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IFRS Interpretations Committee Meeting

Staff Paper

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Project **Levies charged for participation in a market on a specified date**

Topic **Recognition of liabilities**

Purpose of the paper

1. This paper discusses the following issue: when should the liability for the obligation to pay a levy be recognised?
2. The objective of this paper is:
   (a) to present the requirements in the IFRS literature regarding executory contracts;
   (b) to present the requirements in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* regarding the notion of 'present obligation';
   (c) to discuss when the entity has a present obligation to pay a levy charged for participation in a market on a specified date;
   (d) to present the guidance in IFRIC 6 *Liabilities Arising from Participating in a Specific Market – Waste Electrical and Electronic Equipment*.

Introduction

3. As expressed in Agenda paper 2, we think that the obligation to pay a levy in the cases described in these papers is associated with a right to participate in a specific market for a specified period.
4. The Conceptual Framework refers to executory contracts as contracts that are equally proportionately unperformed.

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5. Even though a levy is not a contract but a tax put in place by a public authority, we think it might be useful to analyse the concept of executory versus non executory in the IFRS literature and assess whether this concept should be used to determine when the liability for the obligation to pay a levy should be recognised.

Guidance regarding executory contracts in the IFRS literature

6. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (paragraph 1) shall be applied in accounting for provisions, except those resulting from executory contracts (except when they are onerous). According to IAS 37, no liability should be recognised to the extent that it relates to an executory contract (except when it is onerous).
7. Thus, we think that the date of recognition of the liability depends on whether the transaction associated with the payment of a levy is analysed as executory or not.
8. According to IAS 37 (paragraph 3), 'executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent'. For example, executory contracts encompass commitments to purchase assets or services in the future.
9. The *Conceptual Framework* (paragraph 4.46) specifies that 'in practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements'.
10. In our view, the exclusion from the scope of IAS 37 of executory contracts comes from the definition of a provision.
11. According to IAS 37 (paragraph 10), a provision is a liability of uncertain timing and amount. IAS 37 (paragraph 14) provides that a provision shall be recognised only when all the following conditions are met:

    (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.'

12. We think that when a contract is executory, the entity has a contractual right to receive an asset or a service in the future, as well as a contractual obligation to pay a consideration in exchange, the whole resulting in a net nil right/obligation. Thus, in our view, an executory contract does not result in a net outflow of resources embodying economic benefits. In that case, to the extent that the right has not been received, we think that no provision should be recognised (even if the entity has a present obligation), because the condition (b) in paragraph 14 of IAS 37 is not met.

13. We observe that IAS 37 is consistent with this rationale, an executory contract being excluded from its scope (unless the contract is onerous).

14. We also note that IAS 37 (paragraph 18) specifies that 'no provision is recognised for costs that need to be incurred to operate in the future'. In our view, when a transaction is executory, this implies that the costs associated with this transaction are costs that need to be incurred to operate in the future or the cost of an asset that has not yet been received. In that case, in accordance with IAS 37, no provision is recognised.

15. However, according to the Conceptual Framework (paragraph 4.46), obligations under contracts that are equally proportionately unperformed 'may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.'

16. For example, in the case of finance leases, no asset and no liability are recognised at the date the lease is signed. However, when the asset is delivered to the lessee at the start of the lease term, the lessor has performed (part of) its obligation under the lease contract so that lease contract ceases to be executary at that point in time. It is at that time (ie the commencement of the lease term) that the asset and the liability are recognised (IAS 17 *Leases* paragraph 20) for the fair value of the leased property or, if lower, the present value of the minimum lease payments.

17. The rationale is explained in the Conceptual Framework (paragraph 4.6): 'In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of finance leases, the substance and economic reality are that the lessee acquires the economic benefits of the use of the leased asset for

the major part of its useful life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the finance lease gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the lessee's balance sheet.' The same rationale is provided in IAS 17 (paragraph 21 to 23).

Are the levies considered in these papers executory transactions?

18. A levy is a tax put in place by a public authority: it is not a contract.

19. Nevertheless, we think that the transactions associated with the payment of the levies considered in these papers should be in most cases analysed as executory (to the extent that the entity does not yet benefit from the right to participate in the market), even if these transactions are not in the form of contracts. In fact, as stated in the framework, attention needs to be given to the underlying substance and economic reality and not merely the legal form of a transaction.

