STAFF PAPER

IFRS Interpretations Committee Meeting

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Project	**Levies charged for participation in a specific market—date of recognition of a liability**		
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Introduction

1. The Interpretations Committee received a request to clarify whether, under certain circumstances, IFRIC 6 *Liabilities arising from participating in a specific market—Waste Electrical and Electronic Equipment* should be applied by analogy to identify the event that gives rise to a liability for other levies charged for participation in a market on a specified date. The concern relates to when a liability should be recognised and to the definition of a present obligation in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

2. At the July 2011 meeting, the Committee decided to add this issue to its agenda with the aim of developing guidance.

Purpose of the paper

3. The objectives of this paper are:

    (a) To provide a summary of the decisions taken by the Committee regarding the accounting treatment applicable to levies charged for participation in a specific market;

(b) To provide examples in order to illustrate how levies charged for participation in a specific market should be accounted for in the annual financial statements using the principles identified;

(c) To determine the accounting in the interim financial statements;

(d) To analyse the impact of minimum thresholds on the accounting for levies charged for participation in a specific market;

(e) To agree on the next steps in order to clarify the IFRS literature with regards to levies charges for participation in a specific market.

Decisions taken in the November 2011 meeting regarding the accounting for a liability to pay a levy charged for participation in a specific market

4. At the November 2011 meeting, the Committee tentatively decided to set out the following principles regarding the accounting for a liability to pay a levy charged for participation in a specific market within the scope of IAS 37:

(a) An entity does not have a constructive obligation to pay a levy that arises from operating in a future period, as a result of being economically compelled to continue operating in that future period.

(b) The preparation of financial statements on the going concern principle does not create a present obligation in accordance with IAS 37 and therefore does not lead to the recognition of a liability at a reporting date for levies that arise from operating in the future.

(c) The obligating event in accordance with IAS 37 is the last of the necessary events that is sufficient to create the present obligation when more than one event is required to create an obligation. Consequently, for example, the obligating event for a levy that is charged if the entity undertakes discrete activities both in the current and in the previous period is the activity in the latter period as identified by the legislation.

(d) The obligating event arises progressively if the activity that creates the present obligation occurs over a period of time. For example, a liability is recognised progressively if the obligating event as identified by the legislation is the generation of revenues over a period of time.

(e) The liability for the obligation to pay a levy gives rise to an expense, unless the levy is an exchange transaction in which the entity that pays the levy receives assets or future services in consideration for the payment of the levy.

Illustrated examples

5. We provide below three examples in order to illustrate the application of the principles described above. The objective is to check that there is a common understanding of how to apply those principles to different fact patterns.

Example 1:

> Entity A is a calendar year-end entity. An annual levy is due if Entity A generates revenues in a specific market in 20X1 and the amount of the levy is determined by reference to revenues generated by Entity A in the market in 20X1.
>
> In this example, the liability is recognised progressively over 20X1 because the obligating event as identified by the legislation is the generation of revenues progressively over 20X1. Entity A has a present obligation to pay a levy to the extent of revenues generated to date. At any point in time in 20X1, it has a present obligation to pay a larger levy only if it generates additional revenues. The obligation to pay a levy for the revenues generated to date is independent of future revenues being generated. Entity A does not have any present obligation for revenues that will be generated in the future. In other words, the last of the necessary events that is sufficient to create the present obligation is the generation of revenues progressively over 20X1.

Example 2:

> Entity B is a calendar year-end entity. An annual levy is due as soon as Entity B generates revenues in a specific market in 20X1 and the amount of the levy is determined by reference to revenues generated by Entity B in the market in 20X0. Entity B starts to generate revenues in the market on 3 January 20X1.

