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Project **IAS 37 Provisions, Contingent liabilities and Contingent Assets**

Topic Levies charged by public authorities on entities that operate in a specific market—[Draft] IFRIC Interpretation

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## [DRAFT] IFRIC INTERPRETATION XX

### *LEVIES CHARGED BY PUBLIC AUTHORITIES ON ENTITIES THAT OPERATE IN A SPECIFIC MARKET*

#### References

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- IAS 1 *Presentation of Financial Statements*
- IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*
- IAS 12 *Income Taxes*
- IAS 34 *Interim Financial Reporting*
- IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*
- IFRIC 6 *Liabilities arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment*

#### Background

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1. A public authority may impose a levy on entities that operate in a specific market. Examples of public authorities include national governments, regional governments (for example, state, provincial, territorial), local governments (for example, city, town) and their component entities (for example, departments, agencies, boards, commissions).

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This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IFRS Interpretations Committee or the IASB. 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*.

Interpretations are published only after the IFRS Interpretations Committee and the Board have each completed their full due process, including appropriate public consultation and formal voting procedures. The approval of an Interpretation by the Board is reported in *IASB Update*.

2. The IFRS Interpretations Committee has received requests for guidance on the accounting for levies in the financial statements of the entity paying the levy. 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 *Provisions, Contingent Liabilities and Contingent Assets*.
3. In particular, the concerns expressed in the requests 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 activity that triggers the payment of the levy occurs.

## Scope

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4. The [draft] Interpretation addresses the accounting for levies that are recognised in accordance with the definition of a liability provided in IAS 37.
5. This [draft] Interpretation does not address the accounting for:
  - a) income taxes that are within the scope of IAS 12 *Income taxes*, ie taxes based on a taxable profit (ie a net amount of revenues and expenses);
  - b) levies that are due only if a minimum revenue threshold is achieved;
  - c) fines or other penalties imposed for breaches of the legislation; and
  - d) contracts between a public authority and a private entity.
6. Levies within the scope of this [draft] Interpretation have the following characteristics:
  - a) they require a transfer of resources to a public authority (or to a third party designated by a public authority) in accordance with legislation (ie laws and/or regulations);
  - b) they are paid by entities that operate in a specific market identified by the legislation (such as a specific country, a specific region, or a specific market in a specific country);
  - c) they are non-exchange transactions, ie transactions in which the entity paying the levy does not receive any specific asset directly in exchange for the payment of the levy;

- d) they are triggered when a specific activity identified by the legislation occurs (such as operating in a specific country or operating in a specific market in a specific country); and
- e) the calculation basis of the levy uses data for the current period or a previous reporting period, such as the gross amount of revenues, assets or liabilities.

## Issues

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7. In order to clarify the accounting for a levy, this [draft] Interpretation addresses the following issues:
- a) What is the obligating event that gives rise to a liability to pay a levy?
  - b) 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?
  - c) Does the going concern principle imply that an entity has a present obligation to pay a levy that will arise from operating in a future period?
  - 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) Can the levy expense be anticipated or deferred in the interim financial statements?

## Consensus

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8. The obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy as identified by the legislation. For example, if the activity that triggers the payment of the levy is the generation of revenues in the current period and the calculation of the levy is based upon revenues generated in a previous period, the obligating event for that levy is the generation of revenues in the current period.
9. 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.

10. The preparation of financial statements under 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 a future period.
11. The liability to pay a levy is recognised progressively if the obligating event occurs over a period of time (ie if the activity 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 obligating event is the generation of revenues in the current period over a period of time.
12. The liability to pay a levy that is in the scope of this interpretation gives rise to an expense.
13. The same recognition principles shall be applied in the interim financial statements as are applied in the annual financial statements. As a result, in the interim financial statements, the levy expense should not be:
  - a) anticipated if there is no present obligation to pay the levy at the end of the interim reporting period; or
  - b) deferred if a present obligation to pay the levy exists at the end of the interim period.

