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Project	**Negative Low Emission Vehicle Credits (IAS 37)**		
Paper topic	Initial consideration		
CONTACT(S)	Syamsul Hidayah	shidayah@ifrs.org	+44 (0) 20 7246 6470
	Joan Brown	jbrown@ifrs.org	+44 (0) 20 7246 6916

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Introduction

1. The IFRS Interpretations Committee (Committee) received a submission about IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The submitter asks whether an entity with negative low emission vehicle credits has a present obligation that meets the definition of a liability in IAS 37.

2. This paper:

   (a) provides the Committee with a summary of the matter;

   (b) presents our research and analysis; and

   (c) asks the Committee whether it agrees with our analysis and recommendation not to add a standard-setting project to the work plan.

Structure of the paper

3. This paper includes the following:

   (a) background information (paragraph 5–16);

   (b) summary of outreach (paragraph 17–23);

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(c) technical analysis of the questions in the submission:

(i) staff analysis of, and conclusions on, question 1 (paragraphs 24–45);

(ii) staff analysis of, and conclusions on, question 2 (paragraphs 46–48);

(iii) question for the Committee;

(d) analysis of whether to add a standard-setting project to the work plan:

(i) staff analysis and conclusions (paragraphs 49–50);

(ii) staff recommendations (paragraphs 51–52); and

(iii) questions for the Committee.

4. There are two appendices to the paper:

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

(b) Appendix B—submission.

Background information

5. The entity described in the submission is operating in a jurisdiction whose government has introduced measures to promote energy efficiency and reduce carbon emissions. Entities that produce or import passenger vehicles are required to sign commitments to comply with the measures.

6. Under these measures, an entity receives positive credits at the end of a calendar year if it has produced or imported during that year:

(a) *low* energy vehicles—traditional energy vehicles whose average fuel consumption is better than a standard set by the government; or

(b) a higher number of *new* energy vehicles—for example, electric cars—than a target number set by the government for that entity (the target being a proportion of the entity's production or import volumes of traditional energy vehicles).

7. Conversely, an entity receives negative credits if it has produced or imported:

   (a) traditional energy vehicles whose average fuel consumption is worse than the standard set by the government; or

   (b) fewer new energy vehicles than the target number set by the government for that entity.

8. An entity that receives both positive and negative credits may offset them. An entity with net negative credits is required to eliminate them by purchasing positive new energy credits from another entity. The government has established a trading platform for this purpose.

9. If an entity does not eliminate its negative credits by purchasing positive new energy credits, it must submit a remedial plan to the government, showing how it will adjust its import and production activities to generate sufficient positive credits in the following period to eliminate its current negative credits.

10. An entity that fails to eliminate its negative credits (by failing to either purchase positive new energy credits or adhere to a remedial plan) may face economic sanctions. Although the measures impose no direct financial penalties on such an entity, they allow the government to prevent the entity from accessing the market, for example, by not approving the entity's applications for the launch of new vehicle models.

11. Activities follow an annual cycle:

    (a) credits are generated throughout a calendar year (year 20X0).

    (b) in April 20X1, the government announces the credits each entity receives at 31 December 20X0.

    (c) the market platform is open for new energy credits trading from August 20X1 to October 20X1.

12. The measures have now been in force for a few years. Many entities with negative credits in previous years have eliminated those credits by purchasing positive new energy credits from other entities. They are likely to continue to purchase positive new energy credits in the future because the consequences of not doing so would be more costly and disruptive.

13. The submitter asks two questions.

Question 1

14. The first question is whether an entity with negative credits has a present obligation that meets the definition of a liability in IAS 37. The submitter outlines two views:

    (a) View A—*no, negative credits do not create a liability*. The rationale is that no present obligation exists independently of the entity's future actions. There are no direct financial penalties for an entity that chooses not to purchase new energy credits—the entity could avoid an outflow of economic resources through its future actions, for example, by submitting a remedial plan or by exiting the market. These actions might not be economical but that does not mean they are unrealistic.

