

## Improving the Financial Reporting of Income Tax

Discussion Paper



DECEMBER

2011

# Improving the Financial Reporting of Income Tax

## Discussion Paper

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The purpose of the discussion paper is to stimulate debate on the issues presented and to assist the IASB in making progress with its income tax project.

The paper is issued by the European Financial Reporting Advisory Group (EFRAG) and the UK standard setter, the UK Accounting Standards Board (ASB).

The issue of this paper is also supported by the following standard setters in Europe:

Belgium, Commission des Normes Comptables/Commissie voor Boekhoudkundige Normen  
Cyprus, ICPAC – Institute of Certified Public Accountants of Cyprus  
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## DISCLAIMER

**These bodies, while encouraging debate on the issues presented in the paper, do not express any opinion on those matters at this stage.**

Copies of the paper are available from the websites of those bodies issuing the paper. A limited number of copies of the paper will also be made available in printed form, and can be obtained from either EFRAG or the ASB.

**The paper invites comment on its proposals via the ‘Questions for Respondents’ at the end of each section (which are summarised in the Invitation to Comment). Such comments should be sent by email to:**

**[commentletters@efrag.org](mailto:commentletters@efrag.org) or**

**by post to:**

**EFRAG  
35 Square de Meeûs  
B-1000 Brussels  
Belgium**

**so as to arrive no later than 29 June 2012. All comments received will be placed on the public record unless confidentiality is requested.**

## The Corporate Income Tax Project and EFRAG's Proactive Work in Europe

The Corporate Income Tax project was initiated to respond to criticisms from the user and preparer community who have questioned the decision usefulness of the information provided by the existing income tax standard, and claim that IAS 12 is too difficult to apply and understand. This Discussion Paper (DP) has been developed jointly with the UK and German standard setters and represents the first step in response to those concerns. The DP does not attempt to repeat the work recently done by the International Accounting Standards Board (IASB) in their 2009 exposure draft to amend IAS 12.

Taken as a whole, the paper attempts to get constituent feedback on the accounting for income tax and whether future efforts should be focused on improving IAS 12 and retaining its basic principles or developing a new approach based on different principles.

It is important to set the project within the broader context of our Proactive Work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB's work. This proactive work is done in partnership with National Standard Setters in Europe to ensure resources are used efficiently and to promote stronger coordination at a European level. There are four strategic aims that underpin proactive work:

- Engaging with European constituents to ensure we understand their issues and how financial reporting affects them;
- Influencing the development of global financial reporting standards;
- Providing thought leadership in developing the principles and practices that underpin financial reporting; and
- Promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our proactive work and current projects is available on the EFRAG's website ([www.efrag.org](http://www.efrag.org)).

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The financial reporting for income tax has often been criticised by both users and preparers. Users have expressed an interest in having better information on the current and future implications income tax may have on an entity's cash flows. Many preparers complain that accounting requirements for income tax are too complex. Some question the underlying principle of IAS 12 and point to the many exceptions to the principle as evidence the standard is in some way fundamentally flawed. Others maintain that the principle contained in IAS 12 is not flawed and that any approach to income tax would have difficulty dealing with the complex and different requirements in various tax jurisdictions around the world.

This Discussion Paper (DP) represents the first step of responding to that dispute. It aims at setting out the arguments and providing analysis to stimulate discussion and debate. Accordingly, the objective of the DP is to gain input and not offer conclusions because engaging with constituents is a critical step in developing our understanding to help formulate a position in the future on whether IAS 12 should be improved or whether there should a fundamental rethink and a new approach pursued.

The DP is a two-part consultation on the financial reporting of income taxes. The first part of the DP examines whether significant improvements to IAS 12 should be considered. The approach of the DP is not to repeat the work that has already been done by the IASB in its recent exposure draft of amendments to IAS 12. That effort focused on certain convergence issues with US GAAP and other technical issues in practice. As stated above, any approach to the accounting for income tax would need to deal with the complexities of various global tax requirements.

In determining whether IAS 12 can be significantly improved, the DP focuses on user needs rather than attempting to resolve in this phase the narrower but complex implementation issues. **Users want better information related to an entity's income tax charge and potential future cash flow impacts and the DP discusses potential improvements.** These improvements include changes to disclosures by introducing more transparent tax rate reconciliation requirements. The DP explores whether the reconciliation disclosure might be improved by requiring a more standardised reconciliation to reduce the diversity in practice and by introducing more transparent tax rate reconciliation requirements.

The DP also addresses what some view as recognition and measurement deficiencies of the existing standard. These include the lack of discounting deferred tax amounts and the lack of guidance for uncertain tax positions. Generally discounting is required in other IFRS where the effect is material. Deferred tax amounts are material to many entities and discounting amounts that are not already implicitly discounted would reflect the time value of money. On the other hand, the introduction of discounting would introduce additional complexity.