In this example, the liability is recognised at a point in time on 3 January 20X1 because the obligating event as identified by the legislation is the generation of revenues at a point in time in 20X1. The generation of revenues in 20X0 is a necessary event but is not sufficient to create a present obligation to pay a levy. Before 3 January 2011, Entity B has no obligation. In other words, the last of the necessary events that is sufficient to create the present obligation is the generation of revenues at a point in time in 20X1. A full liability is recognised on 3 January 20X1 because at that date the amount of the levy is independent of future revenues being generated and is based on revenues generated in 20X0.

Example 3:

Entity C is a calendar year-end entity. An annual levy is due if Entity C is a bank at the end of the annual period of account. The amount of the levy is determined by reference to data in the balance sheet of Entity C at the end of the annual period of account. If the period of account is less or more than 12 months, the amount of the levy is adjusted in order to reflect the length of the period that it reflects. Entity C reports its annual financial statements on 31 December 20X1.

In this example, the liability is recognised at a point in time on 31 December 20X1 because the obligating event as identified by the legislation is to be a bank at the end of the annual period of account. Before the end of the annual period of account, Entity C does not have a present obligation to pay a levy, even if it is economically compelled to continue operating in the future and to be a bank at the end of the annual period of account. In other words, the last of the necessary events that is sufficient to create the present obligation is to be a bank at the end of the annual period of account, which does not occur until 31 December 20X1.

Question for the Committee

Does the Committee agree that the rationale developed in Examples 1, 2 and 3 is consistent with the principles described in the first section?

Accounting for levies in the IFRS interim financial statements

6. In the previous papers, we focused on the accounting for levies in the annual financial statements under the requirements of IAS 37. The objective of this section is to determine how the principles described above for the accounting of levies in the scope of IAS 37 should be applied in the context of interim financial statements and in the light of the guidance provided in IAS 34 *Interim Financial Reporting*.

7. IAS 34 states that the same recognition principles should be applied in the annual and the interim financial statements.

> Paragraph 29: … the principles for recognising assets, liabilities, income, and expenses for interim periods are the same as in annual financial statements.
>
> Paragraph 31: The definitions of assets, liabilities, income, and expenses are fundamental to recognition, at the end of both annual and interim financial reporting periods.
>
> Paragraph 32: … a liability at the end of an interim reporting period must represent an existing obligation at that date, just as it must at the end of an annual reporting period.
>
> Paragraph B4: The Standard requires that an entity apply the same criteria for recognising and measuring a provision at an interim date as it would at the end of its financial year. The existence or non-existence of an obligation to transfer benefits is not a function of the length of the reporting period. It is a question of fact.

8. Applying the requirements of IAS 34, no liability should be recognised at the end of an interim reporting period if the obligating event has not yet occurred. For example, an entity does not have an obligation at the end of an interim reporting period if the present obligation arises only at the end of the annual reporting period. If there is no present obligation to pay a levy at the end of an interim reporting period, the expense should not be anticipated even if the costs associated with the obligation are incurred irregularly during the financial year and tend to

recur from year to year. Similarly, if a present obligation to pay a levy exists at the end of an interim reporting period, the expense should not be deferred (unless it meets the definition of an asset) even if the costs associated with the obligation are incurred irregularly during the financial year and tend to recur from year to year. This principle is explained in paragraph 39 and illustrated in paragraphs B2 and B11 of IAS 34.

> Paragraph 39: Costs that are incurred unevenly during an entity's financial year shall be anticipated or deferred for interim reporting purposes if, and only if, it is also appropriate to anticipate or defer that type of cost at the end of the financial year.
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> Paragraph B2: The cost of a planned major periodic maintenance or overhaul or other seasonal expenditure that is expected to occur late in the year is not anticipated for interim reporting purposes unless an event has caused the entity to have a legal or constructive obligation. The mere intention or necessity to incur expenditure related to the future is not sufficient to give rise to an obligation.
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> Paragraph B11: An entity's budget may include certain costs expected to be incurred irregularly during the financial year, such as charitable contributions and employee training costs. Those costs generally are discretionary even though they are planned and tend to recur from year to year. Recognising an obligation at the end of an interim financial reporting period for such costs that have not yet been incurred generally is not consistent with the definition of a liability.

