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Objet **Potential agenda item request in relation to the accounting of levies on productive assets for a service provider**

Paris, 20 May 2014

Dear Sir,

We are writing to clarify the interplay between IFRIC 21 and the other standards regarding the accounting for the costs that arise from recognizing a liability to pay a levy. In summary, our concern is to determine whether the recognition of a liability to pay a levy would give rise to an asset or an expense under the relevant standards.

You will find attached to this e-mail a more detailed explanation of the issue, possible alternative accounting treatments and reasons for the Committee to address the issue in the form of a Committee potential agenda request. The alternative accounting treatments have significant impacts on interim accounts.

Although this issue has arisen in France with levies on productive assets that are triggered in full at a specified date, we believe this issue is relevant to other jurisdictions that have currently or will introduce levies with same characteristics. Consequently, we believe that addressing this issue should eliminate diversity in the accounting treatment of such levies and is necessary to reach the expected benefits of the implementation of IFRIC 21

Yours sincerely

Magali VIANDIER
Directeur de la Division Comptabilité Consolidation

Enclosed: IFRS IC potential agenda item request

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IFRS IC potential agenda item request

Clarification on whether the recognition of a liability to pay a levy on productive assets for a service provider gives rise to an asset (cost of inventories or prepaid expense) or an immediate expense.

- **The Issue**:

The issue we are requesting the Committee to clarify is the interplay between IFRIC 21 and the other standards regarding the accounting for the costs that arise from recognizing a liability to pay a levy. IFRIC 21 recommends that entities should look to other standards to decide whether the recognition of a liability to pay a levy would give rise to an asset or an expense under the relevant standards.

In some circumstances, the triggering event identified by the legislation for the recognition of an annual levy is the ownership or the operation of productive assets. These levies are assessed on the value of these productive assets or their technical characteristics.

The entities concerned are service providers who do not currently account for inventories because the service is continuously delivered and cannot be stored (e.g. electricity, communication, transportation). The revenues of these entities are recognized with the related costs as services are delivered.

IFRS stand the following:

- ✓ IAS 18 (§ 19) requires that revenue and expenses related to the same transaction are recognized simultaneously (matching of revenues and expenses).
- ✓ IAS 2 defines the cost inventories measurement for a service provider (§ 19) and specifies that the inventories include the costs of the service for which the entity has not yet recognized the related revenue (§ 8).

On the basis of these elements, a question arises about how levies on productive assets have to be considered for a service provider who does not currently account for inventories.

Are these levies to be considered as costs which are not directly engaged in providing the service to be expensed as incurred (View 1) or costs of inventories to be charged to profit and loss account upon the delivery of the services (View 2)

Current practice

The debate arises from the implementation of IFRIC 21 and the reference to other standards to decide whether the recognition of a liability to pay a levy gives rise to an asset or an expense. In number of situations, even though the obligating event as defined by the legislation is a specified date, levies on productive assets relate to a period of year rather than a single date. These two views of the nature of the levies lead to an alternative accounting treatment.

View 1: a levy on productive assets that is triggered in full at a specified date is an administrative overhead to be expensed as it is incurred

Supporters of this view consider that:

- Levies on productive assets belong to the category of "administrative overheads that do not contribute to bringing inventories to their present location and condition" which are excluded from cost inventories according to IAS 2 §16.

- As levies on productive assets are only due in respect of the ownership or the operation of these assets at a specified date and are not assessed on the level of the production, the supporters of this view consider that they cannot be attributable to inventories.

- The wording of IAS 2 § 19 "to the extent that service providers have inventories" prohibits providers of services without inventories to account levies as cost of inventories.

View 2: a levy on productive assets has to be included in cost of inventories and recognized as expense in the period in which the related revenue is recognized.

Supporters of this view consider that:

- Levies on productive assets belong to the category of fixed production overheads to be comprised in cost of inventories. Indeed, as per IAS 2 (§12) , this category includes all indirect costs of production that remain relatively constant regardless of the volume of production such as depreciation and maintenance of factory buildings and equipment and the cost of factory management and administration. The fact that a levy on assets is raised at a specified date and independently of the level of production does not lead to the exclusion of this levy from the category of fixed production overheads.

- The wording of IAS 2 § 19 "to the extent that service providers have inventories" is only a reminder that service providers do not systematically account for inventories and not a restriction of accounting inventories for service providers. Until now, the absence of inventories only results from:

  - an efficient accounting: levies were recognized progressively as expenses between two payments

  - a continuous delivery of services.

In any case, if service providers without inventories are considered as out of the scope of IAS 2 because of the writing of paragraph 19, the supporters of this view consider that the matching principle under IAS 18§19 is applicable. As per this standard, revenue and expenses that relate to the same transaction or other event have to be recognized simultaneously, levies on productive assets have to be recorded as expense at the time revenues derived from these productive assets are recognized in the profit and loss account.