Users also want to understand an entity's uncertain tax position. IAS 12's lack of guidance on uncertain tax positions has resulted in diversity in practice. The DP discusses the alternative approaches to the measurement of uncertain tax positions, including the weighted average approach and the most likely approach.

It is acknowledged that improved disclosure, the discounting of deferred tax amounts and guidance on uncertain tax positions can be part of any approach to the accounting for income taxes. However, these issues may resolve some of the criticisms of the current approach to incomes taxes.

The second part of the DP reviews the alternative approaches to income tax. These approaches include:

- temporary difference approach,
- flow-through approach,
- partial tax allocation approach,
- valuation adjustment approach, and
- an accruals or timing difference approach.

In considering each of the alternative approaches to the accounting for income tax, the DP makes the case for each by pointing out the alternative's merits compared to the others. The DP also highlights some of the key weaknesses of each alternative. It is the validity of these strengths and weaknesses that we particularly welcome constituents to consider and challenge.

The debate on the best way to improve the financial reporting for income tax is a genuine one, and at this stage of our due process we are not fixed on a particular solution. We want to ensure that we have analysed all the key issues in a comprehensive and technically sound manner that is consistent, where appropriate, with other IFRS literature. The next steps to be taken in this project by EFRAG and its partners will depend on the comments received from constituents.



Comments are welcome on any aspect of the financial reporting for income tax under IAS 12. Comments are most useful if they are supported with reasons and identify any relevant paragraphs in the Consultation Paper.

Respondents need not address every question. In particular respondents are encouraged to comment only on that Part of the consultation that is most relevant to their position.

## The purpose of this Consultation

- Int 1 Accounting for income tax under International Financial Reporting Standards ('IFRS') is dealt with in IAS 12 *Income Taxes*. This Consultation discusses the future of IAS 12, which some believe is unsatisfactory in certain respects.
- Int 2 It is often said that users of financial statements do not find information produced in accordance with IAS 12 useful. This is a serious problem because for many businesses tax is one of the largest expenses. The complexity of tax makes it difficult to assess its impact and how it has been managed: this requires clear and transparent information, which is not sufficiently provided by financial statements prepared under IAS 12. Although IAS 12 requires extensive disclosures, these tend to focus on accounting technicalities such as temporary differences and their accounting treatment rather than on aspects that are of real concern to users such as tax cash flows and implications for future tax cash flows.
- Int 3 In some cases preparers find the requirements of IAS 12 difficult to apply in practice. Its requirements are said to be unclear, and preparers sometimes question the relevance and understandability of the information that is provided in accordance with the standard.
- Int 4 The objective of this Consultation is to gain input and not offer conclusions because engaging with constituents is a critical step in developing our understanding to help formulate a position in the future on whether IAS 12 should be improved or whether there should be a fundamental rethink and a new approach pursued. This Discussion Paper (DP) represents a first step and aims at setting out the arguments and providing analysis to stimulate discussion and debate.
- Int 5 Because it is the intent of the Consultation to gather evidence and views, it does not contain any specific proposals. Although it notes some possible advantages and disadvantages of different means of improving financial reporting requirements, it does not seek to advocate any particular course.
- Int 6 There are two distinct strategies that could be adopted to address deficiencies in IAS 12.
- (a) A number of limited amendments to IAS 12 could be made. These amendments would address specific issues where the current requirements are unsatisfactory, and could also improve the disclosures provided in financial statements prepared under IAS 12. Under this approach, the core principles of IAS 12 would remain unchanged.
  - (b) A new standard on accounting for income tax could be developed, based on different principles from those used in IAS 12.
- Int 7 The ASB, EFRAG and ASCG have been working on developing a different approach to accounting for income tax for some time. It has become clear that this is a considerable challenge, and it might be some years before a new standard reflecting such an approach could be introduced. On the other hand, limited amendments could be implemented relatively quickly and cause less disruptive change than a complete replacement of IAS 12.
- Int 8 Some may disagree that changes to IAS 12 should be contemplated. They may believe that there are no deficiencies in the standard, or at least none that are serious enough to justify the cost and effort of changes.
- Int 9 Those who believe that changes to IAS 12 are warranted, may nonetheless consider that there are other topics to which the limited resources of IASB should be directed. That raises an issue that should be considered in the context of IASB's deliberations on its agenda, on which IASB published a consultation in July 2011, and falls outside the compass of the current consultation.



Int 10 This Consultation is divided into two parts.

