

## EFRAG Short Discussion Series

### LEVIES: WHAT WOULD HAVE TO BE CHANGED IN IFRS FOR A DIFFERENT ACCOUNTING OUTCOME?



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- 1 The EFRAG Short Discussion Series addresses topical and problematic issues with the aim of helping the IASB to address cross-cutting dilemmas in financial reporting and stimulating debate among European constituents and beyond. **It is not the purpose of the paper to reach a conclusion on the best accounting treatment for levies but to investigate different alternatives to address the concerns expressed by European constituents.**

We welcome views on any of the points addressed in this paper. Specific questions are given at the end of the document. These comments should be sent by email to [commentletters@efrag.org](mailto:commentletters@efrag.org) or by post to:

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so as to arrive no later than 15 December 2014.  
All comments will be placed on the public record unless confidentiality is requested.

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- 2 IFRIC 21 *Levies*, endorsed in 2014, addresses the timing of recognition of a liability to pay a levy. The Interpretation states that a liability is recognised when the obligating event identified by the law occurs. The consensus of IFRIC 21 was based on the definition of a liability in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and the Conceptual Framework.
- 3 Combined with the requirements in IAS 38 *Intangible Assets*, IFRIC 21 will often result in the immediate expense of levies charged on an periodic basis (i.e., annually), when the law indicates an activity that occurs at a point-in-time. Some have expressed concern with this outcome because they believe that the cost of a levy charged periodically should be recognised over the period it refers to. They believe the economic substance of a recurring levy is that the entity is paying to operate over an annual period, although the law may identify a different activity that triggers the payment (such as being in operation at a certain date).
- 4 Based on this, some have claimed that the EU should call for a revision of the principles in IAS 37. However, it is important to note that the definition of a liability in IAS 37 is the same that is found in the Conceptual Framework. In addition, some of the principles in IAS 37 are unrelated to the issue under discussion and consequential changes to IAS 37 would not affect the outcome.
- 5 It is also important to note that the accounting outcome criticised by some constituents is affected not only by the IFRIC 21 requirements on the timing of recognition of the liability, but also by the accounting for the debit side of the transaction for which the Interpretation redirects to the applicable Standard (in most cases, IAS 38). Therefore, a discussion on alternative approaches should address also the debit side and extend to other pronouncements.
- 6 The aim of this paper is to:
  - (a) revisit the main changes proposed in the IAS 37 amendment project to assess if they would be relevant in considering whether to modify the consensus in IFRIC 21 to address the concerns expressed by European constituents; and
  - (b) illustrate alternative approaches that would affect the accounting outcome that some constituents are concerned about, that is the immediate charge to profit and loss of recurring levies when the law indicates a point-in-time obligating event.
- 7 This paper is consistent with the view expressed by EFRAG in the bulletin issued jointly with the standard setters of France, Germany, Italy and the United Kingdom, that the asset-liability approach can be implemented and provide relevant performance reporting information. Any alternative that would be only based on the matching approach consisting of recognising on the balance sheet items that do not meet the definitions of assets and liabilities with the aim of achieving a desired cost pattern is not considered.



- 8 In this paper, the alternatives discussed include:
- (a) amending the definition and recognition of a liability (paragraph 42);
  - (b) developing guidance to assess if the entity is receiving an asset or a service in exchange for the payment of the levy (paragraph 58);
  - (c) considering if other features of the law could affect when the obligating event occurs, beyond the date specified in the law (paragraph 65);
  - (d) amending IAS 34 *Interim Financial Reporting* (paragraph 69);
  - (e) applying the IAS 12 *Income Taxes* model (paragraph 77); and
  - (f) carrying out a Research project for levies and other similar transactions (paragraph 82).
- 9 The IASB is currently reviewing the Conceptual Framework for Financial Reporting and if and how the definition and recognition criteria for liabilities should be modified. This paper considers the implications of the current debate in paragraph 42 below.

