STAFF PAPER

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IFRS® Interpretations Committee meeting

Project	**Negative Low Emission Vehicle Credits (IAS 37)**
Paper topic	Wording of tentative agenda decision

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Introduction

1. At its November 2021 meeting, the IFRS Interpretations Committee (Committee) discussed a request about IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The request asked whether an entity with negative low emission vehicle credits has a present obligation that meets the definition of a liability in IAS 37.

2. At that meeting, the Committee tentatively decided not to add a standard-setting project on this matter to the work plan.

3. The purpose of this meeting is to approve the wording of a tentative agenda decision.

Structure of the paper

4. This paper includes:

   (a) background information (paragraphs 6–21);

   (b) staff comments on the draft tentative agenda decision (paragraphs 22–24); and

   (c) a question for the Committee.

5. There are two appendices to the paper:

   (a) Appendix A—proposed wording of the tentative agenda decision.

   (b) Appendix B—additional analysis—consideration of IFRIC 6.

Background information

The request

6. The request described measures to promote energy efficiency and reduce carbon emissions. The measures are contained in an order issued by a government. They apply to entities that produce or import passenger vehicles for sale in a specified market, and are mandatory for those entities. Under the measures, entities receive positive credits if in a calendar year they have produced or imported vehicles whose average fuel emissions are lower than a target set by the government, and negative credits if in that year they have produced or imported vehicles whose average fuel emissions are higher than the target.

7. The measures require an entity that receives negative credits for one year to eliminate those negative credits, either by purchasing positive credits from another entity or by generating positive credits itself in the following year (by producing or importing more low emission vehicles). If the entity fails to eliminate its negative credits in one or other of those two ways, the government can impose sanctions on the entity. The sanctions may include restricting the entity's access to the market.

8. The request asked whether an entity that has generated negative credits has a present obligation that meets the definition of a liability in IAS 37.

Applicable paragraphs of IAS 37

9. Paragraph 10 of IAS 37 defines a liability as:

   > …a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

10. Paragraph 10 of IAS 37 distinguishes legal obligations (which derive from an operation of law) from constructive obligations (which derive from an entity's actions) and 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.

11. Paragraph 17 of IAS 37 states that an entity has no realistic alternative to settling an obligation 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.

12. Paragraph 19 of IAS 37 states that:

> It is only those obligations arising from past events existing independently of an entity's future actions (ie the future conduct of its business) that are recognised as provisions.

13. Paragraph 19 also gives an example of a situation in which no such obligation exists:

> … because of commercial pressures or legal requirements, an entity may intend or need to carry out expenditure to operate in a particular way in the future (for example, by fitting smoke filters in a certain type of factory). 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 recognised.

Previous staff analysis and conclusions

14. The staff analysed the request in Agenda Paper 4 *Negative Low Emission Vehicle Credits (IAS 37)—Initial Consideration* for the Committee's November 2021 meeting.

15. The staff concluded that in the fact pattern described in the request, an entity that has generated negative credits has an obligation that meets the definition of a liability in

IAS 37, except in (possibly rare) circumstances in which accepting sanctions for failing to eliminate those negative credits is a realistic alternative for that entity.

16. The rationale for the staff conclusion was that:

    (a) an entity that has generated negative credits has an obligation to eliminate them. The entity can settle that obligation either by purchasing positive credits from another entity or by generating positive credits itself in the following year and using those positive credits to offset the negative balance. In either case, settlement involves an outflow from the entity of resources embodying economic benefits. In the first case, the resource is cash; in the second case, the resources are the positive credits the entity will generate itself and could otherwise have used for other purposes—for example, to sell to other entities with negative credits.

    (b) the obligation is a present obligation that arises from past events (the past production or import of vehicles) and exists independently of the entity's future actions. The circumstances are different from those described in the smoke filter example in IAS 37: the entity's future actions determine only the method of settlement of the obligation, not the obligation's existence.

    (c) the entity owes the obligation to society in general, on whose behalf the government has implemented the measures.

    (d) an entity would have no realistic alternative to settling the obligation, except in (possibly rare) circumstances in which accepting the sanctions for failing to eliminate the negative credits is a realistic alternative for that entity.

17. The staff also concluded that, because the obligation derives from an order issued by a government (not the entity's actions), it is a legal obligation, not a constructive obligation.

18. On the basis of the conclusions described in paragraphs 15–17, the staff further concluded that the requirements of IAS 37 provide an adequate basis for an entity to determine the required accounting and recommended that the Committee not add a standard-setting project to the work plan. The staff paper included draft wording for a tentative agenda decision.