- Part 1 considers significant improvements that might be made to IAS 12 focusing on users' needs rather than the issues that arise in application.
- Part 2 reviews a number of alternative approaches to income tax including:
  1. temporary difference approach,
  2. flow-through approach,
  3. partial tax allocation approach,
  4. valuation adjustment approach, and
  5. an accruals or timing difference approach.

[Respondents are welcome to comment on either or both parts of this Consultation.](#)

Int 11 IASB has already attempted to address the shortcomings of IAS 12 through a series of limited amendments. An Exposure Draft was issued in March 2009 that proposed a number of changes that would be reflected in a revised standard. After considering respondents' views on the Exposure Draft, the IASB decided not to proceed with it. Instead it announced that it would consider undertaking a fundamental review at some time in the future. It also indicated that it might consider a more limited scope project to amend the standard. This resulted in an amendment to IAS 12 *Deferred Tax: Recovery of Underlying Assets*, which was issued in December 2010.

Int 12 It is, however, possible that, although the Exposure Draft did not achieve support, another set of limited amendments might be worthwhile. One of the principal objectives of the 2009 Exposure Draft was to achieve a greater degree of convergence between IFRS and the US standard, Current Topic 740 (formerly FAS 109). There was also a focus on technical and conceptual issues rather than improvement to the usefulness and transparency of the information that the standard provided. Possible improvements of the latter kind are discussed in Part 1. We analyse user needs in Chapter 1 and Chapter 2 then discusses some changes to IAS 12 that have the potential to respond to these identified needs.

Int 13 We have deliberately not catalogued all the known criticism of the standard as we were conscious that we did not want to replicate the work that has already been done by the IASB through their work on IAS 12. In any event, it is likely that because of the fundamental difference in recognition and measurement under tax law and financial reporting any approach is likely to result in anomalies or call for exemptions.

Int 14 The Corporate Reporting Users' Forum (CRUF), in a wide-ranging letter addressed to the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) in 2008, ranked work on IAS 12 as a high priority. They noted that 'the existing data set is confusing and not useful' and therefore suggested that a 'fundamental rethink' was required. Many others, including several respondents to the IASB's Exposure Draft of late 2010, have advocated a 'fundamental rethink'.

Int 15 Whether developing a new approach to tax accounting is worthwhile depends, in part, on possible outcomes. For this reason possible approaches are reviewed in Part 2. This part may assist respondents in forming a view as to the strategy for change that should be preferred and, if a new standard is to be developed, which of the approaches should be the focus of further research.

Int 16 There are several current proposals for extension and reform of financial reporting, which have as their objective making financial reporting more relevant to a wider group of stakeholders and for a larger number of purposes than is the case under present practice. This Consultation does not express a view on these proposals, but has been developed on the basis that the objectives and users of financial reporting will remain as set out in IASB's *Conceptual Framework for Financial Reporting 2010*.

Int 17 This Consultation has been developed by a team of staff drawn from EFRAG, the German Accounting Standards Board and the UK Accounting Standards Board (the Boards). They have been assisted by a Tax Advisory Panel (Panel), whose membership was drawn from a variety of countries and backgrounds. Panel members have given generously their time and expertise by discussing many issues over several meetings and entering into voluminous correspondence. The Boards wish to express their gratitude to them for their significant contribution.

## Question to constituents - General

Q0.1 Do you consider that there are deficiencies in IAS 12 that should be addressed? If so, should they be addressed through limited amendments to the standard or by developing a new standard based on different principles?

## Questions to constituents - Part 1: Possible amendments to IAS 12

Q1.1 Under current IAS 12 a difference between the tax paid and the current tax expense reported in the income statement leads to misunderstandings of these relationships.

Do you agree that additional disclosure that would provide a reconciliation of the taxes paid and current tax expense will help in understanding this relationship? (Paragraphs 1.15 to 1.18)

Q1.2 Do you agree that additional more detailed disclosures regarding deferred tax assets, especially unused tax losses and unused tax credits are necessary and useful? (Paragraphs 1.23 to 1.24)

Q1.3 Do you agree with the identified users' information needs in Chapter 1 of Part 1? Do you have any suggestion for additional information requirements regarding reporting of income taxes? (Paragraphs 1.8 to 1.24)

Q1.4 Do you agree that tax strategies to accommodate user information needs should be disclosed in the management commentary and not in the financial statements? Why or why not? (Paragraphs 1.8 to 1.9)

Q1.5 The reconciliation of the actual tax charge to the charge on profit at the statutory tax rate (tax rate reconciliation) is quite complicated and leads to some misunderstandings.

Do you agree that the suggestions made in the paper are helpful by clarifying the explanation why the current tax charge is not equivalent to the standard rate of tax applied to the accounting profit? Why or why not? (Paragraphs 1.19 to 1.20 and 2.21 to 2.34)

Q1.6 The amounts currently disclosed provide limited information about future tax cash flows.