    (b) View B—*yes, negative credits do create a liability*. The rationale is that the entity has a present obligation to purchase positive new energy credits and no realistic alternative to settling that obligation, because the alternative courses of action would be so costly and disruptive. If an entity has signed up to the measures and has an established past pattern of purchasing new energy credits, it has created a valid expectation that it will discharge its responsibility in the same manner in the future.

Question 2

15. The submitter's second question applies only if the answer to the question in paragraph 14 above is "*no, negative credits do not create a liability*". The submitter asks whether the Committee's views would be different if, before the end of the reporting period, the entity had entered into a binding contract to purchase positive new energy credits, that contract being settled after the end of the reporting period.

16. Appendix B to this paper reproduces the submission, which provides further details about the views the submitter identifies.

Summary of outreach

17. We sent information requests to members of the International Forum of Accounting Standard-Setters, securities regulators, and large accounting firms. The submission was also made available on our website.

18. The request asked those participating to provide information about:

    (a) whether they have seen similar schemes (or schemes that gives rise to similar questions) operating in their jurisdiction and, if so, whether those schemes have a material effect on entities affected.

    (b) if amounts are material, whether entities with negative credits recognise a liability.

    (c) whether there are differences between the scheme(s) operating in their jurisdiction and the scheme described in the submission that might affect the conclusion about whether negative credits give rise to a liability.

19. We have received 11 responses—five from national standard-setters, five from large accounting firms and one from an organisation representing a group of securities regulators. The views received represent informal opinions and do not reflect the official views of those respondents or their organisations.

Findings from outreach

Is the fact pattern common?

20. Most respondents said the fact pattern described in the submission is common in China. One respondent said it has observed similar schemes in Canada, the European Union and the US. However, those schemes have some different features, for example, the existence of financial penalties. A few respondents said they expect similar fact patterns to emerge in their jurisdiction in the future, given the increasing demand for carbon emission reductions.

Are negative energy credits typically material?

21. Responses were mixed regarding the materiality of negative energy credits arising from the scheme described in the submission, or from similar schemes. Many respondents said negative energy credits are, or can be, material, while others said they are generally immaterial.

What is the accounting applied?

22. Many respondents who commented on the accounting for negative energy credits said they have observed diversity in practice. Some entities recognise a liability while others do not.

23. Some respondents either explained the basis for an accounting treatment applied by entities in their jurisdiction or expressed support for one of the views set out in the submission. These respondents identified arguments for each view that were generally consistent with those in the submission:

    (a) if entities do not recognise a liability, it is on the basis that:

        (i) they do not yet have a binding contract to purchase positive energy credits from another entity;

        (ii) an option exists for entities to avoid the obligation by changing their future actions, for example, by submitting a remedial plan to the government or by discontinuing their operations; and/or

        (iii) there is no direct financial penalty imposed by the government on entities that fail to purchase energy credits.

    (b) if entities recognise a liability, it is on the basis that they have a constructive obligation:

        (i) some respondents referred to the entities' previous purchases of positive energy credits. Those purchases have established a pattern of past practice and created a valid expectation that the entities will continue to use this option to settle their future obligations. These respondents note that most entities started to recognise a liability only recently, because they were first required to establish a pattern of past practice.

(ii) one respondent said entities recognise a liability because they have made a public written statement, and thereby indicated they will accept responsibility for eliminating negative energy credits they receive.

Technical analysis of the questions in the submission

Staff analysis of question 1—does an entity with negative credits have a liability?

24. 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. [1]

25. Paragraphs 17–22 of IAS 37, Illustrative Examples accompanying IAS 37, and IFRIC 21 *Levies* (an interpretation of IAS 37) include requirements and examples supporting this definition.

26. In this section, we analyse how each aspect of the definition and supporting requirements and examples might apply to an entity with net negative energy credits.

Has there been an obligating event that results in an entity having no realistic alternative to settling the obligation?

27. 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.