# Recent debate on levies



- 10 IFRIC 21 provides the following guidance on the recognition of a liability to pay levies:
  - (a) If the obligating event occurs over a period of time (for example, the generation of revenue), the liability is recognised progressively over time; and
  - (b) If the obligating event occurs at a point in time (such as a requirement to be in business at a certain date), the liability is recognised at that point in time.
- 11 In both cases – progressive or immediate recognition of the liability - the Interpretation does not specify when and how the cost of the levy should be recognised. Specifically, the Interpretation clarifies that ‘economic compulsion’ and the going concern principle do not create, or imply that, an obligating event has occurred.
- 12 IFRIC 21 prescribes that an entity shall apply the same recognition principles in the annual and the interim financial statements. In addition, the Interpretation does not deal with how to account for the costs arising from the recognition of the liability to pay a levy. Other standards are applied in determining whether the recognition of a liability gives rise to an asset or expense.
- 13 Some constituents have expressed concerns about the following examples in IFRIC 21:
  - (a) Example 1: A levy measured as a percentage of the revenues from period N, which becomes due as soon as revenues are generated in the following period<sup>1</sup>. Under the Interpretation, the liability is recognised in full at the beginning of the following period (or more precisely, when revenue is first generated) because the obligating event in the law is the generation of revenue.
  - (b) Example 2: A levy which becomes due if the entity is still operating in a specified industry at the end of the reporting period<sup>2</sup>. Under the Interpretation, the liability is recognised in full on the last day of the reporting period, because the activity that triggers the payment is being in operation on the last day.
  - (c) Example 3: A levy which becomes due when the entity exceeds a specified minimum revenue threshold in the period. Under the Interpretation, the liability is recognised only when the minimum threshold is reached, because this is the obligating event in the law.
- 14 In all these cases, some constituents take exception to the conclusion because they believe that all the examples are annual levies related to a reporting period and should be recognised over the year, regardless of the legal reference to a specific date. These constituents believe that the reference to a point in time is used for measurement purposes and should not affect the period of recognition of the levy.

<sup>1</sup> This scenario is similar to the French ‘imposition forfaitaire sur les entreprises de réseaux’ which is enacted if, as at 1 January, an entity possesses railway equipment used in the prior year to transport passengers.

<sup>2</sup> This scenario is similar to the UK bank levy, which is enacted if, as at the end of a period of account, an entity qualifies as an entity subject to the levy.

- 15 They also believe that the lack of guidance in IFRIC 21 on the debit side of the entry will implicitly lead in most cases to the immediate recognition of the full amount as an expense because a levy will often fail to meet the recognition criteria in IAS 38.
- 16 For these reasons, while most agreed that the consensus in IFRIC 21 is a technically correct interpretation of the principles in IAS 37, there are concerns that on occasions it would result in delayed or anticipated recognition of liabilities and inappropriate recognition pattern of the cost.
- 17 If the application of IAS 37 results in an outcome that may not provide relevant information, some draw the conclusion that IAS 37 needs to be amended. However, the principles in IAS 37 deal with different aspects:
- (a) Definition of a liability;
  - (b) Recognition of a provision; and
  - (c) Measurement of a provision.
- 18 It is therefore important to identify exactly what parts of IAS 37 have affected the consensus in IFRIC 21. Calling for changes in IAS 37 on a generic basis may pass an inappropriate message to the IASB and persuade the Board that there is support for changes that do not affect the specific issue (and that are in fact opposed by European constituents).