9. Consequently, we think that the same principles should apply in the annual financial statements and in the interim financial statements for the recognition of a liability to pay a levy that is in the scope of IAS 37.

10. Applying these principles to the examples described above, the outcome would be the following in the half-year financial statements:

(a) Example 1: At 30 June 20X1, Entity A has an obligation to pay the levy to the extent of the revenues generated from 1 January 20X1 to 30 June 20X1. The expense is recognised over 20X1, ie an expense is recognised both in the first and second half-year reporting periods based on revenues generated in each period.

(b) Example 2: The liability is recognised in full on 3 January 20X1, ie in the first half-year reporting period. There is no expense accounted for in the second half-year reporting period.

(c) Example 3: The liability is recognised in full on 31 December 20X1, ie in the second half-year reporting period. There is no expense accounted for in the first half-year reporting period.

Questions for the Committee
Does the Committee agree that for levies within the scope of IAS 37, the same recognition principles should be applied in the annual and interim financial statements under the current requirements of IAS 34? Does the Committee agree with the rationale developed in Examples 1, 2 and 3?

Should the Board consider adding to its agenda a project on interim accounting?

11. In examples 2 and 3 described above, some might consider that the outcome in the interim financial statements is misleading for users and is not representative of the economics of the transaction. Indeed, the full expense is accounted for in one interim reporting period, resulting in fluctuations from period to period that might be difficult to explain to users. Others might consider that the outcome is representative of the economics of the transaction and that the smoothing of interim expenses does not give a fair representation of the entity's liabilities at the interim reporting date.

12. It should be noted that in US GAAP (subtopic 270-10 on interim reporting), annual operating costs that benefit more than one interim period or that are associated with an activity performed in more than one interim period may be allocated to the other interim periods through the use of accruals or deferrals. For example, property taxes may be deferred and allocated within a fiscal year if the costs benefit more than one interim period. Therefore, US GAAP appears to be different from IFRS for interim reporting.

> [Emphasis added.]
>
> 270-10-45-2 ...certain accounting principles and practices followed for annual reporting purposes <u>may require modification at interim reporting dates so that the reported results for the interim period may better relate to the results of operations for the annual period.</u>
>
> 270-10-45-8 …a. Costs and expenses other than product costs shall be charged to income in interim periods as incurred, or be allocated among interim periods based on an estimate of time expired, <u>**benefit** received or activity associated with the periods</u>. Procedures adopted for assigning specific costs and expenses items to an interim period shall be consistent with the basis followed by the entity in reporting results of operations at annual reporting dates. <u>However, if a specific cost or expense item charged to expense for annual reporting purposes **benefits more** than one interim period, the cost or expense item may be allocated to those interim periods….</u>
>
> 270-10-45-9 A complete list of examples of application of paragraphs 270-10-45-7 through 45-8 is not practical; however, the following examples of applications may be helpful:
>
> a. If a cost that is expensed for annual reporting purposes clearly <u>**benefits** two or more interim periods, each interim period shall be charged for an appropriate portion of the annual cost by the use of accruals and deferrals</u>.

b. …

d. Property taxes (and similar costs such as interest and rents) may be accrued or deferred at annual reporting date, to achieve a full year's charge of taxes to cost and expenses. Similar procedures shall be adopted at each interim reporting date to provide an appropriate cost in each period.

13. If it is considered that IAS 34 should be changed in order to reflect what some might argue is a fairer representation of the economic effects of the levies, then we think that this would require modifying the principles of IAS 34. The question would be whether the levy that is expensed in one interim period in Examples 2 and 3 benefits other interim periods. We do not think that this issue should be addressed by introducing some specific requirements in IAS 34 applicable only to levies. We think that the issue is broader because it might affect the accounting for other annual recurring operating expenses that are irregularly incurred during the financial year. As a result, if it is considered that IAS 34 should be changed, we think that this matter should be referred to the Board as part of a broader project on interim accounting.