20. As mentioned in Agenda paper 2, we think that the obligation to pay a levy as described in these papers is associated with a right to participate in a market for a specified period. As for an executory contract, we think that this transaction results in a net nil right/obligation because it is a transaction between an entity and the public authority in which the entity is granted a right in exchange for paying the levy. The transaction is executory unless and until the entity starts to benefit from the right of participation or the entity pays the levy before it starts to benefit from the right.

21. We think that a consequence of our analysis of the substance of the levies as being executory is that they represent costs of a specified period that need to be incurred to operate in that period.

Question for the Committee
Does the Committee agree that the transactions associated with the payment of the levies considered in these papers should be in most cases analysed as executory, ie the levies are costs that need to be incurred to operate in a specified period?

Requirements in IAS 37 for identifying liabilities

22. IAS 37 (paragraph 14) requires a provision to be recognised when all the following conditions are met:

    (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.’

23. A legal obligation is usually easy to identify as it arises from a contract or from legislation (or other operation of law).

24. A constructive obligation is more difficult to identify. It ‘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.’

25. IAS 37 (paragraph 17) specifies that ‘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.’

26. The notion of ‘no realistic alternative’ is part of the definition of an obligating event. It means that if there is a realistic possibility that the entity can avoid settlement, no obligation arises.

27. IAS 37 (paragraph 18 and 19) also states that:

(a) 'Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in future.'

(b) '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'.

28. In our view, these paragraphs disallow certain provisions that might otherwise be recognised when the obligation is dependent on the entity's future actions. No provision is recognised when the entity can avoid the expenditure by its future actions, even if those costs need to be incurred to operate in the future.

29. For example, an entity that is required to fit smoke filters to its factories (because of legal requirements or commercial pressures) has no present obligation for the future expenditure because it can avoid the expenditure by its future actions. This example is described in detail below.

30. We observe that in the illustrative examples in IAS 37, the fact that an entity has 'no realistic alternative' but to settle the obligation does not lead to a constructive obligation when this obligation is dependent on an entity's future actions.

31. In other words, when it comes to the entity's future actions, the fact that the expenditure needs to be incurred to operate in the future or the fact that it is economically unrealistic for the entity to avoid the expenditure or the fact that it would be necessary for an entity to take some unrealistic action to avoid the expenditure does not cause the recognition of a liability. For example, no provision is recognised for future staff training costs or repairs and maintenance costs, even if those costs need to be incurred to operate in the future. These examples provided in IAS 37 are also described in detail below.

32. Lastly, we observe that, as discussed in more detail later in this paper, the guidance in IFRIC 6 is consistent with this rationale. IFRIC 6 (BC 10) also concludes that a stated intention to participate in a market during a future measurement period (ie activity period in these papers) does not create a constructive obligation for future waste management costs.

33. IAS 37 provides several examples to illustrate that no provision is recognised when the entity can avoid the expenditure by its future actions.

Requirements to fit smoke filters

34. IAS 37 (paragraph 19) provides an example of an entity that is required to fit smoke filters to its factories (because of legal requirements or commercial pressures).

35. 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 the future expenditure.

36. IAS 37 (IE 6) goes on to say that if legislation exists but the enforcement date has not yet been reached, there is no obligation. If the enforcement date has been reached, there is still no obligation for the costs of fitting smoke filters because no obligating event has occurred (the fitting of the filters). However, an obligation might arise to pay fines or penalties under the legislation.

37. We observe that IAS 37 did not conclude that there is a constructive obligation to fit the filters, even if some could argue that the entity has in certain cases created valid expectations on the part of customers that it will comply with the legislation.

Staff training as a result of changes in the income tax system

38. IAS 37 (IE 7) gives another example of a government that introduces changes to the income tax system. As a result, an entity in the financial services sector will need to retrain a large proportion of its administrative and sales workforce in order to ensure continued compliance with financial services regulation. At the end of the reporting period, no retraining of staff has taken place. According to IE 7, there is no obligation because no obligating event has taken place.

39. We note that it is economically unrealistic for the entity not to incur the expenditure if it has an intention of continuing in business. But that fact does not cause the recognition of a liability in this example.

40. We also observe that IAS 37 did not conclude that there is a constructive obligation to retrain the staff, even if some could argue that the entity has in certain cases created

valid expectations on the part of staff or customers that the workforce will be retrained.