# Assessing the impact on levies of the main changes proposed in the IAS 37 amendment project



- 19 While IAS 37 does not seem to raise specific application problems, there has been debate about some of its conceptual issues. For instance, some argue that the likelihood of outflows threshold create an accounting bright line – an obligation with a 51% probability to result in an outflow of resources is recognised in full, while an obligation with a 49% probability to result in an outflow of resources is only disclosed.
- 20 Another issue is the application of the probability threshold to the population of items (i.e. the unit of account). If an entity sells goods with a warranty to repair defects, and the expected fault rate is 1%, when is the threshold hit? In practice, many entities will start to recognise a provision as soon as they sell the first item, although for each individual item there is only a 1% probability of being faulty.
- 21 This debate led to the publication in June 2005 of an exposure draft (the 2005 ED) on *Proposed Amendments to IAS 37*. In the light of the comments received, the IASB developed more guidance on the proposed measurement requirements. An exposure draft *Measurement of Liabilities* in IAS 37 was published in January 2010 (the 2010 ED).
- 22 Paragraphs 23 to 29 contain a summary of the main proposals contained in the IASB replacement project of IAS 37.

## *Removal of the probability of outflows threshold*

- 23 The 2005 ED proposed that probability, which is currently taken into account in the recognition criteria, should henceforth be dealt with via measurement instead. Following the 2005 ED requirements, a liability would be recognised when there was a present obligation that could be reliably measured. Under the proposal, present obligations would meet the definition of a liability even if the likelihood of an outflow was low.
- 24 The above requirements would lead to the elimination of the notion of contingent liability since present obligations would give rise to liabilities, regardless of the likelihood of the outflow of resources (i.e. probable or possible). The uncertainty about future events that affect the amount that would be required to settle a liability would be reflected in the measurement of the liability.

## *Expected value*

- 25 The removal of the probability of outflow criterion would lead to a measurement of liabilities based on the expected value, i.e. the probability-weighted average of the outflows for the range of possible outcomes. This would be the appropriate measurement basis for both liabilities for a class of similar obligations and liabilities for single obligations.
- 26 The most likely outcome criterion as currently prescribed in IAS 37 for measuring single obligations would therefore be removed.



*Risk adjustment*

- 27 The expected cash payments should take into account the time value of money and the risk that the actual outflows might ultimately differ from those expected ('risk adjustment').

*Service margin*

- 28 If the liability related to undertaking a service at a future date, the outflows would be the amounts that the entity estimates it would pay a contractor at the future date to undertake the service on its behalf. If there were not a market for the service, the entity would estimate the amount it would charge another party at the future date to undertake the service. The entity would need to assess the costs to fulfil the obligation and add the margin it would require to undertake the service for the other party ('service margin').
- 29 The above would imply that the measurement of liabilities would be based on a 'value' notion instead of a 'cost' notion.

*EFRAG's views on the IASB proposals in the IAS 37 replacement project*

- 30 EFRAG disagreed with the proposed amendments. EFRAG believed that the removal of the probability of outflows recognition criterion should be considered in the context of the Conceptual Framework debate. Regarding the requirements to apply an expected value approach to all liabilities in scope, EFRAG believed that this model in many cases was unlikely to provide decision-useful information when applied to single liabilities. Also EFRAG argued that the measurement of liabilities in the scope of IAS 37 should be based on cost and opposed a value notion. Finally, EFRAG did not agree with the requirement to add a systematic and explicit adjustment for risk in excess of the expected present value of the outflows to compensate for their potential variability.
- 31 Following the comments received by constituents, the IASB decided to stop the IAS 37 amendment project. Currently the IASB has a project on non-financial liabilities on its research agenda, but the timing of preliminary work has not yet been announced.

*Would the changes proposed in the IAS 37 amendment project address constituents' concerns?*

- 32 The proposals in the IAS 37 amendment project were mostly focused on three aspects:
- (a) Providing additional guidance on the existence of a present obligation, especially in the context of initiated or threatened proceedings against the entity;
  - (b) Removal of the probability of outflows recognition threshold; and
  - (c) Modification of the measurement of a provision.