How would you suggest the disclosures in IAS 12 be improved to provide better information about future cash flows? (Paragraphs 1.13 to 1.14 and 2.35 to 2.40)

Q1.7 The possibility of discounting deferred tax balances is discussed in paragraphs 2.44 to 2.50. In your view, should discounting deferred tax amounts be required? Please explain.

Q1.8 Currently IAS 12 neither provides explicit guidance for accounting for uncertain tax positions nor contains any specific disclosure requirements regarding the tax risk position.

(a) Do you agree required information regarding uncertain tax positions should be disclosed? If so, which of the following do you prefer:

Alternative 1: Disclosure requirements should be included in management commentary.

Alternative 2: Disclosure requirements should be split in two parts. Part 1 would include disclosure of all positions for which the tax payer must establish a tax provision under IFRS and will be disclosed in notes to the financial statements. Part 2 would include all other uncertainties regarding income taxes for which no provision is recognised. (Paragraphs 1.10 to 1.12)

(b) Do you agree that IAS 12 should address the recognition and measurement of uncertain tax position? Why or why not? If you agree, should the measurement be based on the most likely outcome or a probability weighted method? Should measurement include the likelihood the tax position will be reviewed by the tax authorities or should that review be assumed? (Paragraph 2.51 to 2.59)

Q1.9 Are there any issues with IAS 12, which are not addressed in Part 1, that would significantly improve the standard? What amendments would address these issues?

Q1.10 What is your view on the exemptions that currently exist in IAS 12?

## Questions to constituents - Part 2: Alternative approaches to accounting for income tax

Q2.1 If the development of a new standard for income tax, based on different principles from those used in IAS 12 is to be considered, which of the approaches discussed in Part 2 seem to have most merit and should be considered as a basis for further development?

Q2.2 Do you think that there are any specific practical difficulties with implementing the approach(es) that you favour in practice? If so, how can those difficulties be addressed?

Q2.3 Are there any approaches that are not discussed in Part 2 that should be considered?

Q2.4 In your view should a combination of approaches be considered? If so, which approach should be used in what circumstances?

Q2.5 Do you have any further comments on the discussion of the various approaches in Part 2?



## CHAPTER 1 Introduction: A focus on user needs

### Background

- 1.1 For decades there have been debates in the accounting profession about how the future tax consequences of transactions and other events should be reflected in the financial statements. It is fair to say that many of those concerns continue to be expressed by both those who prepare financial statements and those who rely on them to make decisions. In this paper we have taken a different starting point. We look to frame an approach to the issues by starting with the information needs of users. Whilst standard setters in the past have implicitly considered approaches that produce useful information, we would argue that the focus has been sharply fixed on resolving complex recognition and measurement issues without standing back and considering what information users need in the first place.
- 1.2 As a starting point it is important to be clear why accounting for corporate income tax is so complex. At a fundamental level, the objectives of financial reporting and tax reporting differ. Financial reporting is intended to provide financial statement users with useful information for resource allocation decisions; whereas the tax law is designed to achieve various government objectives such as generating revenue and, at times, encouraging what are deemed to be socially beneficial actions, rather than reflecting a purely economic perspective. These different objectives lead to rules that differ in both the scope and timing of which transactions are included in measured income. As a result, deferred taxes are intended to resolve the different application of two sets of reporting rules designed to meet different objectives. Adding to this complexity, many entities operate in more than one tax jurisdiction, and as a result, must deal with tax laws that are not just different from financial reporting requirements but vary by tax jurisdiction. Furthermore, managers usually have incentives to maximise cash flow for shareholders in part by minimising current tax payments. These efforts have an impact on deferred taxes through the interplay of the differences in the financial reporting requirements and tax planning. This suggests that financial statements should attempt to provide useful information for evaluating this aspect of management's stewardship of the entity's resources.
- 1.3 Despite these challenges, accounting for income tax and the related disclosures are often criticised by users of financial statements as being very complex, incomplete and non-standardised. Users often claim that the information about deferred tax in particular is inadequate and tax remains a 'black box' that makes it difficult to predict future tax cash flows with any degree of precision. They indicate that it would be helpful to understand an entity's tax strategy and to be provided with clear explanations of why the tax expense for the period is not simply the accounting profit at the statutory tax rate. That said, users cannot be expected to have the technical accounting knowledge to make sense of complex tax issues and the accounting anomalies that result from the mixed measurement model that underpins the financial statements.
- 1.4 The challenges faced by users are typified by the following statement from a group of investment analysts<sup>1</sup> :

*...despite their importance, tax issues get very little attention from investors. There are clear reasons behind this. First, there is reluctance on the part of corporates to reveal details of their tax planning strategy beyond what is in the financial statements, thereby restricting the analysis an investor can undertake. Secondly, many users have limited knowledge of the intricacies of tax issues and struggle to use the information that is available.*

Addressing these challenges is not straightforward and there are limits to what can be achieved with financial reporting alone.

