STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 37 Provisions, Contingent liabilities and Contingent assets**		
Paper topic	IFRIC Interpretation X *Levies charged by public authorities on entities that participate in a specific market*		
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Introduction

1. At the January 2012 meeting, the IFRS Interpretations Committee ('the Committee') tentatively decided to develop an interpretation on the accounting for levies charged by public authorities on entities that participate in a specific market. The purpose of this paper is to propose a draft interpretation.
2. The structure of the paper is the following:
   - (a) Background information on the draft interpretation
   - (b) Transition issues
   - (c) Accounting for levies that are due only if a threshold is met
   - (d) Proposed withdrawal of IFRIC 6
   - (e) Appendix A: Proposed draft interpretation

Background information on the draft interpretation

3. The 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

specific market. The concern relates to when a liability within the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* should be recognised and to the definition of a present obligation in IAS 37.

4. At the July 2011 meeting, the Committee decided to add this issue to its agenda with the aim of developing guidance. At the November 2011 meeting, the Committee developed principles regarding the accounting for levies that are within the scope of IAS 37.

5. At the January 2012 meeting, the Committee reviewed and agreed with some examples that illustrate the application of the principles identified. The Committee noted that, in accordance with IAS 34 *Interim Financial Reporting*, the same recognition principles should be applied in the interim financial statements as are applied in the annual financial statements.

6. We present in Appendix A a draft interpretation on the accounting for levies charged by public authorities that are within the scope of IAS 37. The consensus is based on the principles identified so far by the Committee. The draft interpretation includes the illustrative examples that the Committee agreed on at the January 2012 meeting. At this stage, the draft interpretation does not address the accounting for levies that are due only if a revenue threshold is met (see section below).

Question to the Committee
Does the Committee have any comments on the draft interpretation presented in Appendix A of this paper?

Transition issues

7. We note that levies are generally annual recurring taxes. We think that an entity that would be required to make a change as a result of this interpretation will generally postpone the recognition of the liability to pay a levy in a subsequent period. We think that the initial application of the interpretation should result in the levy expense being accounted for once in each reporting period (including the current period and the comparative periods). As a result, we recommend to the Committee that the interpretation should be applied retrospectively in accordance

with IAS 8 *Accounting Policies, Changes in accounting Estimates and Errors*. We do not think that there should be any consequential amendments made to IFRS 1 *First-Time Adoption of International Financial Reporting Standards*.

Question to the Committee
Does the Committee agree that the interpretation should be applied retrospectively?

Accounting for levies that are due only if a threshold is met

8. With respect to levies that are due only if a minimum revenue threshold is achieved, the Committee did not reach a consensus as to whether:

   (a) reaching the threshold is the obligating event (ie it is a recognition criterion) and the liability should be recognised at a point in time only after the threshold is reached; or

   (b) generating revenue during the levy period as identified by the legislation is the obligating event (ie the threshold only affects the measurement of the liability) and the liability should be recognised progressively as the entity makes progress towards the relevant threshold if the threshold is expected to be met.

9. The Committee noted that IAS 34 provides some guidance on the accounting for tax liabilities within the scope of IAS 12 and contingent lease payments within the scope of IAS 17. The Committee decided to ask the Board whether the Board thinks that the rationale developed in this guidance:

   (a) only applies to interim financial statements or also applies to annual financial statements; and

   (b) is consistent with the core principle of IAS 34 that the same recognition principles should be applied in both the annual and the interim financial statements.

10. The Committee also asked the staff to consult the Board on whether the characteristics of the levies within the scope of the draft interpretation are such

that they would warrant special treatment. So far, the Committee considers that it is appropriate to treat them under IAS 37.

11. This paper was posted before the Board could discuss the questions raised by the Committee. The Board will discuss the questions raised by the Committee at its February meeting (27 February-2 March). The staff will summarise the Board's feedback in a supplementary document that will be sent to the Committee members before the March 2012 meeting.

12. Assuming that the Committee can reach a consensus on this matter, an additional illustrative example would be added as shown below.

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. The amount of the levy is determined by reference to revenues over CU50 millions generated by Entity D in the market in 20X1, ie the levy rate is 0% below CU50 millions revenue and x% above CU50 millions revenue. Through 20X1, Entity D expects to meet the revenue threshold. Its revenues reach the threshold on 30 September 20X1. The question is whether the liability should be recognised only after the threshold is reached or not.

