective of this paper is not to provide specific answers to each of the situations reported to us. Instead, we aim to assess whether current guidance is

sufficient to help preparers of financial statements and others to apply IFRSs to a range of facts and circumstances.

3. From the examples described in the feedback that we received, we have drawn out features that we have identified as being of relevance for the purpose of the analysis; ie they raise contentious questions when applying judgement to appropriately recognise non-financial liabilities under IAS 37. Those features are included as a basis for discussion and may not fully correspond on an individual basis to any specific situation reported to us (see agenda paper 5 for more information about those specific situations).

Applicability of the guidance in IFRIC 6

4. The original submission expressed concerns as to whether the levies described could be analysed in the same way as the Waste Electrical and Electronic Equipment (WE&EE) decommissioning obligation and whether the analysis would reach the same conclusion as the consensus in IFRIC 6.

5. The concerns expressed were about tensions between:

   (a) recognition of a liability only in the period in which the participation in the relevant market/activity identified by the legislation occurs; and

   (b) recognition in the preceding financial reporting period because of a constructive obligation arising in that preceding period triggered by the entity having no realistic alternative but to remain in the market on the specified date.

6. The tension is heightened in the case of those levies when the participation date set out in the legislation is the first day of a financial reporting period, ie what is the difference between 23:59:59 on 31 December and 00:00:01 on 1 January? This is in contrast to aspects of the situation considered by IFRIC 6 of the effect that an activity several years earlier should have on the timing of liability recognition.

Understanding the term **'measurement period'**

7. We note that IFRIC 6 provides guidance on when to recognise the liability for WE&EE. It does not give guidance on how to measure the liability (IFRIC 6.5).

8. The term *measurement period* is used by IFRIC 6 to describe the period during which participation in the market triggers the obligation for which a liability shall be recognised. Some of the levies that give rise to the issues being considered by this paper measure the amount of the levy based on financial data for a particular period. To avoid confusion between the period in which that entity participates in the qualifying activity and the period that is used to calculate the amount of the levy, this paper uses the following terms:

   (a) *Activity date/period*: this is the date/period in which the entity's participation in the event/market/activity occurs (in IFRIC 6 this is called the *measurement period*);

   (b) *Calculation date/period*: this is the date/period of the financial (or other) data used to calculate (measure) the amount of the liability.

9. For the WE&EE obligations addressed by IFRIC 6, the activity date/period and the calculation date/period coincided, which meant that it was not necessary to distinguish between the two periods.

10. In all but one of the situations reported to us, the activity date/period and the calculation date/period fall in different financial reporting periods.

Comparison of the levies with WE&EE / applicability of IFRIC 6

11. IFRIC 6 considered three different activities that (potentially) took place in three different periods:

   (a) The manufacture and/or sale of the (original) goods that were later recycled;

   (b) The sale of other similar goods during what IFRIC 6 called the measurement period; and

(c) The recycling/waste management activities relating to the (original) goods.

12. IFRIC 6 gave guidance on which of these three periods was relevant, in the context of WE&EE, to determining the timing of recognition of the liability. The guidance given in IFRIC 6 was that the period in which the other similar goods were sold (the “measurement period”) was the applicable period for determining when to recognise the liability, and that this was not affected by the entity’s participation in the manufacture and/or sale of the original goods.

13. IFRIC 6 did not give guidance on the measurement of the liability and so did not (need to) contemplate the effect that a possible fourth period (what we have called the calculation period) might have on the timing of recognition of the liability.

14. The levies that are the subject of this paper refer only to one activity period, not three, but, in some cases, identify a different calculation period.

15. We think therefore that IFRIC 6 addresses a different set of circumstances from those present in the levies that are the subject of this paper and is therefore not directly applicable. However, we think that IAS 37 is the applicable standard and we note that IFRIC 6 is an interpretation of IAS 37. We therefore think that conclusions drawn for the accounting for the levies considered in this paper should be consistent with IAS 37 and with the conclusions drawn in IFRIC 6. In this respect, any differences in the way in which IAS 37 is applied to the levies compared with its application to WE&EE set out in IFRIC 6 must be justified on the basis of different facts and circumstances in the levies.

Question for the Committee
Does the Committee agree with staff observations in paragraphs 11 to 15 and the conclusion that IFRIC 6 is not directly applicable, but because IFRIC 6 is an interpretation of IAS 37, any conclusions drawn on the application of IAS 37 to the levies must be consistent with the conclusions drawn in IFRIC 6?