## Appendix A

### Effective date and transition

***This appendix is an integral part of the [draft] Interpretation and has the same authority as the other parts of the [draft] Interpretation.***

- A1 An entity shall apply this [draft] Interpretation for annual periods beginning on or after [date]. Earlier application is permitted. If an entity applies this [draft] Interpretation for an earlier period, it shall disclose that fact.
- A2 Changes in accounting policies resulting from the initial application of this [draft] Interpretation are accounted for retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

## Appendix B

### Illustrative examples

***These examples accompany, but are not part of, the [draft] Interpretation. The objective of these examples is to illustrate the accounting for the liability to pay a levy in the annual and in the interim financial statements.***

#### Example 1:

Entity A has an annual reporting period that ends on 31 December. A levy is triggered progressively as Entity A generates revenues in a specific market in 20X1. 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 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 activity that triggers the payment of the levy as identified by the legislation occurs progressively during 20X1.

In the interim financial report (for example at 30 June 20X1), Entity A has an obligation to pay the levy on revenues generated from 1 January 20X1 to the end of the interim period. As a result, an expense is recognised in the 20X1 interim periods based on revenues generated in each respective interim period.

Example 2:

Entity B has an annual reporting period that ends on 31 December. A levy is triggered in full as soon as Entity B generates revenues in a specific market in 20X1. 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 in full 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 necessary, but not sufficient, to create a present obligation to pay a levy. Before 3 January 20X1, Entity B has no obligation. In other words, the activity that triggers the payment of the levy as identified by the legislation is the first generation of revenues at a point in time in 20X1. The generation of revenues in 20X0 is not the activity that triggers the payment of the levy. The amount of revenues generated in 20X0 only affects the measurement of the liability. In the interim financial report, because the liability is recognised in full on 3 January 20X1, the expense is recognised in full in the first interim period of 20X1. The expense shall not be deferred until subsequent interim periods or be anticipated in previous interim periods.

Example 3:

Entity C has an annual reporting period that ends on 31 December. A levy is triggered only if Entity C operates as 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. 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 operate as 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 operate as a bank at the end of the annual reporting period. In other words, the activity that triggers the payment of the levy as identified by the legislation is to operate as a bank at the end of the annual reporting period, which does not occur until 31 December 20X1. Even if the amount of the liability is based on the length of the reporting period, that does not imply that the liability should be recognised progressively during 20X1, because the obligating event is to operate as a bank at the end of the annual reporting period.

In the interim financial report, because the liability is recognised in full on 31 December 20X1, the expense is recognised in full in the last interim period of 20X1. The expense shall not be deferred until subsequent interim periods or be anticipated in previous interim periods.



**Basis for Conclusions on [draft] IFRIC Interpretation XX *Levies charged by public authorities on entities that operate in a specific market***

*This Basis for Conclusions accompanies, but is not part of, [draft] IFRIC XX.*

**Introduction**

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- BC1 This Basis for Conclusions summarises the IFRS Interpretations Committee’s considerations in reaching its consensus. The IFRS Interpretations Committee (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 obligating event that gives rise to a liability for other levies charged by public authorities on entities that operate 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 *Provisions, Contingent Liabilities and Contingent Assets*.
- BC2 In particular, 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 activity that triggers the payment of the levy occurs. For example, the activity 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).
- BC3 The Committee was informed that there was diversity in practice in how entities account for the obligation to pay such a levy.

## Scope

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- BC4 The Committee observed that the question raised in the submission relates to the accounting for levies whose calculation basis uses data for the current or a previous reporting period, such as the gross amount of revenues, assets or liabilities. The Committee noted that these levies do not meet the definition of income taxes provided in IAS 12 *Income Taxes* because they are not based on taxable profit. The Committee noted that the term ‘taxable profit’ implies a notion of a net amount of revenues and expenses. The Committee also noted that levies that are not within the scope of IAS 12 are recognised in accordance with the definition of a liability provided in IAS 37. As a result, the [draft] Interpretation addresses the accounting for levies that are recognised in accordance with the definition of a liability provided in IAS 37.
- BC5 The [draft] Interpretation addresses the accounting for levies that are non-exchange transactions, ie transactions in which the entity paying the levy transfers resources to a public authority (or to a third party designated by a public authority) without receiving any specific asset directly in exchange for the payment of the levy. The Committee noted that the scope of the [draft] Interpretation covers the majority of levies, but that judgement would be required in certain instances to determine whether the entity paying the levy receives an asset directly in exchange for the payment of the levy (such as rights to receive specific future goods or services).
- BC6 The [draft] Interpretation does not address the accounting for contracts between a public authority and a private entity (including levies that are in substance payments related to a contract with a public authority).
- BC7 The [draft] Interpretation does not address the accounting for levies that are due only if a minimum revenue threshold is achieved in the current period because the Committee did not reach a consensus as to whether the obligating event is:
- a. the generation of revenues only after the threshold is passed; or

- b. the generation of revenues as the entity makes progress towards the revenue threshold (the existence of the threshold being taken into account when assessing whether the obligation should be recognised).