View A: The liability is recognised progressively during the year 20X1 as the entity makes progress towards the revenue threshold if the revenue threshold is expected to be met, because the obligating event as identified by the legislation is the generation of revenues during the year 20X1. In other words, each sale made in the levy period as identified by the legislation is a part achievement to meeting the revenue threshold for that levy period.

In the interim financial report (at 30 June 20X1), Entity D has an obligation to pay the levy on revenues generated from 1 January 20X1 to 30 June 20X1 if the revenue threshold is expected to be met. In other words, an expense is recognised in both the first and second half-year based on revenues generated in that half-year using the levy rate that would be applicable to expected total annual revenues, that is, the estimated average annual effective levy rate applied to the revenues of the period.

View B: The liability is recognised progressively between 30 September 20X1 and 31 December 20X1 because the obligating event as identified by the legislation is the generation of revenues only after the threshold is reached. The amount of the liability is based on revenues generated to date.

Because the liability is recognised progressively between 30 September 20X1 and 31 December 20X1, the expense is recognised in full in the second half-year, ie there is no expense accounted for in the first half-year.

Question for the Committee

Assuming that the Committee can reach a consensus on the accounting for levies that are due only if a revenue threshold is met, does the Committee agree to include Example 4 in the new interpretation?

Proposed withdrawal of IFRIC 6

13. We note that IFRIC 6 addresses the accounting for a particular type of 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 think that an additional example that illustrates the accounting for the liability for the decommissioning of WE&EE could be included in the new interpretation. In that case, we think that IFRIC 6 should be withdrawn because the new interpretation will address levies generally and that the guidance in IFRIC 6 will no longer be needed.

14. We propose to add the following example shown below. The rationale in this example is based on the principles identified in the draft interpretation and on the consensus reached in IFRIC 6.

Example 5:

Entity E is a calendar year-end entity and is a producer of electrical equipment. An annual levy is due if Entity E has a market share in 20X1 as a result of selling electrical equipment and generating sales in 20X1 in a specific market. The amount of the levy is determined by reference to the costs of waste management for electrical equipment sold in the past by producers of electrical equipment. The waste management costs for which Entity E is responsible because of its participation in the market during 20X1 is based on the market share of Entity E during 20X0. Entity E had a market share in 20X0. Entity E generates sales of electrical equipment in the market on 3 January 20X1. As a result, Entity E has a market share in 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 participation in the market in 20X1, ie the existence of a market share in the market in 20X1. Consequently, a liability for waste management costs for electrical equipment does not arise as a result of the production or sale of electrical equipment in the market, nor as a result of Entity's E having a market share in 20X0. Before 3 January 20X1, Entity E has no obligation. In other words, the obligating event is the event that triggers the payment of the levy as identified by the legislation, ie is the existence of a market share in 20X1. The full liability is recognised on 3 January 20X1 because at that date the amount of the levy is independent of future sales and is based on the market share during 20X0.

Because the liability is recognised in full on 3 January 20X1, the expense is recognised in full in the first half-year, ie there is no expense accounted for in the second half-year.

Question for the Committee

1. Does the Committee agree that IFRIC 6 should be withdrawn?

2. Does the Committee agree with the rationale developed in example 5?

3. Does the Committee agree to include Example 5 above in the new interpretation?

Appendix A: Proposed draft interpretation X *Levies charged by public authorities on entities that participate in a specific market*

Background

1. Levies are taxes established to provide revenue to a public authority. Levies may take various forms but they share the following characteristics:

    (a) they are resources transferred to public authorities in accordance with the legislation (ie laws and/or regulations);

    (b) they are non-exchange transactions, ie the entity that pays the levy transfers resources to the public authority, without receiving any specific good or service directly in exchange;

    (c) they are due when a specific event identified by the legislation occurs;

    (d) the event that triggers the payment of the levy as identified by the legislation might occur on a specified date or might occur over a specified period;

    (e) they are generally recurring taxes;

    (f) they might be payable in instalments; and

    (g) the calculation basis of the levy is based upon data for the current or a previous reporting period such as the gross amount of sales/revenues, assets or liabilities.