- 1.5 As the income tax an entity will pay in the future depends on many firm-related (endogenous) and economy-wide (exogenous) issues, the financial statements can only reasonably provide some of the information requested by users.

<sup>1</sup> Citi Investment Research: *Eight for '08. Our guide to the Eight Key Tax Issues Facing Investors in 2008*, page 4. Citi Investment Research is a division of Citigroup Global Markets Inc.



1.6 The CFA Institute has noted that:

*Analysts sometimes analyse corporate performance on a pre-tax basis to avoid the complexity associated with income tax reporting. However, an entity's income tax accounting is too important to be ignored, due to significant cash flow and valuation consequences. Therefore, it is essential to have a clear picture of the effects of the differences between taxable income and financial statement income, including the impact of significant non-recurring transactions. From a user's perspective, unravelling these effects is a difficult and time-consuming task, especially in the absence of transparent disclosures<sup>2</sup>.*

We address income tax disclosures below.

1.7 Based on views put forward by users and other research by PricewaterhouseCoopers we have identified the following seven categories of tax information that are likely to be relevant to investors and creditors (noting that all of them can be addressed by financial statements):

- a. Tax strategies and objectives;
- b. Clarity on tax risk position;
- c. Cash tax and future tax cash flows;
- d. A clear explanation of the difference between the taxes paid and the charge made in the income statement;
- e. A clear explanation as to why the current tax charge is not equivalent to the accounting profit at the statutory rate of tax (tax rate reconciliation);
- f. Improved understanding of the effective tax rate;
- g. A reasonable value of losses carried forward (or other deferred tax assets).

In the following section we discuss each category in more detail.

#### **a. Tax strategies and objectives**

1.8 A clear tax strategy and accessible disclosure of this tax strategy is essential because it is difficult without it to put the other disclosures related to tax in context. Thus, the users want to know how the tax strategy is determined by the entity's management, and they especially want to understand the approach to managing their tax exposures and their policies in significant areas such as tax planning and transfer pricing. Moreover, users would appreciate more information on the impact of tax on a business, thus tax can have a substantial impact on the overall business strategy of an entity, for example, a business may in part be dependent on the tax treatment of its products<sup>3</sup>.

1.9 Although the arguments to support reporting information about tax strategies seem to be compelling it is not clear whether such information properly belongs in the notes to the financial statements or elsewhere in the corporate report. It goes beyond the scope of this DP but information reported about corporate income tax should be complementary and together should attempt to respond in a comprehensive manner to the needs of users.

#### **b. Clarity on tax risk position**

1.10 The growing international reach of business means that the decisions, activities and operations undertaken by an entity give rise to various areas of uncertainty, which in turn create business risk. Some of these uncertainties will have to do with tax cash flows in the future. These tax uncertainties are often in relation to the application of tax law that have some degree of ambiguity. In any transaction there may be uncertainty as to how the relevant law will be applied and uncertainty arising from specific judgement calls. Often the more unusual and less routine a particular transaction is the greater the risk associated with the transaction is likely to be. One-off, non-routine transactions, such as acquisitions or the disposal of a business or of parts of a business, or significant restructuring projects and reorganisations, will usually cause greater tax risks than the routine everyday business such as selling products and services. As a result users want a clear explanation of any material tax risks that the entity faces.

<sup>2</sup> CFA Institute: *Comment Letter on Exposure Draft on Income Taxes (ED/2009/2)*, page 5.

<sup>3</sup> PWC: *Tax Transparency Framework*, 2008, page 15; PWC: *Tax transparency: Communicating the Tax Companies Pay*, 2010, page 9; Citi Investment Research: *Eight for '08. Our guide to the Eight Key Tax Issues Facing Investors in 2008*, page 11.

- 1.11 Thus, tax uncertainty in the financial statements is of interest to users and they are interested in how tax risk is reflected in the financial statements. To the extent that the tax charge tends to fluctuate, they will wish to understand why this is so and how it may fluctuate in the future<sup>4</sup>. Currently IAS 12 neither provides explicit guidance for accounting for uncertain tax positions<sup>5</sup> nor contains any specific disclosure requirements regarding tax risk position.