14. The Staff is of the view that the principles of IAS 34 should not be changed and that introducing a smoothing mechanism in IAS 34 might create additional issues because the accounting principles would be different in the annual and interim financial statements.

Questions for the Committee
Does the Committee want to ask the Board to consider whether it should add to its agenda a project on interim accounting?

Impact of thresholds on the accounting for the liability to pay a levy

15. When the legislation specifies that the levy is due only if a minimum threshold is achieved, the question that arises is whether the existence of the threshold should affect the date of recognition of the liability or whether it should only affect the measurement of the liability.

Example 4: Entity D is a calendar year-end entity. An annual levy is due if Entity D generates revenues over CU50 million in a specific market in 20X1 and the amount of the levy is determined by reference to the revenues over CU50 million generated by Entity D in the market in 20X1.

16. The question is whether the levy should be recognised at a point in time when the threshold is met or whether it should be recognised progressively before the threshold is met.

17. IAS 37 or IAS 34 does not provide any guidance on the impact of thresholds on the accounting for a liability in the scope of IAS 37. But IAS 34 provides some guidance on the impact of thresholds on the accounting for liabilities in the scope of IAS 12 *Income taxes* and IAS 17 *Leases*.

Guidance on income taxes in IAS 34

18. According to IAS 34 (paragraph B12), interim period income tax expense is accrued over the year using a weighted average annual tax rate expected for the full financial year applied to the income generated in the period. The weighted average annual tax rate reflects the progressive tax rate structure, ie income taxes are assessed on an annual basis.

    Emphasis added

    B12 Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual

> effective income tax rate applied to the pre-tax income of the interim period.
>
> B13 This is consistent with the basic concept set out in paragraph 28 that the same accounting recognition and measurement principles shall be applied in an interim financial report as are applied in annual financial statements. Income taxes are assessed on an annual basis. Interim period income tax expense is calculated by applying to an interim period's pre-tax income the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate. That estimated average annual rate would reflect a blend of the progressive tax rate structure expected to be applicable to the full year's earnings…

19. In our understanding, for example, if an entity expects to earn CU20,000[1] pre-tax income each half-year (ie the entity expects annual earnings of CU40,000) and operates in a jurisdiction with a tax rate of 0% on the first CU30,000 of annual earnings and 20% of all additional earnings, then a liability of CU1,000[2] should be recognised at the half year reporting date. Consequently, an income tax liability (in the scope of IAS 12) would be recognised before the threshold is met.

Guidance on contingent lease payments in IAS 34

20. According to IAS 34 (paragraph B7), if a lease provides for contingent payments based on the lessee achieving a certain level of annual sales, contingent rental expense are recognised in an interim reporting period before the required annual level of sales has been achieved if the achievement of the target that triggers the contingent rental expense is probable. Contingent rents are lease payments that

[1] In this paper, monetary amounts are denominated in 'currency units (CU)'.

[2] CU1,000 = weighted average annual tax rate applied to first half-year income = 5% X CU20,000. Weighted average annual tax rate = ((40,000 – 30,000) X 20%) / 40,000 = 5%

are in the scope of IAS 17. Consequently, according to paragraph B7, a liability (in the scope of IAS 17) would be recognised before the threshold is met.

> Paragraph B7: Contingent lease payments can be an example of a legal or constructive obligation that is recognised as a liability. If a lease provides for contingent payments based on the lessee achieving a certain level of annual sales, an obligation can arise in the interim periods of the financial year before the required annual level of sales has been achieved, if that required level of sales is expected to be achieved and the entity, therefore, has no realistic alternative but to make the future lease payment.

21. Paragraph B7 does not specify whether the amount of the liability should be estimated:

    (a) on the basis of revenues generated to date in comparison with the total revenues generated over the year; or

    (b) on the basis of a straight-line allocation over the year.

