In depth
A look at current financial reporting issues

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What's inside:

IFRIC 21 – Levies

What does it mean?

At a glance

IFRIC 21, 'Levies', sets out guidance for recognising an obligation to pay a levy that is not income tax. The interpretation could result in recognition of a liability later than previously, particularly in connection with levies that are triggered by circumstances on a specific date.

Background

The IFRS Interpretation Committee (IC) published IFRIC 21 'Levies' in May 2013. The interpretation is effective for annual periods starting on or after 1 January 2014 (17 June 2014 for EU entities). This publication summarises the key accounting implications.

The IC issued IFRIC 21 to address diversity in practice in the recognition of the liability to pay a levy. The interpretation focuses on the accounting when a levy is measured based on information relating to a period before the obligation to pay arises, or when the levy is only payable if a certain threshold is met (for example, revenue in excess of a specific amount).

IFRIC 21 does not address whether the liability to pay a levy gives rise to an asset or an expense. Entities will need to apply other standards to determine the accounting for the expense.

A provision should be recognised when:

- an entity has a present obligation (legal or constructive) as a result of a past event;
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

IFRIC 21 did not change these criteria, but it did clarify that the obligating event for a levy is the event that gives rise to an obligation to pay. IFRIC 21 also clarifies the obligating event if a minimum threshold applies. The interpretation might therefore give rise to earlier or later recognition of a liability than previously, particularly in connection with levies that are triggered by circumstances on a specific date.

The interpretation was published in May 2013 and is applicable retrospectively as of 1 January 2014 (17 June 2014 for EU entities).

Scope

IFRIC 21 addresses the accounting for a liability to pay a levy recognised in accordance with IAS 37 '*Provisions*' and the liability to pay a levy whose timing and/or amount is certain.

The interpretation excludes:
- income taxes in the scope of IAS 12, 'Income taxes',
- fines or penalties for breaches of the legislation, and
- payments in exchange for an asset or service.

Application of IFRIC 21 to liabilities arising from emission trading schemes is optional. This is because the IASB has a comprehensive project on this topic on its research agenda, which is expected to address the accounting for these liabilities.

The scope includes any charges imposed by the government that are not in the scope of another standard. The following transactions are likely to be in the scope of IFRIC 21:

- Levies on receipts
- Capital taxes
- Property taxes
- Production taxes
- Non-deductible VAT
- Non-refundable import duties
- Oil-pollution tax
- Bank levies
- Other taxes based on assets, liabilities or physical measures

One of the difficulties in considering what items are within the scope of the interpretation is that 'levies' are often given different names, such as tax, rents, royalties, contributions and fees.

Example 1: Property tax

Entities often pay property taxes that are collected to fund public services such as road maintenance. Are such taxes in the scope of IAS 37 and IFRIC 21?

Analysis: Most property taxes are in the scope of IFRIC 21. The application of the interpretation to such taxes will generally require a detailed analysis of the arrangements for each tax to determine when the obligation is recognised. Some payments might arise from a contractual agreement with the government, or they might be related to specific services received from the government. Such transactions would be outside the scope of IFRIC 21.

Example 2: Payroll tax

An entity pays tax to the government based on wages paid to employees. The amount is due only if annual wages exceed a minimum amount. Is this tax in the scope of IAS 37 and IFRIC 21?

Analysis: Levies imposed on employee benefits are not explicitly outside the scope of the interpretation. The scope of IAS 37, however, excludes provisions addressed by another standard. IAS 19 addresses all forms of consideration given by an entity in exchange for service rendered by employees. This includes benefits settled by payments made directly to the employees or to others. The scope of IAS 19 is broad and, as a result, the majority of payroll taxes will be in the scope of IAS 19 and thus fall outside the scope of IAS 37 and IFRIC 21.

Example 3: Payments to third parties

Are payments imposed by the government and paid to third parties within the scope of the interpretation?

Analysis: The scope of IFRIC 21 applies to levies not only paid to government but also 'imposed' by the government. Such payments to third parties would therefore be in the scope of the interpretation (for example, a television tax paid by households to the national broadcaster).

Refresher of IAS 37: Provisions

Provisions can be distinguished from other liabilities, such as trade payables and accruals, because there is uncertainty about the timing or amount required in settlement.