Scope

2. The [draft] interpretation addresses the accounting for levies charged by public authorities on entities that participate in a specific market (other than income taxes that are within the scope of IAS 12 *Income taxes*) in both the annual and interim financial statements of the entity that pays the levy.
3. Specifically, the [draft] interpretation clarifies when the liability to pay a levy should be recognised in accordance with the definition of a liability provided in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This [draft]

interpretation does not address the accounting for contracts between a private entity and a public authority.

Issues

4. In order to clarify when the liability to pay a levy should be recognised, this [draft] interpretation addresses the following issues:
   (a) Does economic compulsion to continue operating in a future period create a constructive obligation to pay a levy that will arise from operating in a future period?
   (b) Does the going concern principle imply that the entity has a present obligation to continue operating in the future?
   (c) What is the obligating event that gives rise to a liability to pay a levy?
   (d) Does the recognition of a liability to pay a levy arise at a point in time or does it, in some circumstances, arise progressively over time?
   (e) Does the recognition of the liability to pay a levy give rise to an expense or an asset?
   (f) Do the same principles apply in both the annual and interim financial statements?

Consensus

5. An entity does not have a constructive obligation to pay a levy that will arise from operating in a future period as a result of being economically compelled to continue operating in that future period.
6. The preparation of financial statements on the going concern principle does not imply that an entity has a present obligation to continue operating in the future and therefore does not lead to the recognition of a liability at a reporting date for levies that will arise from operating in the future.
7. The obligating event that gives rise to a liability to pay a levy is the event that triggers the payment of the levy as identified by the legislation. For example, if a levy is due only if the entity undertakes discrete activities both in the previous and

in the current period, the obligating event for that levy is the activity undertaken in the current period.

8. The liability to pay a levy is recognised progressively if the event that triggers the payment of the levy as identified by the legislation occurs over a period of time. For example, a liability to pay a levy is recognised progressively if the event that triggers the payment of the levy as identified by the legislation is the generation of revenues over a period of time.

9. The liability to pay a levy gives rise to an expense, unless the entity paying the levy receives an asset directly in exchange for the payment of the levy.

10. In accordance with IAS 34 *Interim Financial Reporting*, the same recognition principles shall be applied in the interim financial statements as are applied in the annual financial statements.

Effective date and transition

11. An entity shall apply this [draft] interpretation for annual periods beginning on or after xxxx. Earlier application is permitted. If an entity applies this [draft] interpretation for a period beginning before xxxx, it shall disclose that fact.

12. An entity shall apply a change in accounting policy in accordance with IAS 8 from the beginning of the earliest comparative period presented.

Illustrative examples

13. These examples accompany, but are not part of, [draft] IFRIC XX. The objective of these examples is to illustrate when the liability to pay a levy should be recognised in the annual and in the interim financial statements.

<u>Example 1:</u>

> 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 during 20X1 as the entity generates revenues because the obligating event as identified by the legislation is the generation of revenues progressively during 20X1. At any point in time in 20X1, Entity A has a present obligation to pay a levy on revenues generated to date. Entity A has no present obligation to pay a levy that will arise from generating revenues in the future. In other words, the obligating event occurs progressively during 20X1 because the event that triggers the payment of the levy as identified by the legislation occurs progressively during 20X1.In the interim financial report (at 30 June 20X1), Entity A has an obligation to pay the levy on revenues generated from 1 January 20X1 to 30 June 20X1. As a result, an expense is recognised in both the first and second half-year based on revenues generated in the respective half-year periods.

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 generated revenues in the market in 20X0. Entity B starts to generate revenues in the market in 20X1 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 first generation of revenues 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 20X1, Entity B has no obligation. In other words, the obligating event is the event that triggers the payment of the levy as identified by the legislation, ie the generation of revenues at a point in time in 20X1.

The full liability is recognised on 3 January 20X1 because at that date the amount of the levy is independent of future revenues and is based on revenues generated in 20X0.

Because the liability is recognised in full on 3 January 20X1, the expense is recognised in full in the first half-year, ie there is no expense accounted for in the second half-year.