Analysis of the requirements of IAS 37 (and where applicable IFRIC 6) against the generic terms of levies where the activity date/period and the calculation date/period differ

16. The following analysis considers the effect that having a different activity date/period from the calculation date/period has on the timing of recognition of the liability.

17. We note that the following analyses/views exist in practice:

    (a) View 1: the existence of a calculation date/period that is different from the activity date/period has no effect on the timing of liability recognition, ie the two periods are independent of each other for financial reporting purposes. The only determinant of when to recognise the liability is the activity date/period.

    (b) View 2A: the existence of a calculation date/period that is different from the activity date/period affects the timing of liability recognition; both periods have to be considered when identifying when to recognise the liability so that the underlying economic substance is properly reflected.

    (c) View 2B: a calculation date/period that precedes the activity date/period may, in some circumstances, create a constructive obligation before the activity date/period.

18. In the situations reported to us, some believe that the date on which the entity falls within the scope of the levy (the activity date/period) is the obligating event. Others believe that additional features of the levy should be considered in applying judgement to reach an accounting treatment that would appropriately reflect the economic reality of the levy.

19. Before developing an analysis addressing the views expressed in paragraph 17 above, we consider some variations in a simple fact pattern, designed to focus on the key tension points that appear to be the cause of the concerns over the accounting for the levies in the submission.

20. Relevant paragraphs of IAS 37 used in the analysis below are reproduced in Appendix A of this paper for ease of reference.

Situations where the levy is a fixed amount

Description of the fact pattern and issue raised

21. Our objective in this section is to obtain agreement within the Committee on the accounting treatment for a basic example fact pattern of a fixed amount levy (e.g. € 50,000) that an entity has to pay if the activity date/period for the levy is the first day of the current annual financial reporting period. Under the terms of the levy, the entity must pay € 50,000 if it participates in a specified activity from 1 January 20X1.

22. The question is whether the entity could or should recognise the levy in the preceding financial annual reporting period.

Our analysis

23. Under this fact pattern, we think that the application of the criteria for the recognition of a liability set out in paragraph 14 of IAS 37 leads to not recognising a liability before the activity date. This is because:

    (a) the present obligation does not arise until the entity is in operation on the activity date;

    (b) it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and

    (c) the amount of the levy is fixed, and hence a reliable estimate can be made of the amount of the obligation.

24. One could argue that the going concern principle and the argument that the entity cannot realistically curtail its activities before the activity date would be in favour of recognising a liability in the preceding financial period (20X0 in this example). This argument would rely on a future outflow of economic benefits being probable (even virtually certain). We disagree with this argument.

25. We think that in the basic fact pattern considered in this section, the argument that the probability of an outflow exists in the immediately preceding financial annual reporting period would not be relevant, because criterion (a) of paragraph 14 of IAS 37 would not be met before the activity date.

26. We also note that not recognising the liability in the preceding financial year on the basis of an expectation of continuing to participate in the activity during the activity period is consistent with the conclusions in IFRIC 6. In paragraphs BC9 and BC10 of the Basis for Conclusions for IFRIC 6 the Committee rejected a rationale that a liability should be recognised in a previous year (i.e. before the "measurement period") based on a stated intention to participate in a market during a future "measurement period". Constituents' argument to support that rationale had been that the entities would have to take unrealistic action to avoid paying the liability in the "measurement period".

27. In the case of WE&EE and IFRIC 6, some constituents had identified the obligating event as being the manufacture or sale of the original products. The consensus in IFRIC 6 identifies a different obligating event: participation in the market during the "measurement period".

28. In both this example fact pattern and the WE&EE circumstances, the presence or absence of the entity's activity in the period preceding the activity period has no impact on the levy payable.

Conclusion on the specific fact pattern

29. In the circumstances of the simple example analysed in paragraphs 21 to 28 above we think that a liability must be recognised when the entity participates in the activity during the activity period, and not before.

30. In the circumstances of the various fact patterns reported to us, we observe that the concern raised in relation to the situations described to us lies in that the levy is calculated based on the activity of the entity in the preceding annual financial reporting period.

31. Consequently, we believe that the perceived tension in determining the obligating event lies in the fact that the activity date/period, and the calculation

date/period, occur in two successive financial annual reporting periods and not within the same annual reporting period.

Situations where calculation of the levy is based on activity in a previous annual financial reporting period

Description of example

32. Consider an example fact pattern in which the entity is required to pay a levy if it participates in a certain activity in 20X1, and the amount of the levy is calculated as a percentage of its 20X0 revenue from that same activity.