IAS 37 sets out three criteria that must be met to recognise a provision. There must be a:

- present obligation as a result of a past event;
- probable outflow of resources embodying economic benefits; and
- reliable estimate.

Present obligation as a result of a past event

A past event that leads to a present obligation is called an obligating event. This is an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling the obligation.

In rare cases, it is not clear whether there is a present obligation. In these cases, a past event gives rise to a present obligation if, taking account of all available evidence, it is more likely than not that a present obligation exists at the balance sheet date.

Only liabilities that exist at the balance sheet date can be recognised. An entity does not have a present obligation, and a provision is not recognised, where an entity can avoid future expenditure by its future actions.

The existence of laws and regulations does not automatically create an obligating event. An entity might choose to avoid the impact of a particular law that affects its future operations by closing that line of business or making changes to its operations.

Probable outflow of resources embodying economic benefits

An outflow of resources is probable if it is more likely than not to occur.

Reliable estimate

An entity will normally be able to determine a range of possible outcomes to enable it to make an estimate of an obligation that will be sufficiently reliable to use in recognising a provision.

New clarifications in IFRIC 21

IFRIC 21 addresses the following issues:

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

The obligating event that gives rise to a liability to pay a levy is the event identified by the legislation that triggers the obligation to pay the levy.

Example 4: Obligating event – generation of revenue

An entity reports annually on 31 December. A levy is triggered in full as soon as an entity generates revenue in 20X1. The levy is calculated based on a certain percentage of revenue generated by the entity in 20X0. The entity generated revenue in 20X0 and, in 20X1, starts to generate revenue on 3 January 20X1. What is the obligating event in this case?

Analysis: The obligating event, and thus the activity that triggers the payment of the levy, is the first generation of revenue in 20X1. The generation of revenue in 20X0 is not the activity that triggers the payment of the levy and the recognition of the liability. This is necessary, but not sufficient, for recognition. The amount of revenue generated in 20X0 only affects the measurement of the liability.

Example 5: Obligating event – operation on a particular date

A levy is triggered if an entity is operating at the end of the annual reporting period. The levy is calculated based on total equity in the entity's statement of financial position at the end of the annual reporting period. The end of the entity's annual reporting period is 31 December 20X1. What is the obligating event that gives rise to a liability to pay the levy?

Analysis: The obligating event is the entity operating at the end of the annual reporting period. Before that point, the entity has no present obligation to pay a levy, even if it is economically compelled to continue to operate in the future.

When is a liability to pay a levy recognised?

A liability to pay a levy is recognised when the obligating event occurs. This might arise at a point in time or progressively over time.

In example 4, the obligating event is the first generation of revenue in 20X1. Thus, the liability is recognised on 3 January in full. In the interim financial report (if any), the liability is recognised in full in the interim period in which 3 January falls. This means that, if the entity issues quarterly interim reports, the liability is recognised in full in the first quarter.

In example 5, the obligating event is operating at a specified date and thus the bank recognises the liability on 31 December 20X1. This means that, if the entity issues quarterly reports, the liability is recognised in full in the last quarter of the year, because the liability is recognised in full on 31 December 20x1.

Another common example of levies recognised at a point in time is as follows:

Example 6: Property tax – point in time

Legislation requires an entity to pay a levy if it owns property at 31 December. The property tax is 1% of the most recent property valuation, payable by the owner of the property on 31 December. The most recent property valuation is from 30 June of the same year. When is the liability recognised?

Analysis: The obligating event is ownership of the property on 31 December. The owner of the property has no present obligation to pay the levy during the year, as it could sell the property before 31 December, or the legislation could change. The liability is therefore recognised on 31 December. The date of the property valuation is not relevant. It is only used to measure the liability.

However, the obligating event for some levies might occur over time, and not at a point in time:

Example 7: Recognition over time

A government imposes a levy of 1% of current year revenues. When is the liability recognised?

Analysis: The obligating event is the progressive generation of revenue. At any point in time during the year, the entity has a present obligation to pay a levy on revenue generated to date. Thus, the liability is recognised progressively concurrently with the revenue being generated.

Example 8: Property tax – over time

Assume the same facts as example 6, but that the obligating event is not specified in the legislation. Entities have a choice of settling the tax either once a year or on a monthly basis. An entity that sells the property during the year would be required to settle the tax for the period up to the sale. Would monthly recognition be appropriate?