Reasons for the IFRIC IC to address the issue

(a) Is the issue widespread and has, or is expected to have, a material effect on those affected,

Yes. The issue affects entities in France but potentially other jurisdictions with levies on productive assets (property taxes for example) are concerned. Diversity in practice would affect the timing of the expense recognition and would have a potential impact on interim accounts.

(b) Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

Yes. In the absence of further guidance, diversity in practice could arise from implementation of IFRC 21.

(c) Can the issue be resolved efficiently within the confines of IFRS and the conceptual framework for financial reporting

The clarification required (whether the recognition of a liability to pay a levy gives rise to an asset or an expense) forms part of the discussions and decisions made by the IC on the interpretation.

IFRIC 21 addresses only the accounting for a liability to pay a levy and refers entities to other standards to assess whether the recognition of a liability to pay a levy gives rise to an asset or an expense

(d) Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost effective for the Interpretation Committee to undertake the due process,

The issue is sufficiently narrow because it directly arises from the implementation of IFRIC 21

(e) Will the solution developed by the Interpretation Committee be effective for a reasonable time period? The Interpretation Committee will not add an item to its agenda if the issue is being addressed in a forthcoming standard an/or if a short-term improvement is not justified.

There is no current relevant IASB project on this item

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IFRS Interpretations Committee

Michael Stewart
Director of Implementation Activities

By Email: ifric@ifrs.org

Paris, June 26, 2014

Subject: potential agenda item requests linked to the implementation of IFRIC 21

Dear Sir,

As agreed, please find herewith our updated potential agenda item request linked to the implementation of IFRIC 21.

It relates to the interplay of IFRIC 21 with the other standards (here under IAS2-IAS18) it refers to in order to decide whether the recognition of a liability to pay a levy gives rise to an asset or an expense.

A very significant divergence of views exists in France on those subjects but we do not believe the issues are specific to this jurisdiction.

At the same time, we strongly believe that not addressing them would undermine the expected benefits of the implementation of IFRIC 21.

Since our initial request, the publication of IFRS15 which will replace IAS18 and 11 is likely to also trigger similar questions around costs to fulfil a contract because of § 95 that refers to costs scoped in IAS2

Very truly yours

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Nicolas de Paillerets
Director of Group Accounting Principles

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IFRS INTERPRETATIONS COMMITTEE

POTENTIAL AGENDA ITEM REQUESTS

Issue linked to the IMPLEMENTATION OF IFRIC 21

Is a levy on productive assets held at a given date a fixed production overheads that is attributable to [a service provider] inventory or an administrative overheads to be immediately expensed ?

A business pays an annual levy linked to the existence of PPE at a given date (e.g. 01/01/YY). The triggering event as identified by the legislation has been determined to be the existence of the assets at the given date.

The business is a service provider that is capital intensive : a [third] of its COS is amortization of PPE on which the levy is assessed annually.

Because the service is continuously delivered to the customers and cannot be stored (e.g. electricity, communications, transportation), the business does not account for inventories[1] per se.

Revenue is recognized as delivered together with the related costs. This is currently achieved by apportioning to each period in which service is delivered a portion of the annual production costs, including the aforementioned levy.

IFRIC 21 § 3 refers entities to other standards to decide whether the recognition of a liability to pay a levy gives rise to an asset or an expense.

IAS 2 prescribes the accounting treatment for inventories in order to determine the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised.

IAS 2 § 8 and 19 define what constitute inventories for a service provider and which costs are included in inventories. IAS 2 § 12 and 13 define the components of costs of conversion (and § 14 their allocation among products). IAS 2 § 15 and 16 clarify the other costs that are or are not part of inventories.

IAS18 § 19 and 21 prescribe that revenue and expenses that relate to the same transaction or other event are recognised simultaneously (the matching of revenues and expenses) and indicate that the requirements of that Standard are generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services.

[1] Other types of service providers beyond those illustrated, capital intensive or not, have 'no physical inventories'

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In the fact pattern described above, one question and two sub-questions arise :

Q1 Per IAS 2, is a levy on productive assets (a) an inventories attributable overheads that are incurred in bringing the inventories to their present location and condition or (b) an administrative overheads that do not contribute to bringing inventories to their present location and condition and hence which shall be expensed as incurred?

Q2 If (a), does the wording in IAS 2 § 19 ”To the extent that service providers have inventories “ prohibit the service provider in the specific facts and circumstances (no inventory recorded) from recognizing an inventory linked to the levy in accordance with §14 to be charged to COS upon the delivery of service (e.g. over time to the P/L as a proxy)?

Q3 If yes to Q2 , does the matching principle in IAS 18 § 19 and 21 provide the adequate basis for recognizing a prepaid / accrued expense to be charged to COS upon the delivery of service (e.g. over time as a proxy)?

Current practice:

The effect of IFRIC21 on the aforementioned practices existing before its enactment are the subject of conflicting views - which reflect a debate linked to the scope of IFRIC 21 and to different views of the nature of levies.