28. View A in the submission (negative credits do not create a liability) relies on an argument that an entity with negative credits has a realistic alternative to purchasing positive new energy credits from another entity. The entity can avoid purchasing positive new energy credits by instead submitting a remedial plan and adjusting its

[1] The definition of a liability in IAS 37 has not been revised following the revision of the definition of a liability in the *Conceptual Framework for Financial Reporting,* issued in 2018.

production or import schedule in the following year to generate positive credits, or even by exiting the market. The fact that implementing a remedial plan may have adverse economic consequences does not make it an unrealistic option. The aim of the measures is to promote energy efficiency, and the option for an entity to eliminate its negative credits by committing to produce more low/new energy vehicles in the following year is one of the options available to help achieve those aims. That option is genuine and realistic.

29. View B in the submission (negative credits do create a liability) relies on the opposite argument. It relies on an argument that, although adopting a remedial plan—or even exiting the market—might be an option in *theory*, for many entities it is not a realistic option in *practice*. Changing production or import schedules is costly and might not be achievable within one year, as evidenced by the fact that many entities have instead established a practice of purchasing positive new energy credits in the market.

30. An additional argument for the existence of a liability is that adopting a remedial plan is not an option for *avoiding* the entity's obligation, it is one means of *settling* that obligation. The basis for this argument would be that the entity's obligation is not to purchase positive new energy credits, it is to eliminate its negative credits. The entity may settle the obligation by purchasing positive new energy credits from another entity, or by submitting a remedial plan and generating its own positive credits in the following period. In either case, settlement involves an outflow of resources embodying economic benefits—in the first case the resource is cash; in the second case the resource is the positive credits the entity generates in the future and could have used for other purposes (for example, to sell to other entities with negative credits).

31. This argument would lead to a conclusion that an entity with negative credits could avoid settling its obligation only if it were able and willing to accept the economic sanctions for non-compliance described in paragraph 10. These sanctions could be major obstacles to operating in the market. So, accepting them is unlikely to be a realistic alternative for many passenger vehicle entities; most entities with negative credits would have no realistic alternative to settling their obligation to eliminate the negative credits.

Is there another party to whom the obligation is owed?

32. Paragraph 20 of IAS 37 states that:

> An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed—indeed the obligation may be to the public at large. …

33. Accordingly, to conclude that an entity with negative credits has an obligation, we need to be satisfied that there is another party to whom the entity owes that obligation.

34. Some have suggested that, unless and until an entity enters into a binding contract to purchase positive new energy credits from another entity, there is no other party to whom the entity owes an obligation—the entity does not owe an obligation to the government because it does not have to make any payment to the government. Accordingly, an obligation arises only when the entity enters into a binding contract with an entity with positive credits.

35. However, an alternative analysis is that an entity with negative credits has an obligation to society in general. This is because, in implementing the measures, the government is acting for the benefit of society, rewarding vehicle producers and importers that contribute to reducing energy usage and carbon emissions. As a result of the measures, an entity that has failed to contribute to the aims of the scheme incurs an obligation to society, which it settles by making payments on behalf of society to the entities that *have* contributed to the aims. An entity can owe an obligation to another party without making payments *to* that other party—it may make payments *on behalf of* that other party.

36. The circumstances of an entity with negative credits are similar to those of an entity that has damaged land and is required by government legislation to rehabilitate that land. Applying IAS 37, such an entity is viewed as having a liability for the costs of rehabilitating the land when it takes the action to which the legislation applies (damaging land)—irrespective of whether it has yet entered into a binding contract with the party it will pay to carry out the rehabilitation work, and even though it will never make any payment to the government. Applying the same rationale, a producer or importer of vehicles would be viewed as having an obligation as soon as it takes

the actions that give rise to negative credits (producing or importing vehicles). That entity's obligation arises when it takes those actions, even if it has not yet entered into a contract to purchase positive new energy credits with another entity.

Does the obligation arise from past events and exist independently of the entity's future actions?

37. In support of View A (negative credits do not create a liability), some argue that there is no obligation that exists independently of the entity's future actions. They refer to paragraph 19 of IAS 37, Illustrative Example 11B Refurbishment costs—legislative requirement, and IFRIC 21.