- 33 In EFRAG's view, the additional guidance on the existence of an obligation is not relevant to levies. The obligation to pay a levy arises out of a law and there is no uncertainty on whether the entity will be subject to it. The issue about recognition of the levies is not if an obligation will arise, but when it arises.
- 34 In EFRAG's view, the removal of the probability of outflows threshold does not affect the timing of recognition of levies. For levies such as those described in the examples above, there is no uncertainty at the point of recognition about whether there will be a future outflow of resources.
- 35 Changes in measurement requirements are also unlikely to affect the treatment of levies. Under IFRIC 21, recognition occurs only after the obligating event has occurred. In most cases, it means that the amount of the liability is certain. Settlement of a levy also does not involve the provision of services, thus the debate about the use of a 'market value' or cost to fulfil is not relevant.
- 36 In EFRAG's view, the proposals in the 2005 ED and 2010 ED are not relevant to the consensus in IFRIC 21, which effectively deals with the concept of 'present' obligation and the timing of recognition of a liability. Re-launching these proposals will not address constituents' concerns about IFRIC 21. Moreover, in investigating the various alternatives below, EFRAG does not identify any possible amendment to IAS 37 in isolation that would solve the concerns expressed by some European constituents with regard to IFRIC 21.

## Accounting for levies: an alternative outcome?



- 37 The debate about IFRIC 21 showed that some constituents would support an alternative outcome when accounting for levies. Those constituents believe that an entity should accrue a liability over the period, or capitalise and amortise the levy if it is paid in advance, so that the cost is recognised over the full reporting period.
- 38 Some counter argue that this approach firstly requires concluding if a point-in-time levy is paid in relation to the prior or the following period. There may be no clear indication of that in the law. If the amount of the levy changes over time, concluding that it should be accrued over the preceding period or amortised over the following period impacts both the profit or loss and the equity of the entity.
- 39 However for levies that are expected to be paid annually, either approach would alleviate the concerns expressed in paragraph 3 above.
- 40 The event triggering the payment and the measurement basis may in some cases be the same – for instance, a levy may become due when an entity generates revenue in the current period and be based on the amount of revenue for that period. In other cases the two may be different – either in period (the trigger may be the generation of revenue in a period, but the measurement is based on revenues from a prior period) or in nature (the trigger may be being in business at a specified date, while the measurement is based on financial data).
- 41 The following sections analyse the possible alternatives proposed in paragraph 8 to see when they would achieve a different outcome.

# Amending the definition and recognition of a liability



## *Present debate on the definition and recognition of liabilities*

- 42 The definition of liability in IAS 37 is the same that is found in the Conceptual Framework. The definition of a liability includes the notion of present obligation. The definition of a liability is currently being revisited in the review of the Conceptual Framework.
- 43 In July 2013 the IASB published the Discussion Paper *A Review of the Conceptual Framework for Financial Reporting* (the 'DP'). In the DP, a liability is defined as a present obligation of the entity to transfer an economic resource as a result of past events.
- 44 Under that definition, however, it is unclear whether such past events are sufficient to create a present obligation if the requirement to transfer an economic resource remains conditional on the entity's future actions. Therefore, the IASB has suggested three different views to develop guidance for the Conceptual Framework:
- (a) View 1: a present obligation must have arisen from past events and be strictly unconditional. An entity does not have a present obligation if it could, at least in theory, avoid the transfer through its future actions;
  - (b) View 2: a present obligation must have arisen from past events and be practically unconditional. An obligation is practically unconditional if the entity does not have the practical ability to avoid the transfer through its future actions; and
  - (c) View 3: a present obligation must have arisen from past events, but may be conditional on the entity's future actions.
- 45 In September 2013 EFRAG issued its final comment letter on the DP and expressed support for an approach that will result in the same outcomes as those that are illustrated for the View 2. EFRAG considered that View 1 would sometimes identify liabilities too late and View 3 would possibly result in too many liabilities being identified.
- 46 However, EFRAG noted that the term 'practically unconditional' in View 2 is ambiguous as some believe it means 'virtually certain', while others believe it means 'unconditional in practice'. EFRAG suggested using the term 'no realistic alternative'. This notion is similar to that of 'economic compulsion' and the 'going concern' assumption that are discussed below.