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 reporting period in a specific market. The amount of the levy is determined by reference to amounts in the balance sheet of Entity C at the end of the annual reporting period. If Entity C changes the end of its annual reporting period and presents financial statements for a period longer or shorter than a year, the amount of the levy is adjusted pro rata in order to reflect the length of the period relative to a 12 month annual period. The end of the annual reporting period of Entity C is 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 reporting period. Before the end of the annual reporting period, Entity C has no 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 reporting period. In other words, the obligating event is the event that triggers the payment of the levy as identified by the legislation, ie is to be a bank at the end of the annual reporting period, which does not occur until 31 December 20X1.The fact that the amount of the liability is based on the length of the reporting period does not imply that the liability should be recognised progressively, because the obligating event is to be a bank at the end of the annual reporting period (irrespective of whether the reporting period is shorter or longer than one year).

Because the liability is recognised in full on 31 December 20X1, the expense is recognised in full in the second half-year, ie there is no expense accounted for in the first half-year.

Basis for Conclusions

Introduction

14. This Basis for Conclusions summarises the IFRS Interpretations Committee's considerations in reaching its [draft] consensus. The IFRS 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 by public authorities on entities that participate in a specific market. The question relates to when the liability to pay a levy should be recognised and to the definition of a present obligation in IAS 37.

15. More specifically, the concerns expressed in the request are about the accounting treatment applicable to levies for which the calculation is based upon financial data related to a period that precedes the period in which the event that triggers the payment of the levy occurs. For example, the event that triggers the payment of the levy as identified by the legislation occurs in 20X1 and the calculation of the levy is based upon financial data for 20X0 (see Illustrative Example 2 above).

16. The Committee was informed that there was diversity in practice in how entities account for the obligation to pay a levy.

Does economic compulsion to continue operating in a future period create a constructive obligation to pay a levy that will arise from operating in a future period?

17. Some argue that if it would be necessary for an entity to take some unrealistic action in order to avoid the obligation to pay a levy (ie to withdraw from the market), then a constructive obligation to pay the levy exists and a liability should be accounted for. For example, in the case where the activity that triggers the payment of the levy occurs in 20X1 and the calculation of the levy is based upon financial data for 20X0 (as in Illustrative Example 2 above), some argue that a liability should be recognised in 20X0. Supporters of this argument emphasise the definition of a constructive obligation in paragraph 10 of IAS 37 and point out

that an entity might in practice have no realistic alternative other than to continue operating in the market in the next period.

18. The Committee noted that a levy charged by a public authority is incurred as a result of operating in a specified period, ie it is an operating cost of the period in which it is triggered according to the legislation. Paragraphs 18 and 19 of IAS 37 state that no provision is recognised for costs that need to be incurred to operate in the future or when the obligation does not exist independently of the entity's future conduct of the business. The Committee observed that when an entity has an economic compulsion to incur operating costs that relate to the future conduct of the business, it does not create a constructive obligation and does not lead to the recognition of a liability as illustrated in the examples accompanying IAS 37. Specifically, no constructive obligation exists for operating costs that relate to the future conduct of the business even if:

    (a) it is economically unrealistic for the entity to avoid the expenditure if it has the intention of continuing in business;

    (b) it would be necessary for an entity to take unrealistic action to avoid the expenditure, such as to sell or stop operating property, plant and equipment; or

    (c) there is a legal requirement to incur the expenditure if the entity does continue in business.

19. Consequently, the Committee concluded that an entity does not have a constructive obligation at a reporting date to pay a levy that will arise from operating in a future period, even if the entity has an economic compulsion to operate in those future periods and there is a virtual certainty that it will do so. This is because this cost relates to the future conduct of the business.

Does the going concern principle imply that the entity has a present obligation to continue operating in a future period?

20. The Committee noted that this issue is related to, but distinct from, the previous issue regarding the existence of a constructive obligation, because it is a question about the fundamental basis of preparation of financial statements. Some question

whether the going concern principle affects the timing of recognition of the liability to pay a levy.

21. The Committee observed that IAS 1 paragraph 28 sets out general features for the financial statements, including the accrual basis of accounting and the going concern principle. The Committee noted that when an entity prepares financial statements on a going concern basis, it shall also apply the accrual basis of accounting and shall comply with all the recognition and measurement provisions of IFRSs. Consequently, the Committee concluded that the going concern principle cannot lead to the recognition of a liability that does not meet the definitions and recognition criteria set out in IAS 37. Specifically, the Committee concluded that the going concern principle cannot give rise to a constructive obligation for costs that will arise from operating in the future or that relate to the future conduct of the business. Paragraphs 18 and 19 in IAS 37 specify that no provision is recognised in these cases.