    (a) 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. Examples of such obligations are penalties or clean-up costs for unlawful environmental damage, both of which would lead to an outflow of resources embodying economic benefits in settlement regardless of the future actions of the entity. Similarly, an entity recognises a provision for the decommissioning costs of an oil installation or a nuclear power station to the extent that the entity is obliged to rectify damage already caused. In contrast, 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.

    (b) Illustrative Example 11B applies paragraph 19 of IAS 37 to an airline with a legal obligation to overhaul its aircraft every three years. The example concludes that the airline does not have a present obligation that exists independently of its future actions because it could avoid the overhaul expenditure, for example by selling the aircraft.

(c) IFRIC 21 applies paragraph 19 of IAS 37 to levies. The consensus in IFRIC 21 is that the event that gives rise to an obligation to pay a levy is the activity that triggers payment of the levy. The Basis for Conclusions accompanying IFRIC 21 explains that a levy that will be triggered by a future activity does not exist independently of the entity's future actions, even if the entity will be economically compelled to carry out the activity that will trigger payment of the levy.

38. Supporters of View A say an entity with negative credits could avoid purchasing positive new energy credits by its future actions, for example, by submitting a remedial plan to the government or even exiting the market. They also note that IFRIC 21 clarifies that economic compulsion is not sufficient to create a present obligation.

39. However, the fact patterns described in paragraph 19 of IAS 37, Illustrative Example 11B and IFRIC 21 are all different from the fact pattern described in the submission. They are all fact patterns in which the activity that triggers a requirement to incur expenditure will occur after the end of the reporting period. It is the absence of a past 'triggering' event that means there is no present obligation in these fact patterns. In contrast, in the fact pattern described in the submission, the activity required to trigger a requirement to eliminate negative credits (the production or import of vehicles) has already occurred by the end of the reporting period. So, it can be concluded that, in the fact pattern described in the submission, the obligation has arisen from past events and exists independently of future events.

If there is an obligation, is it a legal obligation or a constructive obligation?

40. Paragraph 10 of IAS 37 defines a legal obligation and a constructive obligation:

> A *legal obligation* is an obligation that derives from:
>
> (a) a contract (through its explicit or implicit terms);
>
> (b) legislation; or
>
> (c) other operation of law.

> A *constructive obligation* is an obligation that derives from an entity's actions where:
>
> (a) by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
>
> (b) as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.

41. View B in the submission argues that an entity with negative credits and a past practice of purchasing positive new energy credits has a constructive obligation. The argument is that, by signing an annual commitment to comply with the measures and purchasing positive new energy credits in the past, the entity has indicated to other parties—the government, society and entities with positive credits—that it will continue to comply with the measures in the future. As a result, it has created a valid expectation on the part of those other parties that it will comply.

42. However, it could alternatively be argued that an entity with negative credits has a legal obligation, not a constructive obligation:

    (a) the entity's obligation to eliminate negative credits derives from an operation of law (government measures). The government requires producers and importers of passenger vehicles to sign an annual commitment to comply with the measures and enforces compliance by including in the measures economic sanctions for entities that fail to comply. Compliance is mandatory for all entities in the industry, not voluntary.

    (b) a past practice of complying with a legal obligation does not convert that legal obligation into a constructive obligation. Rather, it provides evidence that the legal obligation is enforceable—in this case, that the economic sanctions for non-compliance are effective. In other words, it provides evidence to support a judgement that the entity has no realistic alternative to settling its obligation.

    (c) in support of the view that an entity with negative credits has a constructive obligation, the submitter says the fact pattern described in the submission is akin to that in Illustrative Example 2B accompanying IAS 37. However, there is an important difference in the fact patterns. Example 2B describes a fact pattern in which an entity is not subject to *any* legal requirements—the entity

described in that example is viewed as having a constructive obligation to clean up contaminated land because, despite the absence of any legal requirements, it has published a policy undertaking to clean up contamination it causes, and has honoured that policy in the past. In contrast, the entities described in the submission are subject to government measures and have not accepted any responsibilities beyond those imposed by the measures.