## *Economic compulsion and the going concern assumption*

- 47 Going concern is an underlying assumption of the Conceptual Framework and a general feature of financial reporting under IAS 1 *Presentation of Financial Statements*. When debating IFRIC 21, the Interpretations Committee concluded that the going concern assumption does not lead to recognising a liability for an obligation that will be triggered by operating in a future period.

- 48 However, EFRAG is aware that a number of constituents believe that the economic compulsion creates a constructive obligation to pay a levy, because the entity has no realistic alternative to continue operating its business.
- 49 For example, in certain industries such as banking or telecommunication, an entity may not be able to simply stop its operations, or would incur substantial losses doing so. Some sectors are highly regulated or entities have long-term contractual obligations that need a long period to unwind. Furthermore the regulatory oversight in the sector may be such that entities are not allowed to unilaterally decide to withdraw from the market. Withdrawal would require regulatory approval and due process would need to be applied.
- 50 Based on this view, some conclude that a constructive obligation to pay a levy exists before the occurrence of the triggering event identified in the law. In their view, the liability to pay the levy does not arise from a single obligating event. This argument would require recognition of the liability at an earlier date. It is noted that other Standards require the recognition of a liability when the entity has no realistic alternative to avoid it (such as profit-sharing and bonus plans under IAS 19). The entity's actions that give rise to the constructive obligation could be identified by the fact that the entity has operated for a long time, and therefore it has created an expectation that it will continue to do so until the end of the reporting period.
- 51 Some also point to the illustrative example 2B in IAS 37, under which an entity's published policy of rectifying environmental damage is sufficient to recognise a liability even in a jurisdiction where there is no legal requirement to clean up. An entity's environmental policy made public is sufficient to create a constructive obligation. The entity's commitment to continue in operation should also be sufficient to give rise to a constructive obligation.
- 52 However, this argument may support an earlier recognition of a liability to pay a levy, but not necessarily a progressive recognition over a period of time. Moreover, if an entity is expected to continue operating in the foreseeable future, why should it recognise only the liability to make the payment for the current period? Once the notion of lack of a realistic alternative is introduced, it is not clear why its application should be limited in time.
- 53 EFRAG therefore believes that, in itself, the introduction of this criterion would not always result in the accounting outcome that many constituents consider appropriate for annual levies. Therefore, it should be paired with some other criterion. An alternative would be to start recognising liabilities when the following two conditions are met:
- (a) The entity has no realistic alternative but to settle the liability; and
  - (b) The entity has started to conduct the activities by reference to which the levy is accumulated.



- 54 This would result in the following:
- (a) No liabilities would be recognised until there is no realistic alternative but to make the payment;
  - (b) When this condition is fulfilled, and:
    - (i) it is not possible to identify activities on which the levy is accumulated, the liability would be recognised in full immediately; or
    - (ii) it is possible to identify activities by reference to which the levy is accumulated, the liability would be recognised progressively from the moment the entity starts to be engaged in the activities until the activities are completed.
- 55 The alternative proposed in paragraphs 53 and 54 is in line with View 2 of the DP.<sup>3</sup>
- 56 EFRAG notes that for those levies that are measured based on amounts of revenues or expenses, normally it can be concluded that the activities on which the levy is accumulated are those conducted over the measurement period. However, for those levies that are measured based on balance sheet figures (such as total assets) it would be quite difficult to identify which transactions have given rise to those figures, and when these were performed. Therefore, for these levies there would be less conceptual basis for a progressive recognition of costs and liabilities.
- 57 Any change to the definition and recognition criteria in the Conceptual Framework would apply to all liabilities and not only to liabilities to pay a levy. EFRAG did not assess if this approach could result in any unintended consequences in the accounting for other type of liabilities.

<sup>3</sup> This alternative is also aligned with the most recent decisions taken by the IASB in the current debate on the definition of liabilities in the Conceptual Framework: <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2014/July/AP10C-Conceptual%20Framework.pdf>.