IAS 12 basically states that current tax liabilities (assets) are measured at the amount expected to be paid to (or recovered from) tax authorities using the tax rates (and tax laws) enacted or substantively enacted at the balance sheet date. The implication is that amounts are recognised based on estimates of what will be owed or realised. Alternatively, one can view the recognition of a liability related to a tax authority's challenge of a tax position (or positions) as how much the entity 'expects to pay' to settle a specific tax position or a settlement that aggregates a number of tax positions. No other guidance is provided for recognising or measuring a tax asset or tax liability subject to tax uncertainty. We deal with the recognition and measurement issue of uncertain tax positions more comprehensively in Chapter 2.

- 1.12 The question remains open as to whether such requirements should be disclosed in financial statements or in other parts of the annual report as management commentary. Another alternative could be to split the disclosure requirements in two parts. Part one will be a part of financial statement and will include disclosure of all positions for which the taxpayer must establish a tax liability under IFRS. Part two which will include all other uncertainties regarding income taxes for which no liability is recognised, e.g. uncertainties resulting from contract negotiations.

#### **c. Cash tax and future tax cash flows**

- 1.13 Some users including investors and analysts are most interested in the cash tax payments. Cash figures and forward looking information on tax, such as future cash flows and forecasting the tax rate are likely to be relevant to users' analysis of income taxes. That is partly why users are said to often dismiss the numbers prepared under IAS 12 because it is often difficult to assess how these temporary differences will translate into actual payments of tax and the related timing of those cash flows. An explanation about the timing of reversing significant deferred tax assets and liabilities and the probability for such amounts to have an impact on a cash tax position would be very useful<sup>6</sup>.

- 1.14 Although entities pay not only corporate income tax but many other taxes as well, the only information available is generally that which is disclosed in the financial statements. This information often does not go beyond a corporate income tax charge and does not acknowledge the many other types of 'tax' an entity pays. The notion of the 'total tax contribution' an entity makes is a broader issue of corporate reporting that is not considered further in this paper.

#### **d. A clear explanation of the difference between the taxes paid and the current tax expense reported in the income statement**

- 1.15 A really difficult area for non-tax experts that leads to misunderstandings is the relationship between the current tax expense as reported in the income statement and cash paid for taxes for the current period which is often disclosed in the cash flow statement. Users are increasingly focusing on this aspect<sup>7</sup>.

<sup>4</sup> Citi Investment Research: *Eight for '08. Our guide to the Eight Key Tax Issues Facing Investors in 2008*, page 9; PWC: *Tax Transparency Framework*, 2008, page 20; PWC: *Tax transparency: Communicating the Tax Companies Pay*, 2010, page 8.

<sup>5</sup> Uncertain tax position refers to items for which the tax treatment is unclear, or is a matter of dispute between the reporting entity and the relevant tax authority. These scenarios generally occur where there is uncertainty as to the meaning of the law, or to the applicability of the law to a particular transaction, or both.

<sup>6</sup> CRUF: *Accounting for Tax. Information Required by Investment professional*; PWC: *Investor view*, 2010, page 2; PWC: *Tax Transparency Framework*, 2008, page 26; PWC: *Tax transparency: Communicating the Tax Companies Pay*, 2010, page 8.

<sup>7</sup> CRUF: *Accounting for Tax. Information Required by Investment professional*; PWC: *Investor view*, 2010, page 2; PWC: *Tax Transparency Framework*, 2008, page 25.

- 1.16 Current tax expense is intended to reflect the amount of income taxes payable or refundable to tax authorities for the current year. Thus, in a simple setting, the current tax expense would be calculated by determining taxable income at the time the financial statements are completed and computing the tax liability on this amount. One complication immediately arises. As the book accounting for income taxes usually occurs before the tax return is filed, entities do not know their exact tax liabilities at the time the financial statements are completed. Often, the tax paid during the year is based on an estimate and amounts are advanced to the tax authorities. Another complication arises because the income tax expense reported in the income statement can include in addition to the current income taxes for the year also adjustments to income taxes related to a prior year. Consequently, even without any of the more challenging issues the current tax expense will not exactly equal the tax liability on a tax return.
- 1.17 Another reason for the difference relates to intra-period tax allocation, which requires that the tax expense (or benefit) be allocated to different parts of the income statement, e.g. continuing operations and discontinued operations. This allocation means that the current tax expense is not the tax expense on all types of earnings of the entity, but rather only on a portion of the entity's taxable earnings on continuing operations. Items reported separately below continuing operations, such as discontinued operations, are reported net of their respective tax effects. To obtain the total tax of the entity, the tax expense (or benefit) related to these items would also have to be added to current tax expense. However, occasionally the related tax amounts are not disclosed, and if they are, often current and deferred portions are not disclosed separately.
- 1.18 One simple solution may be to provide a reconciliation of the taxes paid and current tax expense. This could provide information about the items that cause the differences between current tax expense and the cash taxes paid.