43. It could also be argued that a past practice of purchasing new energy credits would be insufficient to create a valid expectation among other parties that an entity with negative credits will continue to purchase positive new energy credits in the future. The measures are relatively new, and it could be expected that entities will continue to re-assess the relative benefits of the options available to them each year. For example, an entity may choose to settle its obligation either by purchasing positive new energy credits one year, and then by submitting the remedial plan to the government the next year.

Staff conclusions on question 1—does an entity with negative credits have a liability?

44. Based on our analysis in paragraphs 24–43, we conclude that, in the fact pattern described in the submission, an entity with net negative credits has a present obligation that meets the definition of a liability in IAS 37, except in (possibly rare) circumstances in which accepting the sanctions for non-compliance described in paragraph 10 of this paper is a realistic alternative to settling the obligation. The rationale for this conclusion is that:

    (a) the entity has an obligation to eliminate its negative credits, which it could settle either by purchasing positive new energy credits from another entity or by submitting a remedial plan to the government and generating its own positive credits in the following period. An entity would have no realistic alternative to settling that obligation using one of those means, except in (possibly rare) circumstances in which accepting the sanctions for non-compliance with the measures is a realistic alternative (see paragraphs 30–31).

(b) the entity owes the obligation to society in general, on whose behalf the government has implemented the measures (see paragraphs 35–36).

(c) 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 (see paragraph 39).

45. For the reasons in paragraph 42, we conclude that the obligation arising from the receipt of negative credits is legal rather than constructive.

Staff analysis and conclusions on question 2—does a binding contract change the conclusion?

46. The second question asked in the submission would arise only if the Committee concluded that the answer to the first question was that the receipt of negative credits *does not* create a present obligation for the receiving entity. The question is whether the answer would change if, by the end of the reporting period, the entity had entered into a binding contract to buy positive new energy credits from another party.

47. The staff conclusion in paragraph 44 is that the receipt of negative credits *does* create a present obligation for the receiving entity. Hence, we also conclude that question 2 need not be considered—the existence of a binding contract does not affect the analysis, except insofar as it would provide evidence that accepting the sanctions is not a realistic alternative to settling the obligation.

48. Entering into a binding contract to purchase credits from another party would create new rights and obligations for an entity—rights and obligations to exchange one resource (cash) for another resource (positive new energy credits). While the contract remains executory, the entity would not recognise those rights and obligations unless the contract were onerous.

Question for the Committee

Question 1 for the Committee
1. Does the Committee agree with the staff conclusions that: (a) in the fact pattern described in the submission, an entity with net negative credits has a present obligation that meets the definition of a liability in IAS 37, except in (possibly rare) circumstances in which accepting the sanctions for non-compliance with the measures is a realistic alternative to settling the obligation (paragraph 44); and (b) because the receipt of negative credits creates a present obligation for the receiving entity, there is no need to consider whether entering into a binding contract would do so (paragraph 47)?

Whether to add a standard setting project to the work plan

Staff analysis and conclusions

49. Paragraph 5.16 of the IFRS Foundation *Due Process Handbook* states that the Committee decides to add a standard-setting project to the work plan only if, among other things, the principles and requirements in IFRS Standards do not provide an adequate basis for an entity to determine the required accounting.

50. Based on our analysis in paragraphs 24–48 of this paper, we conclude that this criterion is not satisfied—the principles and requirements in IAS 37 provide an adequate basis for an entity with negative credits to determine whether, in the fact pattern described, it has a present obligation that meets the definition a liability.

Staff recommendations

51. For the reasons described in paragraph 50, we recommend that the Committee not add a standard-setting project to the work plan. We recommend that the Committee instead publish a tentative agenda decision that outlines whether an entity with negative low emission vehicle credits has a present obligation that meets the definition of a liability in IAS 37.

52. Appendix A to this paper sets out the proposed wording of the tentative agenda decision. In our view, the proposed tentative agenda decision (including the explanatory material contained within it) would not add or change requirements in IFRS Standards.

Questions for the Committee

Questions 2 and 3 for the Committee
2. Does the Committee agree with our recommendation not to add a standard-setting project to the work plan? 3. 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 requirements that an entity could settle or avoid by changing its future operations meet the definition of a liability in IAS 37.