Our analysis

33. The focus of debate in this example, as in view 1 and view 2 (A and B) in paragraph 17 above, is whether the requirement for activity in the preceding period (ie the calculation period) affects the timing of recognition of the liability.

34. We observe that with respect to the recognition of a liability in cases where calculation of the levy is based on the activity of the entity in the financial reporting period preceding the period in which the activity period occurs, the analyses that are currently performed consider the relative weight of:

    (a) the date on which the entity falls within the scope of the levy; and

    (b) the period on which measurement is based.

35. We note that in those instances in which the legislation does not provide elements to help distinguish which of the above factor is predominant, two competing views exist:

    (a) View C: identifying the past event depends on the relative significance of the entity's activity during the calculation period compared with its activity during the activity period;

    (b) View D: the past event is participating in the designated activity in the activity period/date.

Rationale for view C

36. Proponents of view C argue that this view reflects the economics of the levy. In circumstances where the predominant activity occurs in the calculation period, and the activity needed in the activity period is negligible by comparison, the greater significance of the activity in the calculation period leads to recognition of the liability during that period.

37. In our example, the calculation of the levy is proportional to revenue in the calculation period; if the entity did not operate in the calculation period, it would have no obligation regardless of the level of activity in the activity period. Similarly, if the entity had significant activity in the calculation period, e.g. sales of €1 billion, but only sales of €100,000 in the activity period, a levy would be payable and this would be determined predominantly by the activity in the calculation period.

38. Advocates of view C for this example therefore think that the past event giving rise to the obligation is the fact that the entity was in operation during the calculation period. In addition, at the end of the calculation period, it will be possible to conclude that it is probable that there will be an outflow of resources embodying economic benefits in respect of the levy and a reliable estimate can be made, thus satisfying all three criteria in paragraph 14 of IAS 37.

39. Consequently, view C would lead to recognising a liability during the calculation period rather than the activity period in circumstances where the activity in the calculation period has a more significant impact on the levy than the activity in the activity period.

Rationale for view D

40. Advocates of view D argue against recognising a liability before the activity date. They focus on the fact that all three criteria in paragraph 14 of IAS 37 must be met, not just one or two. They believe that the activity date is the obligating event, regardless of whether some degree of certainty exists on the

day before that date. In our example, if the entity had significant sales in 20X0 but no sales in 20X1, then there would be no levy payable.

41. Consequently, they believe that the liability should be recognised only after the entity has participated in the relevant activity on the activity date/period; until then the criterion in paragraph 14(a) of IAS 37 is not met and no liability can be recognised.

Supplementary guidance on identifying the existence of a present obligation

42. In the situations currently under discussion, the contentious point is determining when the present obligation exists. We note that paragraph 15 of IAS 37 provides supplementary guidance for situations in which it is not clear whether there is a present obligation. That paragraph gives an additional criterion for recognition: that "a past event is *deemed* to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period" [emphasis added].

43. We observe that paragraph 15 could be read as supporting view C in circumstances where it is highly unlikely that an outflow of economic benefits can be avoided. We also note, however, that paragraph 15 can be read as not affecting view D because it could be claimed that it is clear when the activity date/period is and therefore this is not one of those "rare cases" when "it is not clear whether there is a present obligation".

44. We therefore do not think that paragraph 15 provides definitive guidance to resolve this issue.

Realistic alternative to settling the obligation created by the event

45. We note that paragraph 17 of IAS 37 states that 'For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event'.

46. We observe that when the activity date is the first day of the financial reporting period immediately following the calculation period, it is virtually certain at

the end of the calculation period that the entity will be assessed as participating in a market on the activity date.

47. We note that two diverging views exist:

(a) View E: some argue against recognising a liability on the basis that paragraph 17 of IAS 37 is worded restrictively and they think it is intended to result in liability recognition only when one of the two criteria identified is met. Some supporting this view also note that paragraph 18 of IAS 37 makes clear that costs that need to be incurred to operate in the future should not be recognised. They view the levy as the 'cost' of participating in a specific activity during a particular period (the activity period). Thus the levy triggered by the entity's activity in 20X1 is the cost of participating in that activity during 20X1;

(b) View F: others express concerns over the use of an assumption that the entity could cease a particular business activity for the purpose of avoiding having to recognise this liability:

(i) the assumption is not consistent with management's expectations, whether or not public statements have been made about their expectations; and

(ii) the assumption is inconsistent with the going concern assumption that is used for recognising and measuring other elements of the financial statements, such as measurement of impairment of assets used in this business activity, or the non-recognition of closure costs.