View A : A levy on productive assets held at a given date is an administrative overheads to be expensed

With respect to Q1, proponents of this view consider that :

- By nature a levy is within the scope of IAS 2 § 16 (c) which excludes administrative overheads that do not contribute to bringing inventories to their present location and condition. The levy is incurred irrespective of production by the mere ownership of the PPE.
- Costs to be attributable to inventories must be incurred over the production period : The levy being due at a given date independently of the production or its level , it is not. And as such once incurred and expensed, it cannot be credited back to future production.

With respect to Q2, they note that the service providers in the fact pattern do not account for ”inventory” and therefore fall out of the remit of IAS 2 § 19.

With respect to Q3, they note that the 2005 IAS 2 eliminated the reference to the matching principle and that the matching principle in IAS 18 does not extend to administrative costs.

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View B : A levy on productive assets held at a given date is a fixed production overhead capitalizable as inventory or prepaid expense (and then charged to COS).

With respect to Q1, proponents of this view consider that :

- The levy being raised on productive assets, it is a natural part of the conversion process. If one wants to view such levies as being administrative, then they can be described as "cost of factory administration" which are part of production overheads per IAS 2 § 12.
- The fact that it is raised at a given date independently of the production does not differentiate this type of costs from other fixed costs like maintenance and depreciation : per IAS 2 § 12 "Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration".
- The fact that per IAS 2 § 13 "capacity is the production expected to be achieved on average over a number of periods or seasons" clearly indicates that fixed overhead costs are allocable among units between periods (a usual practice in manufacturing).
- Furthermore, the provisioning of service is often made under period contracts or other service obligation (regulation) which establishes the link with the assets and future production.

With respect to Q2, they note that in the fact pattern, the absence of inventory is because the service produced is immediately delivered (no physical inventory) and because their current accounting[2] is efficient. They believe that the wording " To the extent that service providers have inventories" should not be overinterpreted as restrictive : it is a mere reminder that not all service provider have physical (supplies, hours) inventories, the wording also introduces some circularity and confusion with the definition of inventories.

With respect to Q3, they note that if IAS 2 § 19 was viewed by its wording as scoping out of IAS 2 those service providers that have "no inventory", then the matching principle under IAS 18 is applicable. As IAS 18 does not elaborate the method to achieve this result, it would also be appropriate in accordance with IAS 8 § 10->12 to refer to the principles and methodologies of IAS 2.

[2] before IFRIC 21, levies costs were progressively recognized over the period between two payments using accrued /prepaid expenses as appropriate.

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Reasons for the IFRS IC to address the issue:

(a) Is the issue widespread and has, or is expected to have, a material effect on those affected?

The issue is widespread as it is not specific to a jurisdiction and it has an effect on the timing of the expense recognition.

(b) Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

Yes, clarification will help reduce diversity of understanding and **help secure the implementation of the interpretation and its expected benefits**.

(c) Can the issue be resolved efficiently within the confines of IFRSs and the Conceptual Framework for Financial Reporting?

Yes, the reference to other standards to decide whether the recognition of a liability to pay a levy gives rise to an asset or an expense form part of the discussions and decisions made by the IC as it established IFRIC 21.

(d) Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process?

Yes, the issue is narrow as it is a matter of clarification of the IC intent when it established IFRIC 21.

(e) Will the solution developed by the Interpretations Committee be effective for a reasonable time period? The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified.

It is a necessary point to secure the implementation of IFRIC 21 and its expected benefits.

Our own tentative view :

Nothing in IFRIC 21 nor in IAS 2 precludes a levy from being per se a production overheads.

Nothing precludes in IAS 2 a service provider to record a prepaid production expenses/incurred production expenses between two points in time that trigger a periodic production liability.

This approach is also consistent with IAS 18.

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IAS2 References (emphasis added):

Definitions

6 The following terms are used in this Standard with the meanings specified: Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

Cost of inventories of a service provider

19 To the extent that service providers have inventories, they measure them at the costs of their production. These costs consist primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labour and other costs relating to sales and general administrative personnel are not included but are recognised as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-attributable overheads that are often factored into prices charged by service providers.

Costs of conversion

12 The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

13 The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

14 A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of

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conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other costs

15 Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

16 Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:

(a) abnormal amounts of wasted materials, labour or other production costs;

(b) storage costs, unless those costs are necessary in the production process before a further production stage;

(c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and

(d) selling costs.

IAS18 References (emphasis added):

19 Revenue and expenses that relate to the same transaction or other event are recognised simultaneously; this process is commonly referred to as the matching of revenues and expenses. Expenses, including warranties and other costs to be incurred after the shipment of the goods can normally be measured reliably when the other conditions for the recognition of revenue have been satisfied. However, revenue cannot be recognised when the expenses cannot be measured reliably; in such circumstances, any consideration already received for the sale of the goods is recognised as a liability.

21 The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognised in the accounting periods in which the services are rendered. The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period. IAS 11 also requires the recognition of revenue on this basis. The requirements of that Standard are generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services.

Submitted by:

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