<u>Accounting for levies when the legislation specifies that the levy is due only if a minimum threshold is achieved</u>

22. We think that there are two different views for the accounting of the liability to pay a levy in Example 4 described above:

    (a) View A: the liability is recognised progressively over 20X1 as the entity generates revenues if the entity expects to meet the annual threshold in 20X1.

    (b) View B: the liability is recognised only after the threshold is met.

23. It should be noted that view A or view B would be applied in the interim financial statements, but also in the annual financial statements (if, for example, the threshold is based on a 2 year period). In other words, the same principles would apply in the annual and in the interim financial statements.

View A: the liability is recognised progressively over 20X1 as the entity generates revenues

24. As mentioned in the first section, the Committee tentatively decided that a liability is recognised progressively if the activity that creates the present obligation occurs over a period of time. Proponents of view A think that the obligating event in Example 4 is the generation of revenues over 20X1. They think that the existence of a threshold only impacts the measurement of the liability, but not the date of recognition of the liability. They note that IAS 34 provides for examples on income taxes and contingent lease payments that are consistent with this rationale (see above).

25. Paragraph B7 in IAS 34 describes a situation in which a lessee will pay an additional rent at the end of the year if sales for the year exceed a certain level. At an interim reporting date, if the cumulative sales threshold has not been reached, but there is a reasonable expectation that the threshold will be met by the end of the year, then a liability for the contingent rent expense is recognised progressively in the interim financial statements over the year. Although contingent lease payments are not within the scope of IAS 37, proponents of view A note that this example is based on the notions developed in IAS 37. Paragraph B7 refers to the notion of ‘legal or constructive obligation’, which is a notion that exists only in IAS 37 (and that does not exist in IAS 17). Proponents of view A think that the rationale in B7 is that the obligating event is the generation of sales over a period of time. The existence of a threshold does not impact this analysis, because it only impacts the measurement of the liability.

26. Furthermore, proponents of view A think that levies based on revenues in the scope of IAS 37 are very similar to income taxes in the scope of IAS 12. They note that income tax liabilities are recognised progressively, as for levies based on revenues generated in the current period (see Example 1 above). They note that if the principles for the accounting for liabilities in the scope of IAS 37 were to be applied to income taxes, the obligating event of an income tax liability would be the generation of income over the year. They also observe that, in the interim financial statements, the existence of thresholds does not impact the date of recognition of a liability in the scope of IAS 12, but impacts the measurement of

the liability. Proponents of view A think that the principles developed in IAS 12 and IAS 34 on income taxes should be applied by analogy to the accounting for levies in the scope of IAS 37. In Example 4, one could argue that the levy rate is 0% below the threshold and x% above the threshold. In that case, a liability would be recognised progressively using an estimated average annual levy rate.

27. Lastly, proponents of view A think that a common characteristic of the examples in IAS 34 on income taxes and contingent lease payments is that the achievement of a sales or income threshold is a continuous event (and not a succession of discrete events). Similarly, in order to reach the revenue threshold in Example 4, the entity has to generate the first CU50 million of revenues over the year. The revenue threshold is met because sales are followed by other sales. Although each sale might be independent from the next, they are all sales in the same lease period or income tax period or levy period (the period being the year if the threshold is assessed on an annual basis as in the examples above). In other words, proponents of view A think that the last event necessary to create the present obligation is the achievement of the threshold, but that achieving the threshold in Example 4 is a continuous event that occurs over an extended period. Proponents of view A think that this situation is different from the situation where multiple discrete events are necessary to create a present obligation. In that case, they acknowledge that the last discrete event that is sufficient to create the obligation is the obligating event as defined in IAS 37.