41. We think the rationale in this last example is that the training costs are future operating costs that the entity could avoid if it withdraws from the market or hires new skilled staff.

Repairs and maintenance

42. IAS 37 (IE 11) gives also two examples in connection with repairs and maintenance obligations. One example relates to a furnace with a lining that needs to be replaced every five years for technical reasons. At the end of the reporting period, the lining has been in use for three years. In the other example, an airline is required by law to overhaul its aircraft once every three years.

43. In both examples, no provision is recognised because there is no present obligation to incur the expenditures independently of the entity's future actions. The entity could, for example, stop operating the furnace, or sell the aircraft.

44. We note that it is economically unrealistic for the entity not to incur the expenditure if it has an intention of continuing in business. But that fact does not cause the recognition of a liability in this example.

When does an entity have a present obligation to pay a levy charged for participation in a market on a specified date?

45. We note that some of the concerns expressed in the original submission are about the accounting treatment applicable to levies for which the calculation period precedes the activity period.

46. The following example illustrates the issue (see also Agenda paper 2C Illustrative examples). The legislation imposes an annual levy for each calendar year for entities participating in a specific market. The levy is due if entity C generates revenues in that specific market in 2011. The amount of the levy is determined by reference to revenues generated by entity C in the market in the preceding year (ie 2010). The levy arising from the activity in the specific market in 2011 is payable in full in April 2012.

Entity C participates in the specific market on 1 January 2011. In this example, the calculation period (ie 2010) precedes the activity period (ie 2011).

47. The question is:

    (a) whether the obligating event is the participation in the market identified by the legislation, or;

    (b) whether other factors create an earlier obligation.

48. In other words, is there a present obligation in 2010, or does the obligating event occur only on 1 January 2011 when the entity participates in the market in 2011?

49. We will focus in the paragraphs below on the notion of 'present obligation' and on the notion of 'obligating event' (ie the event that leads to a present obligation).

50. In the example described above, the entity does not have a legal obligation at year end 2010 to participate in the market in 2011. Thus, the question is whether a constructive obligation exists at year end 2010.

51. Some argue that a constructive obligation exists at year end 2010 because at that date:

    (a) the entity has no realistic alternative but to remain in the market on 1 January 2011, and;

    (b) the amount of the levy is already determined (the calculation basis of the levy is already established).

52. In other words, at year end 2010, some argue that it would be necessary for an entity to take some unrealistic action in order to avoid the obligation (ie to withdraw from the market), meaning that a constructive obligation exists at that date.

53. We think that a consequence of our analysis of the substance of the levies as being executory is that they represent operating costs of a specified period that need to be incurred to operate in the future. In other words, in the example described above, the amount payable in April 2012 is the charge for the right to operate in 2011. The charge is therefore an operating expense of 2011 because this is the period in which entity C receives the benefit.

54. IAS 37 (paragraph 18) emphasises that 'Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in

the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future'. In that case, no provision is recognised to the extent that the right has not been received.

55. Moreover, according to IAS 37 (paragraph 19), a provision can be recognised only in respect of an obligation that arises independently of the entity's future actions.

56. It is important to note that when it comes to the entity's future actions, the fact that the expenditure needs to be incurred to operate in the future or the fact that it is economically unrealistic for the entity to avoid the expenditure does not create a constructive obligation and does not cause the recognition of a liability in IAS 37 (see the illustrative examples in IAS 37 cited above).

57. In our view, the entity has no constructive obligation to pay the levy in 2010 because the entity could stop doing business in the market (even if it is economically unrealistic and if the intention of the entity is to continue in business).

58. As discussed in more detail later in this paper, we observe that IFRIC 6:

    (a) addresses the issue of the date of recognition of a liability for a WE&EE obligation in the case where the calculation period precedes the activity period (as in the case of the levies described above);

    (b) is consistent with the rationale presented above.

59. In particular, IFRIC 6 (paragraph 9 and BC 10) concludes that:

    (a) Participation in the market during the measurement period (ie activity period in these papers) is the obligating event in accordance with paragraph 14 (a) of IAS 37;

    (b) A stated intention to participate in a market during a future measurement period does not create a constructive obligation for future waste management costs.

60. Some question whether the rationale explained above undermines or is undermined by the principle that the entity will continue to operate as a going concern.

