

## STAFF PAPER

IFRS Interpretations Committee  
Meeting

November – 2011

**Project**                      **Levies charged for participation in a specific market – Debit side of the liability**

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This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in *IFRIC Update*. The approval of a final Interpretation by the Board is reported in *IASB Update*.

**Purpose of the paper**

1. At the September 2011 meeting, the Committee noted that the obligation to pay a levy may be associated with an expense or with an asset, depending on the characteristics of each levy. The Committee directed the staff to further analyse:
  - (a) whether levies paid to public authorities are exchange or non-exchange transactions with public authorities;
  - (b) whether a distinction can be made between payments that are analogous to taxes and those that are analogous to licences;
2. This paper discusses the following matters:
  - (a) How are levies accounted for in the financial statements of public authorities?
  - (b) Does the entity that pays the levy purchase a service from the public authority?
  - (c) Does the entity that pays the levy purchase an asset that meets the definition of an intangible asset?

## How are levies accounted for in the financial statements of public authorities?

3. We think that it may be useful to find out how levies are accounted for in the financial statements of public authorities, even if public authorities do not apply IFRSs and if the principles applied might be different. We do not think that the accounting in the financial statements of the public authority should necessarily be symmetrical to the accounting in the financial statements of the entity that pays a levy.
4. We note that the International Public Sector Accounting Standards Board (IPSASB) is a Board of IFAC formed to develop and issue under its own authority International Public Sector Accounting Standards (IPSASs). IPSASs are high quality global financial reporting standards for application by public sector entities other than Government Business Enterprises (GBEs). We understand that IPSASs are drawn primarily from IFRSs but are adapted to a public sector context when appropriate (*Preface to IPSASs*, paragraph 18).
5. According to IPSAS 23 *Revenue from non-exchange transactions (taxes and transfers)*, public sector entities may derive revenues from exchange or non-exchange transactions. An exchange transaction is one in which the public sector entity receives assets or services and directly gives approximately equal value (primarily in the form of goods, services, or use of assets) to the other party in exchange (IPSAS 9 *Revenue from exchange transactions*, paragraph 11).
6. Taxes are not considered exchange transactions, but satisfy the definition of non-exchange transactions because the tax payer transfers resources to the government, without receiving approximately equal value directly in exchange. According to IPSAS 23 (paragraph 7), taxes are economic benefits or service potential compulsory or payable to public sector entities, in accordance with laws and or regulations, established to provide revenue to the government. According to IPSAS 23 (paragraph 63), while the tax payer may benefit from a range of social policies established by the government, these are not provided directly in consideration for the payment of taxes.

7. We also understand that:

- (a) A public sector entity shall recognise an asset in respect of taxes receivable when the taxable event (ie the event that triggers the payment of the levy as identified by the legislation) occurs (IPSAS 23 paragraph 59). The credit side of the asset is revenue or a liability if (b) applies.
- (b) The public sector entity shall recognise a liability when it is required (because of laws or regulation, or a binding arrangement) to return the tax paid by the taxpayer if it does not use the tax as specified (IPSAS 23 paragraphs 22, 52, 55 and 63). In that case, the public sector entity does not recognise revenue until the liability is reduced. According to IPSAS 23, few levies should give rise to a liability because few levies require that the public sector entity returns the tax to the tax payer if it is not used as specified.
- (c) Payments of taxes received prior to the occurrence of the taxable event are recognised as advance receipts (IPSAS 23 paragraph 66).

8. Consequently, we think that levies charged by public authorities would be analysed as non-exchange transactions according to the IPSAS definition unless direct services are rendered by the public authority to the entities that pay the levy.

**Does the entity that pays the levy purchase a service from the public authority?**

9. In most cases, we think that the entity that pays the levy does not have any right to receive specific direct future services in consideration for the payment of the levy. The public authority may provide a variety of public services to the entities that pay the levy, but these services are not directly rendered in consideration for the payment of the levies and there is no evidence that the value of the services rendered to the entity is equivalent to the amount of the levy paid.

10. Consequently, we think that no asset should be recognised by the entity that pays the levy unless:

- (a) The entity has a right to receive specific direct future services from the public authority and these services are associated with future economic benefits whose value is equivalent to the amount of the levy paid.
- (b) The levy has to be paid back to the entity if the public authority does not use the levy as specified in the regulation and the public authority has not yet satisfied its obligations in accordance with the regulation.
- (c) The entity has pre-paid the levy, ie the entity has paid the levy but it does not have yet a present obligation to pay the levy (ie the obligating event that triggers the obligation to pay the levy has not occurred).

**Question for the Committee?**

Does the Committee agree with the analysis of the staff presented in paragraph 10 of this paper?