The request describes government measures that apply to entities that produce or import passenger vehicles for sale in a specified market. At the end of each calendar year, entities receive positive credits if they have exceeded targets for producing or importing low emission vehicles during that year, and negative credits if they have fallen short of those targets. The measures require an entity that receives net negative credits to eliminate them, either by purchasing positive credits from an entity with a surplus or by generating its own positive credits in the following year (by changing its future operations to produce or import a sufficiently higher ratio of low emission vehicles). If the entity fails to eliminate its negative credits in one of those two ways, the government may restrict the entity's access to the market.

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 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 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.

Applying those paragraphs, the Committee concluded that, in the fact pattern described in the request, an entity with negative credits has an obligation that meets the definition of a liability in IAS 37, except in (possibly rare) circumstances in which accepting the possible restrictions on market access is a realistic alternative to eliminating negative credits for that entity. Under the measures, the entity has an obligation to eliminate its negative credits, either by purchasing positive credits from another entity or by generating its own positive credits in the following year. In either case, settlement involves an outflow of resources embodying economic benefits—in the first case, the resource is cash; in the

second case, the resource is the positive credits the entity generates in the future and could otherwise have used for other purposes (for example, to sell to other entities with negative credits). An entity would have a realistic alternative to settling the obligation only if accepting the possible restrictions on market access is a realistic alternative for that entity.

The Committee also observed that the obligation arises from past events (the import or production of vehicles), and it exists independently of the entity's future actions—the entity's future actions affect only whether and how the entity settles the obligation.

The Committee concluded that the principles and requirements in IAS 37 provide an adequate basis for an entity to determine whether the negative credits described in the request create an obligation meeting the definition of a liability. Consequently, the Committee [decided] not to add a standard-setting project to the work plan.

Appendix B—submission

Background

In 2018, the Government introduced new regulatory measures to promote energy efficient and new energy cars (the "Measures"). Entities sign an annual commitment to reiterate that they will comply with the applicable laws and regulations, as well as the Measures.

A Passenger Vehicle Enterprise (PVE or entity) which either produced/imported traditional energy cars with fuel consumption levels better than the standard (set by the government authority), or, produced/imported a higher number of new energy vehicle (defined by the government authority) than the target proportion of cars, receives positive credits. Otherwise, a PVE will receive negative credits, respectively.

Under these Measures, entities with net negative credits (i.e., deficit) are required to bring their respective negative credits to zero by purchasing positive credits generated by other PVEs from the market. Purchased credits can only be used to compensate a deficit but cannot be re-sold to third parties or carried forward to subsequent years.

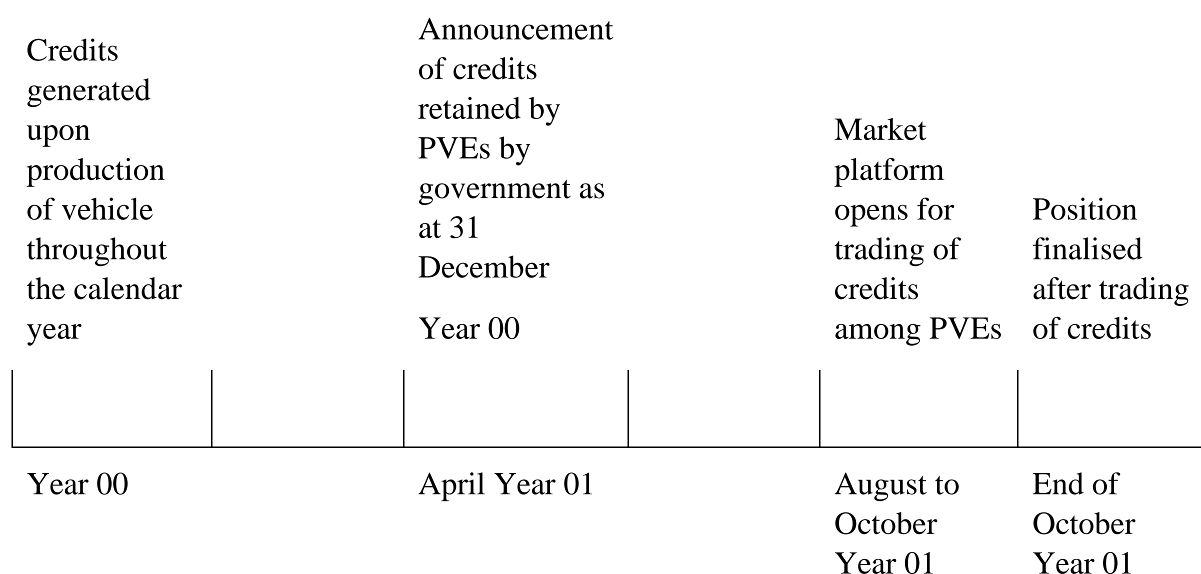
If the entity fails to bring the respective deficit to zero, although no financial penalty is imposed, the entity may face the following consequences:

