

International Financial Reporting Standards Interpretations  
Committee  
IFRS Foundation  
Columbus Building  
7 Westferry Circus  
Canary Wharf  
London  
E14 4HD

12 April 2022

Dear IFRS Interpretations Committee members,

**Invitation to comment - Tentative Agenda Decision (TAD): Negative Low Emission Vehicle Credits (IAS 37 Provisions, Contingent Liabilities and Contingent Assets)**

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the above tentative agenda decision of the IFRS Interpretations Committee (the Committee) that is published in the February 2022 *IFRIC Update*.

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

We do not agree with the tentative agenda decision. We believe that the TAD should conclude that an entity that has produced or imported vehicles with average fuel emissions higher than the government target does not immediately have a legal obligation that meets the definition of a liability in IAS 37. We observe that, in the fact pattern set out in the submission to the Committee, the entity can avoid any obligation in law to purchase or generate positive credits in a future period by accepting the restrictions on future activities in the form of sanctions that the government can impose or by exiting the market (see next). A requirement to settle an obligation by purchasing or generating positive credits will arise only if the entity decides to operate in a manner that would otherwise be restricted by the sanctions, for example, by applying to launch a new model, expand capacity or seek certain tax exemptions. In the fact pattern presented in the submission to the Committee, the entity can exit the market without the government being able to pursue it for the deficit created by its past sales and imports, i.e., the government has no legally enforceable right at the reporting date. We suggest that the Committee specifies in the fact pattern that an entity can also choose to exit the market without consequences and addresses how it has considered this fact in the analysis.

We agree that even though no legal obligation exists, an entity could, nevertheless, have a constructive obligation that meets the definition of a liability in IAS 37. However, there is no action specified in the fact pattern in the submission to the Committee that would have created such an obligation. We see the fact pattern as containing two triggering events, both

of which must have occurred before there is a past obligation. As a result, the entity has a *potential* obligation to purchase or generate positive credits at the point of incurring negative credits and this becomes an obligating event when the entity creates a valid expectation that it will discharge the obligation or when settlement (in this case, the purchase or generation of positive credits) can be enforced by law. The determination of the degree to which this results from a sufficiently specific public announcement by the entity or (in this fact pattern) the submission of a remedial plan for vehicle production/imports for the subsequent year to generate sufficient positive credits to offset the deficit may require significant judgement.

With respect to the wording of the TAD, we have the following specific comments:

1. We disagree with the statement in the TAD that “the activity that may give rise to an obligation to eliminate negative credits is the production or import of vehicles”. In this respect, the TAD seems to be inconsistent with the principles set out in the following guidance:

- Example 3 of IFRIC 21 that clarifies that the fact that the entity is economically compelled to meet the requirements to continue to operate in the future does not result in a present obligation
- Example 11B of IAS 37, which considers a legal requirement to overhaul an aircraft. This example addresses the case where an activity has occurred in the past (flying the aircraft) that triggers a possible future obligation (incurring the cost of overhaul). The example notes that “even a legal requirement to overhaul does not make the costs of overhaul a liability, because no obligation exists to overhaul the aircraft independently of the entity’s future actions – the entity could avoid the future expenditure by its future actions, for example, by selling the aircraft”. The future cost would instead be accounted for separately according to the relevant requirements of the applicable standard.

The TAD does not explain how the conclusion is reconciled with such guidance. Consistent with such guidance, we believe that, in the current fact pattern, no legal obligation exists. It is not clear why there is a difference between the possibility of ‘selling the aircraft’ and accepting the restriction on activities through sanctions the government may impose in applying IAS 37 as both are future decisions an entity can make. As such, we believe that, in both cases, economic compulsion should not be considered when determining whether an obligation exists. We believe that, much like the guidance in IFRIC 21, no obligation exists independently of the entity’s future actions.

2. We also disagree with the assertion that “the requirement that ‘settlement of the obligation can be enforced by law’ is met”. The submission does not refer to any legal action to enforce the settlement of the negative credits nor any financial penalty that will be imposed by the government. The only consequences are related to the future operation by the entity in the market:

- 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.

The TAD seems to take a wide view of what constitutes settlement of the obligation to make good the deficit in emission credits, in particular, that this extends beyond the generation or purchase of positive credits. However, if a remedial plan is submitted, but ultimately insufficient positive credits are generated or purchased, there is still a shortfall in respect of which only the sanctions noted above can be imposed. Settlement of negative credits is, therefore, not enforceable by law, but the existence of sanctions encourages the entity to incur voluntarily the higher future operating cost of compliance. We believe the TAD should clarify the basis for concluding that the future expenditure to eliminate any balance of negative credits is not considered a future operating loss, for which paragraph 63 of IAS 37 prohibits the recognition of a provision.

As governments and entities seek to address the challenges imposed by climate change and the sustainability agenda, we expect the incidence of examples like the one presented to the Committee to increase significantly. We are concerned that the perceived inconsistency between current accounting practice and the drafting of the TAD may have unintended consequences for other fact patterns where entities face economic compulsion to meet requirements imposed by governmental bodies in order to continue to operate in the future in a specific market. Furthermore, we believe that the TAD would effectively amend the guidance of IAS 37, IFRIC 6 and IFRIC 21 and increase diversity in practice and perhaps require entities to restate positions previously taken in their financial statements. We therefore consider that such a change, if intended, should be implemented through a standard-setting project by the IASB.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at the above address or on +44 [0]20 7951 3152.

Yours faithfully

*Ernst + Young Global Limited*