## Developing guidance to assess if the entity is receiving an asset or a service



- 58 Some constituents argue that for some levies the entity is in effect receiving an asset or a service in exchange for the payment, although the law does not indicate this explicitly. In their view, some levies are akin to licenses to operate in the market.
- 59 In other cases, constituents argue that the entity receives some form of benefit from the government. For example, it could be argued that banks receive access to services such as regulatory oversight, or funding from the central bank.
- 60 In the past, other pronouncements (IFRIC 8 *Scope of IFRS 2* later incorporated in IFRS 2 *Share-based Payments*) indicated that an entity may receive unidentifiable goods or services that should be accounted for.
- 61 When the liability arises at a point in time, and the entity can identify an asset, the entity would recognise an asset and liability at that moment and amortise the asset until the date the new obligation arises. The initial measurement of the asset would be at its cost, being the amount of the levy. When the liability arises at a point in time and the entity can identify a service, it would progressively accrue the service between the dates of two consecutive obligations.
- 62 Therefore, identifying an asset or a service would lead to allocating the cost of a recurring levy over time without changing the requirement to recognise a liability. Levies paid in exchange for an asset would be treated as licenses; so if they are expected to recur annually, the related asset would be amortised over a one-year period. However, this approach requires defining what, if any, asset or service is received in exchange for paying a levy. Characteristics of levies that, individually or in combination, would suggest that an asset or service is obtained may include:
- (a) The expected use of the proceeds. If the proceeds of the levy fund a specific activity, fund, or body that, possibly indirectly, could benefit the payer of the levy, this could indicate that the entity receives an asset or service;
  - (b) The stated purpose of the levy. When the law does not indicate the purpose of the levy, it is more probable that the levy is enacted only to contribute to the general budget of the country;
  - (c) Whether the levy replaces or reduces other payments due to the Government. If a levy is introduced and simultaneously there is objective evidence that the Government lowers or does not increase the general income tax rate, it is an indication that the entity is not paying for an asset or a service; and
  - (d) Other facts and circumstances. If the activity is regulated, failure to pay the levy may result in losing the right to operate in the market, which could suggest that the levy is similar to a payment for a license.



- 63 This approach would result in progressive recognition of the cost of a levy over a period in those cases where an entity can identify an asset or a service. A degree of judgment would always be needed and specific facts and circumstances would affect the assessment and it is difficult to predict how often an asset or a service would be recognised.
- 64 In addition, before applying the accounting described in paragraph 61, it is not sufficient to identify an asset or a service but also to distinguish which it is. EFRAG acknowledges that the characteristics suggested in paragraph 62 may not assist in making this distinction.



## Assessing all the features in the law to determine the obligating event



- 65 Some argue that, since the obligation to pay a levy arises from a law (and not from a voluntary negotiation between two parties), there is no ‘economic substance’ beyond what is mandated in the law; therefore the identification of the obligating event must be based strictly on the content of the legislation. However, even under this view it could be argued that, although a law may identify a specified moment in time or event that triggers the payment, other parts of the regulation may indicate how the obligation arises. In other words, the indication of a specified date may be driven by legal or tax reasons only.
- 66 This approach would require identifying other characteristics of the law that could be used to identify when the obligation arises. In this sense, it is different from assuming that there is an ‘economic substance’ to be found outside the requirements of the law.
- 67 For instance, in the case of a levy enacted only if an entity is in operation at the end of the year, IFRIC 21 requires recognition in full only at that date. But if the law indicates that the levy is proportionally reduced for a newcomer based on the number of days in which the entity was in business during the period, this would indicate that the obligating event is being in business over a period of time and not at a specified date.
- 68 If the law measures the liability as a proportion of amounts included in profit or loss (such as revenues or payroll costs), it could be argued that in substance the obligating event is the activity performed progressively over time. Imagine a scenario where the levy becomes due on the beginning of period N but is measured on the revenues of the preceding period. It may be argued that the obligating events indicated by the law are two (being in business at a certain date and generating revenue over a period). It could be questioned what criterion should be used to identify the most relevant one: is it the last event that occurs or the event with greatest impact on the amount to be paid?