- The entity may potentially be impeded in any and all activities connected with any and all government authorities (e.g., tax exemption applications, capacity expansion approvals, import inspections, etc.).
- The entity is required to submit a remedial plan for vehicle production/imports for the subsequent year to generate sufficient positive credits to offset the deficit for the year.
- The Government may disapprove the entity's applications for the launch of any new vehicle models.

In the given fact pattern, since the first introduction of the Measures, many of the PVEs that expected or faced actual deficits, have purchased credits from other PVEs in order to offset the deficit and will likely continue with this practice to maintain a zero-target position as it is costly and disruptive to adjust the operations of the entity within a short period of time. A

trading platform is opened for a few months each year for the purchase and sale of credits among the PVEs.

The timeline of events under this mechanism is shown in the following diagram:



Questions:

(1) Does a deficit position create a legal liability or constructive obligation under IFRS as of the end of a reporting period?

(2) If your answer to Question 1 is "No" (View A), would your view be different in the event that, before the reporting date, the PVE has entered into a binding contract with another PVE to purchase positive credits which will be settled after the end of the reporting period?

Discussion:

(1) Does a deficit position create a legal liability or constructive obligation under IFRS as of the end of a reporting period?

View A: No, the deficit position is neither a legal liability nor a constructive obligation.

Supporters of View A believe the criteria for the recognition of a provision under IAS 37.14(a) are not met. In accordance with paragraph 19 of IAS 37, even when there are commercial pressures or legal requirements and, thus, an entity may intend or need to carry

out expenditure to operate in a particular way in the future, the entity has no present obligation because the entity can avoid the future expenditure by its future actions, for example by changing its method of operation. Applying Illustrative Example 11B on Refurbishment costs- legislative requirement, there is no present obligation as a result of a past obligating event given that the purchase of credits can be avoided by submitting a remedial plan or even by exiting the market. While these alternatives may not be economical, that does not mean they are unrealistic. According to IAS 37.19, only those obligations arising from past events existing independently of an entity's future actions (i.e., the future conduct of its business) should be recognised as provisions.

Supporters of View A further believe that a past pattern of practice to purchase credits does not create any constructive obligation. As the Measures allow an entity to submit a remedial plan and avoid purchasing credits, it is unreasonable for the Government or other parties to have a valid expectation that the entity will not use this avenue in the future. The commitment letter reiterates that the entity will comply with the applicable laws and regulations as well as the Measures but it does not extend beyond these requirements.

IFRIC 21.9 specifies that "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". The Interpretations Committee further clarified in IFRIC 21.BC17 that "when an entity is economically compelled to incur operating costs that relate to the future conduct of the business, that compulsion does not create a constructive obligation and, thus, does not lead to the entity recognising a liability". Therefore, by analogy, the economic pressure which compels the entity to purchase credits in the future in order to continue with the operation without disruption also does not give rise to a constructive obligation at the end of the reporting period.

Since there is no financial penalty for the uncompensated negative credits, the deficit balance is neither a legal liability nor a constructive obligation to the Government or another party for the PVE. The deficit will not directly result in an outflow or transfer of economic resources.