**Does the entity that pays the levy purchase an asset that meets the definition of an intangible asset?**

11. We note that most of the levies considered in this paper are annual recurring levies charged for participation in a specific market. We present below an example that we will use throughout the paper as an illustration.

Example 1: A public authority puts in place an annual recurring levy charged for participation in a specific market. The first levy is due if Entity A participates in a specific market on 1 January 20X1 and the amount of the levy is determined by reference to revenues generated by Entity A in the previous year.

12. In this example, the liability is recognised at a point in time on 1 January 20X1 (see paper 2A). The issue is to determine whether the payment of the levy is:
- (a) analogous to a tax; or
  - (b) the consideration paid for a licence that meets the definition of an intangible asset in IAS 38 *Intangible Assets*.

***View A: the payment of the levy is analogous to a tax***

13. Proponents of view A think that the levy is analogous to a tax for the following reasons:

**The payment of the levy is not an exchange transaction**

14. The payment of the levy is imposed by the public authority. It is the consequence of the entity's participation in the market. While the entity can choose to remain in the market, proponents of view A think that it is not an entity's choice to purchase an asset.
15. The amount of the levy is solely determined by the public authority. It cannot be considered as a market price paid for an asset, because this transaction is not an arm's length transaction between willing parties.

**The asset does not meet the control criteria in IAS 38**

16. IAS 38 (paragraph 13) states that:

An entity controls an asset if it has the power to obtain the future economic benefits flowing from the underlying resource and to restrict access of other to those benefits.

17. Proponents of view A think that the benefits associated with the potential right to operate in the market are the revenues generated through the sales to customers in the market in 20X1 in Example 1. While proponents of view A accept that the levy provides access to the customers in the market in 20X1 and to the benefits

associated, they do not think that the entity has sufficient control over the expected economic benefits that will arise from the sales with customers if the entity cannot restrict the access of other entities to the market and to those revenues (such as new entrants). As the payment of the levy on its own does not provide any legal rights that give the entity the power to restrict access of other entities to the customers and the revenues generated in the market, they think that no asset should be recognised.

**The asset does not generate any future economic benefits**

18. Proponents of view A argue that when a levy is put in place by a public authority, the payment of the levy is not associated with any new or additional economic benefits in comparison with the situation that was prevailing before the levy is put in place, if all the entities that pay the levy can operate in the market.

**Conclusion**

19. Consequently, proponents of view A think that the obligation to pay a levy charged for participation in a specific market is associated with an expense.

***View B: the payment of the levy is the consideration paid for a licence in certain circumstances***

20. Proponents of view B think that the payment of a levy is analogous to a licence (ie a right to operate in the market in 20X1 in Example 1) for the following reasons:

**The payment of the levy may be an exchange transaction in certain circumstances**

21. Proponents of view B note that the distinction between a levy and a licence is often based on the form of the terms used in the regulation rather than on their substance. Proponents of view B think that the substance of the transaction should be analysed in order to determine if the levy is the consideration paid for a licence.

For example, a public authority would achieve the same goal if it puts in place an annual levy or if it sells an annual licence to the entities that want to operate in a specific market.

22. Proponents of view B think that the following indicators tend to provide evidence that the payment of the levy is an exchange transaction:
- (a) The calculation of the levy is based on data measuring the entity's activity in the market (for example revenues generated by the entity in the market, market share of the entity in the market or number of outputs sold by the entity in the market). In that case, proponents of view B think that the levies may have similar characteristics to payments that would be required in a licence contract.
  - (b) The entity or a limited number of entities are granted distinct legal rights that prevent other entities from accessing the market. For example, a public authority could sell a licence to operate in a specific market to the entity for a negligible fixed consideration and put in place a levy based on data measuring the entity's activity in the market. Proponents of view B think that in that case the levies paid may in substance be analysed as additional payments related to the licence sold by the public authority.
  - (c) The market is highly profitable and very few competitors are able to operate in the market. In that case, proponents of view B think that the public authority is in substance selling a licence to participate in a highly profitable market.

### The asset meets the control criteria in IAS 38

23. IAS 38 (paragraph 13) states that:

An entity controls an asset if it has the power to obtain the future economic benefits flowing from the underlying resource and to restrict access of other to those benefits.