View B: the liability is recognised only after the threshold is met

28. Proponents of view B think that the obligating event is the generation of revenues only after the threshold is reached. Proponents of view B do not think that the entity has a present obligation before that date, because the entity could decide to stop business and not pay the levy. In other words, if the threshold has not been met at the interim reporting date, the obligation is still dependent on the entity's future conduct of its business, and IAS 37 (paragraph 19) states that no provision is recognised in that case.

29. Proponents of view B also note that in the oilfield example in IAS 37 (Illustrative example 3), the liability for the obligation to repair the damage caused to the seabed, recognised progressively, corresponds:

    (a) to a present obligation to date that is not conditional upon the future activity and

    (b) to costs that the entity is obliged to incur in order to repair the damages caused to date.

    This is different from a levy that is paid only if the threshold is met. In fact, before the threshold is met, the entity is not obliged to pay any levy.

30. Furthermore, with regard to the principles set out in the first section of this paper, proponents of view B think that:

    (a) The activity performed before the threshold is met is necessary but not sufficient to create the present obligation. They think that the last of the necessary events that is sufficient to create the present obligation is the activity performed only after the threshold is met, because the legislation identifies this specific threshold as the event that triggers the payment of the levy. In other words, the generation of revenues before the threshold is met does not create any present obligation in accordance with IAS 37.

    (b) The entity does not have a constructive obligation to pay a levy that arises from operating in a future period, as a result of being economically compelled to continue operating in that future period.

31. Finally, proponents of view B note that contingent lease payments are lease payments that are within the scope of IAS 17 and that income taxes are in the scope of IAS 12. Proponents of view B think that this guidance is not consistent with the principles in IAS 37 and should not be applied by analogy to levies which are in the scope of IAS 37.

Conclusion

32. As a result, the two views in Example 4 would be the following:

Example 4: Entity D is a calendar year-end entity. An annual levy is due if Entity D generates revenues over CU50 millions in a specific market in 20X1 and the amount of the levy is determined by reference to revenues over CU50 millions generated by Entity D in the market in 20X1. <u>View A:</u> the liability is recognised progressively over the year 20X1 if the required level of revenues is expected to be met, because the obligating event as identified by the legislation is the generation of revenues over the year 20X1. <u>View B:</u> the liability is recognised at a point in time only after the threshold is met because the obligating event as identified by the legislation is the generation of revenues only after the threshold is met.

Questions for the Committee
In Example 4 above, does the Committee think that the liability for the obligation to pay the levy should be recognised progressively over 20X1 if the threshold is expected to be met? If not, does the Committee think that the liability should be recognised at a point in time only after the threshold is met?

Next steps

33. If the Committee reaches a consensus on the issues discussed above, the next step is to determine whether a clarification is needed to the IFRS literature, and if so, what form that clarification needs to take (interpretation, annual improvement, stand-alone amendments).

34. The Staff's recommendation is to issue an interpretation. The scope would be limited to levies within the scope of IAS 37 charged by public authorities for participation in a specific market. The consensus would be based on the principles identified in the first section of this paper and on the Committee's decisions on the issues discussed in this paper. Examples 1, 2, 3 and 4 described in this paper would be provided as illustrative examples. The interpretation would apply to the accounting of levies both in the annual and interim financial statements.

35. We note that IFRIC 6 addresses the accounting for a certain type of government levy (the WE&EE levy). We also note that the Committee observed in the November meeting that the conclusions drawn in this project are consistent with those drawn in IFRIC 6. We therefore think that if the Committee was to decide to develop an interpretation, then it may be appropriate to develop an interpretation that addresses levies generally, of which the WE&EE levy would be one such levy along with the others considered in this project. The consequence would be that the guidance in IFRIC 6 is then subsumed into the new interpretation addressing levies generally. An additional example would be added in the new interpretation to illustrate the accounting for the liability for the decommissioning of WE&EE.

Question for the Committee
Does the Committee think that an interpretation on the accounting for levies charged by public authorities should be issued in order to clarify the existing literature? If not, what are the Committee's views on this matter?