The fact that the Measures allow various means for the remediation, such as submission of a plan to compensate a deficit position for a year under review, demonstrates that the Measures are not primarily intended to force the PVE to pay a compliance penalty. Instead, it aims to incentivise investments and entities' efforts to meet the Measures and to promote energy

efficient and new energy cars. The result of non-compliance will only impact the future operations of the entity.

View B: Yes, the deficit is a constructive obligation.

The deficit has created a duty or responsibility that the PVE has to transfer economic resources which it has no realistic alternative to avoid. There will be indirect economic penalties from the deficit such as economic losses from losing new car model business which require government approval.

Adjusting (future) production/ importation plans is very costly and may take a longer period beyond the subsequent year which would not help to address the deficits in a timely manner. The economic penalties can only be avoided by purchasing credits to compensate negative credit balances which results in an outflow of economic resources. Furthermore, even though theoretically possible, closing down the business is not economically reasonable and, hence, not a realistic alternative to avoid the economic penalties. Supporters of View B believe that there is no guidance on assessing whether an alternative is realistic and the entity is entitled to take into account economic losses or economic penalties when making the assessment. In this fact pattern, given the high economic penalties potentially involved and the disruption resulting from adjustments to operations, submitting a remedial plan and adjusting the operation of the entity are considered unrealistic.

While the settlement of the obligation (negative credit balance) by purchasing positive credits cannot be enforced by law and it is therefore not a legal obligation, a constructive obligation would exist.

In accordance with IAS 37.10 a constructive obligation arises when an entity, by past practice or sufficiently specific communication to affected parties, has created a valid expectation in other parties that it will accept certain responsibilities and that it will discharge those responsibilities.

In this case, the relevant party is the Government and the citizens together with the PVEs which have positive credits for sale. Such valid expectation to compensate existing deficits by purchasing credits from third parties has been created by the PVE’s purchases of credits to offset against the deficit which reveals its commitment to be compliant with the Measures through such purchases. Accordingly, the signed commitment letter and the purchases of

credits in previous years that have established a pattern of past practice give rise to a constructive obligation.[2]

Proponents of this view believe the fact pattern is akin to the situation in Example 2B of the implementation guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* when the entity has a published policy to clean up contamination it causes and there is a record of honouring it. Therefore, there is a present obligation as a result of a past obligating event when vehicle are produced/imported as this creates the negative credit and triggers the recognition of the constructive obligation to purchase credits from other PVEs. In measuring the obligation, the best estimate is determined considering the net negative credits created and, thus, the expected total number of positive credits to be purchased for a given year at each reporting date.

(2) If your answer to Question 1 is "No" (View A), would your view be different in the event that, before the reporting date, the PVE has entered into a binding contract with another PVE to purchase positive credits which will be settled after the end of the reporting period?

View A: Yes, a liability is recognised

By entering into the binding contract (to purchase credits) with another party the entity has turned a situation of economic compulsion into a present legal obligation. As there are no future economic benefits associated with the credits other than to settle the deficit, the contract to purchase the credits in combination with the deficit meets the definition of a provision under IAS 37.14. The entity has no possibility to avoid an outflow of economic resources caused by the past events, i.e. a deficit and the purchase of credits with no alternative use than to settle the deficit.

View B: No, there is neither a legal liability nor a constructive obligation

When the credits are not transferred to the entity prior to the reporting date, there is no direct accounting consequence, as the contract (to acquire credits) is executory at the reporting date

[2] It is believed that IAS 37.14(b) and (c) would be met and thus question 1 focuses on the interpretation of IAS 37.14(a).

(Conceptual Framework 4.56). Proponents of this view believe that the purchase of credits provides the economic benefits of maintaining the production/ import plans for the following year without changes. Therefore, an onerous provision is only required to the extent the cost of fulfilling the contract exceeds the economic cost of the alternative of changing the production/import plans for the following year.

When the purchased credits are transferred to the entity, they should be recognised as an acquired other asset/prepayment which will be derecognised through the income statement once the respective rights are used to settle the negative credit balances (i.e., at the date the negative credit balance has to be settled in accordance with the regulations, which is around October of the following year).