Previous Committee decisions

19. Most Committee members broadly agreed with the staff conclusions and the Committee tentatively decided not to add a standard-setting project to the work plan. However, several Committee members suggested refinements to the wording of the tentative agenda decision and the Committee directed the staff to prepare revised wording for approval by the Committee at a future meeting.

20. Some Committee members also suggested the staff analysis should have considered the consensus in IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment.*

Additional analysis

21. In response that last suggestion, Appendix B to this paper includes an analysis of the implications of the consensus in IFRIC 6. That analysis does not change our previous conclusions summarised in paragraphs 15–17 of this paper.

Staff comments on the draft tentative agenda decision

22. We have refined the draft tentative agenda decision presented to the Committee at the November 2021 meeting, taking into account comments made by Committee members at that meeting. In particular, in response to comments and suggestions from Committee members, we have:

    (a) described an entity that has ‘produced or imported vehicles with average fuel emissions higher than the government target’, not one that has ‘generated’ or ‘received’ negative credits. The purpose of this change is to clarify that the obligating event is the production or import activity, not the arrival at a negative credit position at the year-end, nor the receipt of negative credits after the year-end.

    (b) expanded the discussion of the nature of an entity’s legal obligation and its enforceability by:

        (i) referring to paragraph 10 of IAS 37, which distinguishes legal obligations from constructive obligations, and to paragraph 17 of

IAS 37, which requires that the settlement of a legal obligation can be enforced by law.

(ii) observing that both an entity's obligation to eliminate negative credits and the government sanctions for non-settlement derive from an operation of law.

(iii) applying this observation to explain that the obligation is a legal obligation, and the sanctions are the legal means of enforcing settlement of the obligation. These explanations aim to clarify the conclusion that an entity has a legal obligation that meets the definition of a liability in IAS 37 unless accepting sanctions for non-settlement is a realistic alternative for that entity.

(c) acknowledged that even if an entity does not have a *legal* obligation (because accepting sanctions is a realistic alternative to settlement for that entity), it nevertheless could have a *constructive* obligation that meets the definition of liability in IAS 37. It would have such an obligation if it has taken an action (for example, made a public statement) that has created valid expectations in other parties that it will eliminate its negative credits.

(d) removed a statement describing as 'possibly rare' the circumstances in which accepting sanctions is a realistic alternative for an entity. Although we have evidence that such circumstances are likely to be relatively rare, we cannot be certain of that fact, and the prevalence does not change the analysis or conclusion.

(e) explained how the fact pattern described in the request differs from the fact patterns in other examples that illustrate or interpret the application of paragraph 19 of IAS 37, for example, Illustrative Example 6 (Legal requirement to fit smoke filters), IFRIC 6, and example 2 in IFRIC 21 *Levies*.

(f) stated explicitly that the Committee did not discuss requirements relating to the recognition and measurement of liabilities arising from the measures.

23. The revised draft tentative agenda decision is set out in Appendix A.

24. In our view, the proposed tentative agenda decision (including the explanatory material contained within it) would not add or change requirements in IFRS Accounting Standards.

Question for the Committee

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Does the Committee have any comments on the proposed wording of the tentative agenda decision in Appendix A to this paper?

Appendix A—proposed wording of the tentative agenda decision

Negative Low Emission Vehicle Credits (IAS 37 *Provision, Contingent Liabilities and Contingent Assets*)

The Committee received a request asking whether particular measures to encourage reductions in vehicle carbon emissions give rise to obligations that meet the definition of a liability in IAS 37.

The request

The request described government measures that apply to entities that produce or import passenger vehicles for sale in a specified market. Under the measures, entities receive positive credits if in a calendar year they have produced or imported vehicles whose average fuel emissions are lower than a target set by the government, and negative credits if in that year they have produced or imported vehicles whose average fuel emissions are higher than the target.

The measures require an entity that receives negative credits for one year to eliminate those negative credits, either by purchasing positive credits from another entity or by generating positive credits itself in the following year (by producing or importing more low emission vehicles) and using those positive credits to offset the negative balance. If the entity fails to eliminate its negative credits in one or other of those two ways, the government can impose sanctions on the entity, for example restrict the entity's access to the market.

The request considered the position of an entity that has produced or imported vehicles with average fuel emissions higher than the government target, and asked whether such an entity has a present obligation that meets the definition of a liability in IAS 37.