### Question to Constituents

Q1.1 Under current IAS 12 a difference between the tax paid and the current tax expense reported in the income statement leads to misunderstandings of these relationships.

Do you agree that additional disclosure that would provide a reconciliation of the taxes paid and current tax expense will help in understanding this relationship? (Paragraphs 1.15 to 1.18)

#### **e. A clear explanation as to why the current tax charge is not equivalent to the accounting profit at the statutory rate of tax (tax rate reconciliation)**

- 1.19 The reconciliation of the actual tax charge to the charge on profit at the statutory tax rate has been a requirement of IAS 12 for a long time. Entities are required to provide reconciliation from the hypothetical income tax expense that would result from applying the statutory tax rate to accounting profit to the actual total income tax expense recognised on the income statement for the year—that is, the sum of current and deferred taxes. However, users are interested in a clear and easy understanding of why the tax charge is not equivalent to the accounting profit at the statutory tax rate. They are looking for straightforward tax notes and disclosures without technical complexity<sup>8</sup>.
- 1.20 There has been diversity by reporting entities in practice in how they meet the reconciliation requirement contained in IAS 12. An example of this diversity is illustrated in the appendix to Chapter 2 below. Some users suggest that the tax reconciliation of the actual tax charge to the charge on profit at the statutory rate of tax may provide more useful information if the following issues could be included:
- The reconciliation should be transparent and the notes to the reconciliation should be clear without using any complex and technical descriptions.
  - The applicable tax rate that provides the most meaningful information for a group carrying out its operations mainly outside its local territory is the geographically weighted tax rate. That is an average tax rate weighted in proportion to accounting profit earned in each geographical territory.
  - The disaggregation of reconciled items should be sufficient and their description meaningful<sup>9</sup>.

<sup>8</sup> PWC: *Investor view*, 2010, page1; PWC: *Tax Transparency Framework*, 2008, page 23.

<sup>9</sup> CRUF: *Accounting for Tax. Information Required by Investment professional*.



#### f. Improved Understanding of the effective tax rate

- 1.21 An effective tax rate is a very useful and is becoming of increasing importance to investors and analysts. CFA Institute noted:

*Users employ valuation models that forecast future income and/or cash flows using the entity's effective tax rate as an input. Trends in effective tax rates over time for a firm and the relative effective tax rates for comparable firms within an industry can help assess operating performance. It is for this reason that it is extremely important for the effective tax rate components to be disclosed with full transparency<sup>10</sup>.*

- 1.22 Users are looking for a reasonably understandable sustainable tax rate that might be used to forecast future cash flows<sup>11</sup>. Certain factors mitigate against objectively forecasting a stable and sustainable tax rate that may include changes in the business or changes in tax legislation.

#### g. A reasonable value of losses carried forward (or other deferred tax assets)

- 1.23 Some investor-led research notes that:

*Disclosure of potential deferred tax assets arising from loss carryforwards is often highly value relevant<sup>12</sup>.*

- 1.24 Users note that it would be useful to have more detailed disclosures regarding deferred tax assets, especially unused tax losses and unused tax credits. The current requirements under IAS 12 in this respect are of a general nature as entities are reluctant to give detailed information about this sensitive topic. Users would appreciate additional information such as: geographical breakdown, maturity schedules, losses carried forward and other restrictions<sup>13</sup>.

#### Question to Constituents

- Q1.2 Do you agree that additional more detailed disclosures regarding deferred tax assets, especially unused tax losses and unused tax credits are necessary and useful? (Paragraphs 1.23 to 1.24)

### Conclusion

- 1.25 The analysis of user needs presented in this Chapter has highlighted the current gap between the information provided under IAS 12 and that required by users to enable them to predict future tax cash flows. That said we have also noted that it may not be appropriate to satisfy such needs through additional disclosures in the financial statements but other parts of the corporate report may provide a better location for such information. In the next Chapter we explain how IAS 12 could be amended to better serve the information needs of users.

#### Question to Constituents

- Q1.3 Do you agree with the identified users' information needs in Chapter 1 of Part 1? Do you have any suggestion for additional information requirements regarding reporting of income taxes? (Paragraphs 1.8 to 1.24)
- Q1.4 Do you agree that tax strategies to accommodate user information needs should be disclosed in the management commentary and not in the financial statements? Why or why not? (Paragraphs 1.8 to 1.9)

<sup>10</sup> CFA Institute: *Comment Letter on Exposure Draft on Income Taxes (ED/2009/2)*, page 5.

<sup>11</sup> CRUF: *Accounting for Tax. Information Required by Investment Professional*.

<sup>12</sup> Citi Investment Research: *Eight for '08. Our guide to the Eight Key Tax Issues Facing Investors in 2008*, page 59.