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

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- BC8 According to the definition in paragraph 10 of IAS 37, 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. According to paragraph 14 (a) of IAS 37, a provision should be recognised only when an entity has a present obligation as a result of a past event. The Committee noted that the main consequence of these requirements is that there can be only one single obligating event. The Committee acknowledged that for an obligating event to exist, it may in some circumstances be the case that other events must have occurred previously. For example, for levies charged by public authorities, the Committee observed that, in certain circumstances, the entity paying the levy must have undertaken an activity both in the previous and in the current period in order to be required to pay a levy. The Committee noted that the activity undertaken in the previous period is necessary, but not sufficient, to create a present obligation.
- BC9 Consequently, the Committee concluded that the obligating event that gives rise to a liability to pay a levy is the activity 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 activity that triggers the payment of the levy as identified by the legislation occurs. For example, if the activity that triggers the payment of the levy is the generation of revenues in 20X1 and the calculation of the levy is based upon revenues generated in 20X0, the obligating event for that levy is the generation of revenues in 20X1 (see Illustrative Example 2 above).

**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?**

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- BC10 The Committee considered an argument that if it would be necessary for an entity to take unrealistic action in order to avoid the obligation to pay a levy (eg to withdraw from the market), then a constructive obligation to pay the levy exists and a liability should be recognised. For example, in the case in which 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.
- BC11 The Committee rejected this argument, noting 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. This point is illustrated in the examples accompanying IAS 37.
- BC12 In particular, the Committee concluded that there is no constructive obligation to pay a levy that relates to the future conduct of the business even if:
- a. it is economically unrealistic for the entity to avoid the levy if it has the intention of continuing in business;

- b. there is a legal requirement to incur the levy if the entity does continue in business;
- c. it would be necessary for an entity to take unrealistic action to avoid the levy, such as to sell, or stop operating, property, plant and equipment;
- d. the entity made a statement of intent to operate in the market in the future period(s); or
- e. the entity has a legal or contractual requirement to operate in the market in the future period(s) (for example contractual requirements arising from purchase or sale contracts).

BC13 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 as a result of being economically compelled to continue operating in that future period. This is because this levy cost relates to the future conduct of the business and is an operating cost of that future period.

**Does the going concern principle imply that an entity has a present obligation to pay a levy that will arise from operating in a future period?**

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BC14 The Committee noted that this issue is related to 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.

BC15 The Committee observed that IAS 1 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.

BC16 Specifically, the Committee concluded that the preparation of financial statements under 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 a future period. Paragraphs 18 and 19 of IAS 37 specify that no provision is recognised in that case.

**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?**

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BC17 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 point in time when the obligating event occurs. Nevertheless, they noted that in one example accompanying IAS 37, the liability is recognised progressively over time.

BC18 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.

BC19 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 paragraph 19 of IAS 37, 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).

- BC20 Consequently, the Committee concluded that the liability to pay a levy is recognised progressively if the obligating event (ie the activity 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 obligating event is the generation of revenues in the current period over a period of time (see Illustrative Example 1 above).

### **Can the levy expense be anticipated or deferred in the interim financial statements?**

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- BC21 IAS 34 *Interim Financial Reporting* (paragraph 29) states that the same recognition principles should be applied in the annual and the interim financial statements. Applying the requirements of IAS 34 (paragraphs 31, 32, 39, B2, B4 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.
- BC22 As a result, 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 levy 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 even if the costs associated with the levy are incurred irregularly during the financial year and tend to recur from year to year.
- BC23 This does not preclude an entity from recognising a prepayment as an asset when the entity has paid the levy but does not have yet a present obligation to pay the levy.