## Amending IAS 34



- 69 IFRIC 21 requires an entity to apply the same recognition principles in the annual and interim financial statements. According to IAS 34, measurements for interim reporting purposes should be made on a year-to-date basis, so that the frequency of the entity's reporting does not affect the measurement of its annual results.
- 70 As a consequence, no liability would be recognised at the end of an interim reporting period if the obligating event to pay the levy has not yet occurred. On the other hand, the liability must be recognised in full at the end of the interim reporting period if the obligating event has occurred and the expense cannot be deferred even if the costs associated with the levy recur from year to year. This treatment derives from paragraph 4.50 of the Conceptual Framework that states that 'the application of the matching concept ... does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities'.
- 71 As explained above in paragraphs 58 to 64, if the entity was able to identify an asset or a service, then the cost would be recognised in the interim period either by amortisation or by progressive accrual.
- 72 IAS 34 articulates specifically the discrete period approach for year-end bonuses, contingent lease payments, income taxes and employer payroll tax:
- (a) If a lease provides for contingent payments based on the lessee achieving a certain level of annual sales, paragraph B7 of IAS 34 states that an obligation can arise in the interim periods before the required annual level of sales has been achieved, when the required level of sales is expected to be achieved and the entity will have no realistic alternative but to make the future lease payment;
  - (b) In relation to year-end bonuses, paragraph B6 of IAS 34 requires entities to anticipate the recognition of the bonus in the interim period if the bonus is a legal obligation or past practice would make the bonus a constructive obligation for which the entity has no realistic alternative but to make the payments, assuming a reliable estimation can be made;
  - (c) specific guidance is prescribed in paragraph B6 of IAS 34 for the accounting of employer payroll taxes and insurance contributions. The expense is recognised in interim periods using an estimated average annual effective payroll tax or contribution rate, even though a large portion of the payments may be made early in the financial year (for example, an employer payroll tax or insurance contribution that is imposed up to a certain maximum level of earnings per employee); and
  - (d) IAS 34 also prescribes that income tax is recognised for interim periods based on the expected average annual effective income tax rate applied to the pre-tax income of the interim period. So income tax is not measured in exactly the same way in interim periods as at year-end.



- 73 An additional example could be added in IAS 34 to illustrate that an obligation can arise in interim periods starting from when the entity is expected to meet the point-in-time condition (such as being in business at a specific future date) and therefore it has no realistic alternative but to make the payments.
- 74 For a levy measured on amounts of revenues or expenses, this would imply recognising progressively both the cost and the liability from that moment until the point-in-time condition is met. However, there is a weaker argument to apply the same treatment to levies not measured based on amounts of revenues or expenses; in that case, this approach could simply result in immediate recognition at an earlier date.
- 75 EFRAG thinks that progressive recognition of a levy based on a point-in-time condition and not measured on amounts of revenues or expenses could only be achieved by introducing a specific exception, based on the notion that annual levies benefit more than one interim period. This occurs under US GAAP (Topic 270 *Interim Reporting*) that requires entities to defer or allocate certain levies in their interim financial statements. In this sense, the exception would also enhance comparability between jurisdictions.
- 76 The inclusion of an illustrative example dealing with levies in IAS 34 could provide a short-term solution while the IASB addresses the issue more in general. EFRAG acknowledges that, while it avoids outcomes that some constituents consider undesirable, it would not address the more fundamental conceptual issues.