24. Proponents of view B do not read paragraph 13 of IAS 38 the same way as proponents of view A. Proponents of view B do not think that the entity needs to

have the power to restrict the access of others to the market in order to meet the definition of an asset. This view can be illustrated through the following examples:

- (a) If an entity purchases a non-exclusive software licence for internal use, the software licence meets the definition of an intangible asset although the entity cannot prevent others to purchase and use the software licence. The entity controls the benefits of the use of the software because other entities cannot prevent the entity from using the software.
- (b) If an entity incurs development costs, these costs may be capitalised if they meet the criteria in IAS 38, even if the entity does not have the power to restrict access of other entities to the market. The entity controls the benefits flowing from the development asset because other entities cannot use the development performed by the entity.
- (c) If an entity purchases a cab licence, the licence meets the definition of an intangible asset although other entities can also purchase a cab licence and access the cab market. The entity controls the benefits of the use of the licence because the entity has a right to operate in the market and other entities cannot prevent the entity from operating in the cab market.

25. Similarly, proponents of view B think that the payment of the levy gives the entity a right to operate in the market and access to the benefits in the market if the payment of the levy is analysed as an exchange transaction. The entity controls the access to the benefits in the market because other entities cannot restrict the access of the entity to the market or cannot prevent the entity from participating in the market. The other entities have to pay their own levy to operate in the market, ie they cannot operate in the market based on the entity's levy. For proponents of view B, the fact that other entities have the right to operate in the market if they pay the levy should be taken into account when assessing the probability that sufficient future economic benefits will flow to the entity.

26. Moreover, proponents of view B think that the control criteria would be automatically met if payment of the levy is associated with other distinct legal rights that give the entity the power to restrict the access of other entities to the market. For example, this would be the case if:



- (a) The regulation applicable to the market establishes an agreement procedure for new entrants or for the products sold by new entrants and this procedure is not purely formal (ie there is a barrier to entry); or
- (b) The public authority has granted to the entity or to a limited number of entities a separate right to operate in the market that meets the definition of an intangible asset.

Example 2: A railway entity is granted by a public authority a right to operate a specific railway line for a specified period. The public authority charges at the same time an annual levy for entities participating in the railway market based on revenues generated in the market. In that case, the payment of the levy would be considered in substance as part of the consideration paid for the acquisition of a right to operate the railway line.

**The asset generates future economic benefits**

27. The first issue is to determine whether the payment of the levy generates any future economic benefits. Proponents of view B argue that the payment of the levy, although not directly increasing the future economic benefits of any particular existing asset, may be necessary for an entity to obtain the future economic benefits from its other tangible or intangible assets. They note that this argument is used to capitalise expenditures incurred for safety or environmental reasons in the cost of tangible assets (IAS 16 paragraph 11). If the entity decides to exit the market and does not pay the levy, the other assets used for the production of goods or the rendering of services sold in the market will not generate any revenues in this market and might need to be impaired. Proponents of view B think that the expected economic benefits associated with the payment of the levy in Example 1 described above are the revenues generated in 20X1 in the market through the sales of products or services to customers.

28. The second issue is whether the degree of certainty that economic benefits will flow to the entity is sufficient to warrant the recognition of an asset. As mentioned above, if legal rights that restrict access of other to the market exist, then the criteria should generally be met. In the absence of legal rights, it may be more

difficult to demonstrate that sufficient probable future economic benefits will flow if new entrants are able to access the market and sell their products or services to the customers in the market. But this situation is not different from any intangible asset that does not restrict access of others to the market (such as intangible assets arising from development): entities assess the likelihood of being able to use the asset profitably, and capitalise on that basis.

29. The third issue is whether the entity has already consumed the benefits when the liability is recognised. We note that in certain circumstances, the liability may be recognised progressively as the entity performs its activity (see paper 2A). Thus, when the liability is recognised, the issue is to determine whether the entity has already consumed the benefits and an expense should be recognised, or whether the entity will consume the benefits in the future and an asset should be recognised, or a combination of the two. We think that if the liability is recognised progressively over time, an expense should be recognised because the benefits are already consumed.

### Conclusion

30. Consequently, proponents of view B think that the obligation to pay a levy charged for participation in a specific market is associated with an asset if the payment of the levy is analysed as an exchange transaction. Proponents of view B do not think that the entity needs to have the power to restrict the access of others to the market in order to meet the definition of an asset. The asset would be depreciated over the period for which benefits are expected (ie 20X1 in Example 1). The staff favours view B because of the arguments developed above.

#### **Questions for the Committee**

Does the Committee think that the indicators provided in paragraph 22 provide evidence that the payment of the levy is an exchange transaction? Does the committee think that other indicators should be considered?

For a levy analysed as an exchange transaction, does the Committee think that it may be analysed as the consideration paid for the purchase of a right to operate that meets the definition of an intangible asset:

(a) only if the payment of the levy is associated with distinct legal rights that give the entity the power to restrict access of other entities to the market?

(b) also in the absence of legal rights that give the entity the power to restrict access of other entities to the market?