48. The differing views listed in paragraph 47 above lead us to believe that additional guidance is needed to reduce diversity in practice. Additional guidance could be in the form of clarification of the phrase 'no realistic alternative to settling the obligation created by the event'.

Conclusion on the tensions identified when applying the recognition principles in IAS 37

49. With respect to the tensions analysed in paragraphs 32 to 44 above in relation to the views expressed in paragraph 17 of this paper, we observe that in the fact patterns reported to us, tensions in applying the recognition criteria in paragraph 14 of IAS 37 arise in the cases were the levy combines the two following features:

    (a) the calculation of the levy is based on financial data in the previous financial annual reporting period; and

    (b) it is virtually certain at the end of that preceding period that the entity will have to pay the levy.

50. Given the reported diversities in practice, we believe that additional guidance is needed in cases where the two features listed above exist.

51. With respect to the tension analysed in paragraphs 45 to 48 above in relation to the views expressed in paragraph 17 of this paper, we believe that additional guidance is needed to clarify the phrase 'no realistic alternative to settling the obligation created by the event'.

Agenda criteria assessment

52. Our assessment of the Interpretations Committee's agenda criteria is as follows:

    (a) The issue is widespread and has practical relevance.

    We note that issues on the recognition of liabilities for levies arise in several jurisdictions. We observe diversity in situations in which the main features of a liability are that the measurement period and the qualifying date are in two different consecutive reporting periods.

    (b) The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The Committee will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.

    We note that, although the principle in paragraph 14 of IAS 37 seems clear as to when to recognise a liability, application of that paragraph raises questions in several jurisdictions. The main challenge is determining whether the obligating event is the participation in an activity in the activity period specified by the legislation, or whether other factors create an earlier obligation.

(c) *Financial reporting would be improved through elimination of the diverse reporting methods.*

Yes.

(d) *The issue can be resolved efficiently within the confines of existing IFRSs and the Framework, and the demands of the interpretation process.*

Though levies present a diversity of fact patterns, we observe that they have common features and that those common features are analysed in different ways.

(e) *It is probable that the Committee will be able to reach a consensus on the issue on a timely basis.*

Yes.

(f) *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).*

The project on the revision of IAS 37 is currently at a standstill and further deliberations on this project are not anticipated until later in 2011.

Staff's recommendation

53. As expressed in paragraphs 49 to 51 of this paper, we recommend that the Interpretations Committee or the Board should consider providing guidance:

(a) to clarify the phrase 'no realistic alternative to settling the obligation created by the event'; and

(b) to help apply the recognition criterion in paragraph 14(a) of IAS 37 in those specific cases where the levy combines the two following features:

(i) the measurement of the levy is based on financial data in the previous annual financial reporting period; and

(ii) it is virtually certain at the end of the previous annual financial reporting period that the entity will have to pay the levy.

54. We think that addressing these issues will help, in turn, to identify the appropriate view set out in paragraph 17 of this paper.

Conclusion

55. Given the assessment in paragraph 52 above, we recommend that the Interpretations Committee should take the issue onto its agenda.

56. We believe that issuing interpretative guidance or amendments would reduce current diversity and would enable preparers both to comply with the principles in IAS 37 and to reflect the economic reality of the levy.

57. Because we do not expect such interpretative guidance to call into question the recognition principles in IAS 37, we believe that the Interpretations Committee would be able to reach a consensus sooner than the Board project on the revision of IAS 37 would address the issue.

Question to the Interpretations Committee

58. Consistently with the recommendations in paragraphs 53 to 57, we have the following question for the Interpretations Committee:

Question—staff's recommendation
(1) Does the Interpretations Committee agree with the staff's conclusion summarised in paragraphs 53 to 57 of this paper? (2) Does the Interpretations Committee agree with the staff's recommendation to take the issue onto its agenda?

Appendix A—excerpts from IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

14 A provision shall be recognised when:

(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.

If these conditions are not met, no provision shall be recognised.

15 In rare cases it is not clear whether there is a present obligation. In these cases, a past event is deemed to give rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the end of the reporting period.

17 A past event that leads to a present obligation is called an obligating event. For an event to be an obligating event, it is necessary that the entity has no realistic alternative to settling the obligation created by the event. This is the case only:

(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.