Analysis: Where the legislation does not clarify the obligating event, an indicator might be the payment terms. The payment terms in this case support recognition over time, even though the entity has an option to pay on an annual basis.

Example 9: Recognition over time?

Assume the same facts as example 5, but that the legislation also includes specific provisions for entities that stop business during the year. For those entities, the levy is calculated on a pro rata basis, for example after six months as 0.5% of total equity instead of 1% at the end of the year. Would this amendment change the recognition pattern for all entities, even those who continue doing business through the year?

Analysis: The IC discussed a similar issue and noted that, until the specific condition is met, the pro rata reduction in the threshold does not apply. In our example, the entity cannot recognise the liability earlier than on 31 December, unless it stops business during the year.

What is the obligating event that gives rise to the recognition of a liability to pay a levy that is triggered if a minimum threshold is reached?

Some levies might be more complex (for example, if they include a threshold). IFRIC 21 is explicit that the same principles should be applied for obligations with a minimum threshold. Here is an example:

Example 10: Threshold

Assume the same facts as example 7, but in this case 1% of current year revenues is paid, but only if current year revenue exceeds CU20m?

Analysis: The obligating event occurs in this example when revenue exceeds CU20m. Thus the provision for the levy on the first CU20m will be recognised at that point in time. This means that, if the entity exceeds the CU20m in Q3, a catch-up adjustment of CU200,000 will be recognised when the threshold is reached. The liability is then remeasured progressively as revenue over CU20m is generated and the subsequent recognition takes place over time.

Does economic compulsion to continue operating in a future period create a constructive obligation?

The fact that an entity is economically compelled to continue operating in a future period, or prepares its financial statements under the going concern principle, does not create an obligation to pay a levy that will arise from operating in the future.

The interpretation is clear that only those obligations arising from past events that exist independently of an entity's future activities should be recognised as provisions. The going concern assumption is a fundamental basis of preparation of financial statements and cannot lead to the recognition of a liability that does not meet the definitions and recognition criteria in IAS 37.

The IC considered cases where an entity would need to take unrealistic action to avoid paying a levy – for example, a levy that would be triggered merely by operating for one more day. The IC considered whether a constructive obligation to pay the levy exists, and concluded that there is no constructive obligation, noting that this rationale would bring many types of future expenditure within the scope of IAS 37.

Consider example 6, where, under the going concern assumption, an entity has no realistic alternative to keeping and operating its properties. This does not result in the recognition of a liability. The owner of the property has no present obligation to pay the levy during the year, even if it expects to still own the property on 31 December. Thus the liability is recognised on 31 December.

How should an entity account for a levy that it has prepaid?

An entity should recognise an asset if it has paid a levy before the obligation event but does not yet have a present obligation to pay that levy.

How should an entity account for the 'debit' when a liability is recognised?

IFRIC 21 does not address the accounting for the costs arising from the recognition of a liability to pay a levy. It refers to other standards to decide whether the recognition of a liability gives rise to an asset or an expense.

Example 11: Recognition of an asset under IAS 2

A manufacturing entity imports once a year the raw materials used for production. The import is subject to import duties. How should the entity account for these?

Analysis: The definition of the costs to purchase inventories includes non-refundable import duties. Thus the entity might need to recognise the liability for this levy at the obligating event, which is the date of the import; however, it should recognise the cost as part of the inventory purchased. Subsequently, this forms part of their cost of production and is released over time as the inventory is sold.

Example 12: Recognition of an asset under IAS 16

A government imposes a tax every time a property is purchased. How should the buyer account for this levy?

Analysis: The definition of the purchase price of property, plant and equipment includes non-refundable purchase taxes. IFRIC 21 requires recognition of a liability at the obligating event, which is the date of the transfer of the property. The buyer should recognise the levy as part of the cost of the property and thus recognise the expense over the time the property is depreciated.

In some cases, the recognition of assets might be straightforward. In many cases, however, costs associated with levies might not meet the recognition criteria in these standards.

Effective date and transition

An entity should apply IFRIC 21 for annual periods beginning on or after 1 January 2014. Earlier application is permitted. If an entity applies the interpretation for an earlier period, it should disclose that fact.

Changes in accounting policies resulting from the initial application of this interpretation will be accounted for retrospectively in accordance with IAS 8.