What is the obligating event that gives rise to a liability to pay a levy?

22. According to the definition in IAS 37 paragraph 10, an obligating event is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling the obligation. The Committee noted that the main consequence of that definition is that there can be only one single obligating event. The Committee acknowledges that for an obligating event to exist, it may in some circumstances be the case that other events must have occurred previously. Nevertheless, for levies charged by public authorities, the Committee notes that these previous events are necessary but not sufficient to create a present obligation. Consequently, the Committee concluded that the obligating event that gives rise to a liability to pay a levy is the event that triggers the payment of the levy as identified by the legislation. In other words, the liability to pay a levy is recognised when the event that triggers the payment of the levy as identified by the legislation occurs. As a result, if a levy is due only if the entity undertakes discrete activities both in 20X0 and in 20X1, the obligating event for that levy is the activity undertaken in 20X1 (see Illustrative Example 2 above).

Does the recognition of a liability to pay a levy arise at a point in time or does it, in some circumstances, arise progressively over time?

23. The Committee observed that most of the liabilities in IAS 37 and in the Illustrative Examples accompanying IAS 37 are recognised at a point in time, ie at the date when the obligating event occurs. Nevertheless, they noted that in one example accompanying IAS 37, the liability is recognised progressively over time.

24. In Illustrative Example 3 accompanying IAS 37, an entity operates an offshore oilfield and is required to restore the seabed because of the damage that will be caused by extraction of the oil. According to this example, the restoration costs that arise through the extraction of oil are recognised as a liability when the oil is extracted. The Committee noted that in this example, the damage is directly caused by the extraction of the oil, and that more damage occurs when more oil is extracted. Thus, the outcome is that the liability for damage that is caused over time is recognised progressively over time as the entity extracts oil and causes that damage to the environment.

25. The Committee discussed whether this outcome is linked to a recognition issue or to a measurement issue. The Committee concluded that this is a recognition issue, because the obligating event (ie the damage caused by extraction of the oil) occurs progressively over a period of time. In accordance with IAS 37 paragraph 19, the Committee noted that a present obligation exists to the extent of the damage caused to date to the environment, because the entity has no present obligation to rectify the damage that will result from the extraction of the oil in the future (ie the future conduct of its business).

26. Consequently, the Committee concluded that the liability to pay a levy is recognised progressively if the event that triggers the payment of the levy as identified by the legislation occurs over a period of time. For example, a liability to pay a levy is recognised progressively if the event that triggers the payment of the levy as identified by the legislation is the generation of revenues over a period of time (see Illustrative Example 1 above).

Does the recognition of the liability to pay a levy give rise to an expense or an asset?

27. The Committee noted that levies are a subset of taxes and are non-exchange transactions because the entity that pays the levy transfers resources to the public authority, without receiving any specific good or service directly in exchange for the payment of the levy. As a result, in most cases, the entity that pays the levy does not receive an asset in exchange 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 exchange for the payment of the levies and the public authority does not have any obligation to render those services in exchange for the payment of the levy.

28. The Committee discussed whether an annual levy may be considered in some circumstances as the cost paid for an annual licence to operate in a specific market. The Committee noted that the payment of a levy is not analogous to a licence because:

    (a) it is a tax imposed by a public authority on all the entities that participate in the market;

    (b) it is not a transaction approved by the entity that pays the levy, ie it is not a contract agreed between the entity that pays the levy and the public authority; and

    (c) it is not associated with any additional rights or any additional economic benefits in comparison with the situation that was prevailing before the levy is put in place.

29. The Committee concluded that a levy cannot be considered as the cost paid for a licence. However, the Committee noted that judgment should be applied to determine whether the levy is in substance a transaction in which the entity paying the levy receives an asset (including rights to receive future goods or services) directly in exchange for the payment of the levy. As a result, the liability to pay a levy gives rise to an expense, unless the entity paying the levy receives an asset directly in exchange for the payment of the levy.

30. If 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, then the entity accounts for the payment as a prepayment asset.

Do the same principles apply in both the annual and interim financial statements?

31. IAS 34 (paragraphs 29, 31, 32 and B4) states that the same recognition principles should be applied in the annual and the interim financial statements. Applying the requirements of IAS 34 (paragraphs 39, B2 and B11), 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.

32. Consequently, the Committee concluded 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 within the scope of this interpretation.