## Applying the IAS 12 model



- 77 IFRIC 21 scopes out those outflows of resources imposed by governments that are within the scope of other Standards such as IAS 12 *Income taxes* which includes all domestic and foreign taxes which are based on taxable profits and taxes, such as withholding taxes which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity.
- 78 While levies have different characteristics compared to income taxes (the measurement basis is not profit or loss, levies may be applied only to entities operating in specific industries and they are not due in all circumstances), they are similar insofar that they are both enacted by law and the counterparty is the Government.
- 79 The recognition criterion implicit in IAS 12 is that tax liabilities (or assets) are recognised in the same period to the extent that taxable profits (or losses) are recognised. An application by analogy to levies would lead to the recognition of levies as the entity recognises whatever item is used to measure them.
- 80 For cases such as Example 1 in paragraph 13, this would mean an earlier recognition of the liability. However, this approach would not result in a straight-line recognition over the period, and may even lead to allocation of negative costs to interim period (for instance, assume that a levy is a percentage of the net assets, and the balance at the end of the first six months is higher than the balance at year end).
- 81 It should be noted that an application by analogy of IAS 12 does not imply that all the detailed requirements applicable to the calculation of deferred taxes would be relevant for the accounting of levies.

## Carry out a Research project for levies and other similar transactions



- 82 The discussion above has shown that some difficulties in accounting arise because of the nature of the levy. Levies are not transactions between willing parties, which makes difficult to assess if there is any exchange and, if so, to identify what is received. IFRIC 21 addresses the accounting for a liability to pay a levy if that liability is within the scope of IAS 37. However, IAS 37 may not be appropriate for levies and 'tax-type' obligations.
- 83 Therefore, EFRAG thinks that a Research project focusing on all transactions with government authorities in their capacity as authorities holds promise to provide a robust solution for levies.

# Conclusion



- 84 This paper explores a number of alternatives to address the concerns expressed by some European constituents with regard to IFRIC 21. As explained above, these concerns were raised in relation to obligations arising at a point in time.
- 85 In EFRAG's view, the amendments to IAS 37 proposed in the 2005 ED and 2010 ED do not address the concerns expressed by some European constituents in relation to levies. Indeed, amending IAS 37 may neither be required nor advised to address these concerns.
- 86 In the meanwhile, a possible solution relies on identifying an asset or a service when one or the other arises. In that case, the general principles of recognition would apply – the levy would either be amortised or accrued progressively.
- 87 When that identification is not possible, a progressive recognition could be achieved by requiring recognition as soon as the entity does not have a realistic alternative to payment and linking the obligation to an activity performed over time. The linkage could be justified if the measurement basis for the levy is a revenue or performance measure (recognition would be progressive but not straight-line). This requirement could be introduced either by modifying the definition of liability or by adding an illustrative example in IAS 34 (for point-in-time obligations that recur annually). The latter has the merits of addressing the constituents' concerns in the short term. On the negative, it has a less conceptual basis.
- 88 When the obligation arises at a point-in-time, it is not possible to identify an asset or a service and the measurement basis is a balance sheet figure, EFRAG could not identify any basis to support progressive recognition.



- Q1 Do you have concerns that the application of IFRIC 21 and other relevant Standards may sometimes result in inappropriate outcomes (such as charging immediately to profit or loss the cost of a levy that should be instead recognised over a period)? (see paragraph 3)
- Q2 Based on the existing applicable Standards, do you think that entities will be able in practice to identify assets or services received in exchange for levies? (see paragraphs 58-64)
- Q3 Is the proposed guidance in paragraph 62 helpful in this respect? And, should the guidance also include criteria to distinguish if an entity has received an asset rather than a service (or vice versa)? (see paragraph 64)
- Q4 For those levies where the law indicates a point-in-time obligation, do you agree that there may be other elements in the law to designate the obligating event? If so, do you agree with the elements described in paragraphs 65 to 68?
- Q5 In which cases, if any, can a levy measured on a balance sheet figure be linked to an activity performed over time? (see paragraphs 56 and 74)
- Q6 Do you agree with the inclusion of a specific requirement in IAS 34 as a short term solution? (see paragraph 76)
- Q7 Do you agree that the IASB should add to its agenda a Research project to deal with transactions with Government authorities in their capacity as authorities? (see paragraphs 82-83)
- Q8 Do you think that other different alternatives could be explored in the paper in order to reach a different outcome when accounting for levies?



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