Applicable requirements

Paragraph 10 of IAS 37 defines a liability as 'a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits'. Paragraph 10 of IAS 37 distinguishes legal obligations (which derive from an operation of law) from constructive obligations (which derive from an entity's actions) and 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'. Paragraph 17 of IAS 37 clarifies that an entity has no realistic alternative to settling an obligation only if settlement can be enforced by law or, in the case of a constructive obligation, an action of the entity has created valid expectations in other parties that the entity will discharge the obligation. Paragraph 19 of IAS 37 further clarifies that 'it is only those obligations arising from past events existing independently of an entity's future actions' that are recognised as provisions.

The Committee's conclusions

The Committee concluded that an entity that has produced or imported vehicles with average fuel emissions higher than the government target has a legal obligation that meets the definition of a liability in IAS 37, unless accepting sanctions is a realistic alternative to eliminating negative credits for that entity. The Committee's reasoning was that:

- an obligation to eliminate negative credits arises from the production or import of vehicles with average fuel emissions higher than the government target. To the extent that an entity has produced or imported such vehicles by the end of the reporting period, that obligation has arisen from past events.
- the measures that create the obligation and give the government the authority to impose sanctions derive from an operation of law. Hence, the obligation is a legal obligation and the sanctions are the legal means of enforcing settlement of the obligation. The requirement that 'settlement of the obligation can be enforced by law' is met, unless accepting sanctions for non-settlement is a realistic alternative for an entity.
- an entity can settle its obligation either by purchasing positive credits from another entity or by generating positive credits itself in the following year and using those positive credits to offset the negative balance. In either case, settlement involves an outflow from the entity of resources embodying economic benefits. In the first case, the resource is cash; in the second case, the resources are the positive credits the entity will receive for the following year and could otherwise have used for other purposes—for example, to sell to other entities with negative credits.
- the obligation exists independently of the entity's future actions. The only action required to create an obligation is the production or import of vehicles with average

fuel emissions higher than the government target, and this action has already occurred. The entity's future actions will determine only the means by which the entity settles its present obligation—whether it purchases credits from another entity or generates positive credits itself in the following year. The fact that no future actions are required to create an obligation for the entity distinguishes the fact pattern described in the request from the fact patterns in other examples that illustrate or interpret the application of paragraph 19 of IAS 37—for example, Illustrative Example 6 (Legal requirement to fit smoke filters), IFRIC 6 *Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment* and example 2 in IFRIC 21 *Levies*.

The Committee considered the position of an entity that:

(a) has produced or imported vehicles with average fuel emissions higher than the government target; but

(b) does not have a *legal* obligation that meets the definition of a liability in IAS 37, because accepting sanctions is a realistic alternative to eliminating negative credits for that entity.

The Committee concluded that such an entity nevertheless could have a *constructive* obligation that meets the definition of a liability in IAS 37. It would have such an obligation if it has taken an action (for example, made a public statement) that has created valid expectations in other parties that it will eliminate its negative credits.

The request asked only whether the government measures give rise to present obligations that meet the definition of a liability in IAS 37. The Committee noted that, having identified such an obligation, an entity would apply other requirements in IAS 37 to determine how to recognise and measure the liability. The Committee did not discuss those other requirements.

The Committee concluded that the principles and requirements in IFRS Accounting Standards provide an adequate basis for an entity to determine whether, in the fact pattern described in the request, an entity has a present obligation that meets the definition of a liability in IAS 37. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Appendix B—additional analysis—consideration of IFRIC 6

B1. IFRIC 6 *Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment* describes the requirements of The European Union's Directive on Waste Electrical and Electronic Equipment. That Directive states that the cost of waste management for 'historical' household equipment (equipment sold before 13 August 2005) should be borne by producers of that type of equipment that are in the market during a (later) period to be specified in the applicable legislation of each Member State (the measurement period).

B2. The consensus in IFRIC 6 is that participation in the market during the measurement period is the obligating event in accordance with paragraph 14(a) of IAS 37—the previous production or sale of historical equipment was not an obligating event.

B3. The consensus in IFRIC 6 is different from the staff conclusion on negative low emission vehicle credits (the staff conclusion that the production or import of vehicles is the obligating event). The staff think this difference reflects a difference in the fact patterns. In the fact pattern of IFRIC 6, an entity's obligation is linked *solely* to its market share in a future measurement period, and is entirely unaffected by any previous actions of the entity—there is no past obligating event. Conversely, in the fact pattern described in the request, the liability is linked to the past production or import of vehicles whose average fuel emissions are higher than the government target—the entity's future actions are not events that create obligations; they determine only the means of settling obligations that have arisen from past events.