61. We note that the framework sets out two underlying assumptions: the accrual basis of accounting and the going concern basis.

62. According to IAS 1 (paragraph 28), 'when the accrual basis of accounting is used, an entity recognises items as assets, liabilities, equity, income and expenses (the elements of financial statements) when they satisfy the definitions and recognition criteria for those elements in the framework.'

63. We think that the going concern basis cannot lead to the recognition of a liability that does not meet the definitions and recognition criteria set out in IAS 37 (paragraph 14 (a)).

64. We also note that the framework specifically states that 'the application of the matching concept under this framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets and liabilities'.

65. Consequently, we think that the obligating event in the example above is the participation in the market on 1 January 2011.

Question for the Committee
Does the Committee agree that the obligating event is the participation in the market identified by the legislation for the levies described above?

When should the liability for the obligation to pay a levy be recognised?

66. We think that the following general accounting treatment should be applied for the levies considered in these papers:

    (a) No liability should be recognised to the extent that the entity does not yet benefit from the right to participate in the market (because the transaction is executory in that case and the levy associated with the right to participate in the market is a cost that needs to be incurred to operate in a future period),

    (b) A liability should be recognised only if the entity:

        (i) benefits from the right to participate in the market, and;

        (ii) has a present obligation to pay the levy (as stated in IAS 37).

67. In the rare cases where the levy has been prepaid, an asset should be recognised to reflect the benefit that the entity will receive of operating in that specified future period.

Guidance provided in IFRIC 6 regarding WE&EE obligation

68. The original submission expressed concerns as to whether the levies considered in these papers could be analysed in the same way as the Waste Electrical and Electronic Equipment (WE&EE) decommissioning obligation described in IFRIC 6.

69. We note that for the WE&EE obligation, the activity period and the calculation period coincides most of the time.

70. Nevertheless, we also note that IFRIC 6 (BC 7) provides an example in which 'the waste management costs for which a producer is responsible because of its participation in the market during a specified period (for example 20X6) are not based on the market share of the producer during that period but on the producer's participation in the market during a previous period (for example 20X5)'.

71. Consequently, in our view, IFRIC 6 also addresses the issue of the date of recognition of a liability for a WE&EE obligation in the case where the calculation period precedes the activity period (as in the case of the levies considered in these papers).

72. We observe that the amount of the levies considered in these papers is calculated by reference to financial data that are generally directly or indirectly linked to the past activity of the entity in that market.

73. For the WE&EE obligation, there is not always a link with the past activity of the entity, because the amount of the costs that it bears may correspond to an allocation of the total costs of waste management among the participants present in the market on a specified date, irrespective of whether the entity was present in the market in the past.

74. However, IFRIC 6 specifies in the example provided in BC 7 that the WE&EE obligation may also be linked to the past activity of the entity, as in the case of the levies considered.

75. IFRIC 6 (paragraph 9) states that 'participation in the market during the measurement period is the obligating event in accordance with IAS 37 paragraph 14 (a)' (the measurement period is defined as the activity period in these papers).

76. IFRIC 6 (BC 7) specifies that when the activity period is different from the calculation period, 'this affects only the measurement of the liability and that the obligating event is still the participation in the market'.

77. IFRIC 6 (BC 10) also specifies that 'a stated intention to participate in a market during a future measurement period does not create a constructive obligation for future waste management costs. In accordance with paragraph 19 of IAS 37, a provision can be recognised only in respect of an obligation that arises independently of the entity's future actions'.

78. We observe that the fact that it is economically unrealistic for the entity to withdraw from the market does not cause the recognition of a liability in the rationale developed in IFRIC 6.

79. IFRIC 6 (BC 8) also mentions that 'the IFRIC considered whether its conclusion is undermined by the principle that the entity will continue to operate as a going concern. If the entity will continue to operate in the future, it treats the costs of doing so as future costs. For these future costs, paragraph 18 of IAS 37 emphasises that 'Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore, no provision is recognised for costs that need to be incurred to operate in the future'.'

80. We think that the rationale in IFRIC 6 is consistent with the provisions and the illustrative examples in IAS 37 and our conclusion in the example described above.

Question for the Committee
Does the Committee agree that the rationale in IFRIC 6 is consistent with the provisions and the illustrative examples in IAS 37 and our analysis of the accounting treatment in the example described above?