<sup>13</sup> CRUF: *Accounting for Tax. Information Required by Investment professional*.

## CHAPTER 2 Can IAS 12 be amended to better cater for needs of users?

### Background

- 2.1 The aim of this Consultation is to obtain views on whether the accounting model for income tax under IAS 12 is fundamentally flawed and an alternative approach is necessary. If it is not fundamentally flawed, can the existing approach to accounting for deferred income tax be improved in such a way to better address user needs and reduce some of the criticism it receives? This chapter deals with whether substantive improvements might be made to the existing approach.
- 2.2 As discussed in the prior chapter, users have suggested that they want to know information about the income tax that an entity has paid and information about what it may pay in the future. Improved disclosure about income taxes can help address some of those user needs. However, satisfying user needs solely through disclosure may suggest the underlying accounting model needs to be improved or replaced.
- 2.3 In conclusion, some user needs can be addressed by improving presentation and disclosure requirements under IAS 12 and other needs can be addressed by recognition and measurement issues. Some issues need to be addressed by both. We deal with the possible improvements of presentation and disclosure requirements in the first section of this chapter and with the recognition and measurement issues in the later section of this chapter.

### Improving presentation and disclosure requirements

- 2.4 The principal objective of the disclosures required by IAS 12 is to provide the user with an understanding of the relationship between accounting profit before tax and the related tax effects of assets and liabilities already reflected in the statement of financial position. Analysis of the research carried out by some organisations<sup>14</sup> indicates that current disclosures under IAS 12 are not sufficiently complete to allow inferences of taxable income or tax payments (tax cash flows) by the users of financial statements. Although the provision of information in the notes, beyond that required by IAS 12 is likely to be relevant to users, supplying such information comes at a cost to preparers. The IASB Framework states that information should only be required if the benefits of reporting the information outweigh the costs.
- 2.5 For example, the CFA Institute notes that:  
*We understand that standard setters frequently hear users asking for more transparency in financial statement disclosures while preparers cite information overload as well as adverse cost-benefit arguments. However, the goal of financial reporting is the delivery of decision useful information. We believe that transparent qualitative and quantitative disclosure of income tax matters is essential to user's ability to fully understand the details behind both current and prospective income tax matters*<sup>15</sup>.
- 2.6 We begin with a review of the current corporate reporting of income taxes in the financial statements and the information tax disclosures provide; in the next step we suggest some improvements, which are intended to satisfy user needs.

#### *Current requirements of corporate reporting of income taxes*

- 2.7 To focus the paper and maintain a manageable length, we limit the review to main presentation and disclosure requirements.
- 2.8 The following table summarise the presentation and disclosure requirements of IAS 12

<sup>14</sup> CRUF: *Accounting for Tax. Information Required by Investment Professional*; PWC: *Investor view*, 2010; Citi Investment Research: *Eight for '08. Our guide to the Eight Key Tax Issues Facing Investors in 2008*; CFA Institute: *Comment Letter on Exposure Draft on Income Taxes (ED/2009/2)*.

<sup>15</sup> CFA Institute: *Comment Letter on Exposure Draft on Income Taxes (ED/2009/2)*, page 9.

Statement of financial position	Statement of comprehensive income	Statement of cash flows
<b>Presentation:</b>		
Tax Assets and Liabilities: current and deferred	Income tax expense	Income taxes paid
IAS 1.54 (n),(o)	IAS 1.82(d)	IAS 7.35
<b>Disclosure:</b>		
Analysis of recognised and unrecognised deferred tax and liabilities	Significant components of tax expense	
IAS 12.81 (e), (f), (g),(i)	IAS 12.80	
Amounts recognised directly in equity or in other comprehensive income	Reconciliation of income tax expense for the year to the accounting profit	
IAS 12.81(a), (ab)	IAS 12.81(c),(d)	
Change in the amount arising from business combination		
IAS 12.81(j)		

*Statement of financial position (Balance Sheet)*

Presentation

- 2.9 The presentation requirements for both current and deferred tax in the balance sheet are addressed in IAS 1. Tax assets and liabilities are required to be shown separately from other assets and liabilities, and current tax items should be shown separately from deferred tax items on the face of the balance sheet. Deferred tax assets and liabilities are required to be classified as non-current if a classified balance sheet is presented, even though it may be expected that some part of the deferred tax will reverse within 12 months of the reporting date.
- 2.10 Although tax assets and liabilities are separately measured and recognised, IAS 12 takes a strict position on the extent to which tax assets and liabilities can be offset against one another by presenting only a net figure in the balance sheet. IAS 12 explains that an entity usually has a legally enforceable right to set off current tax assets against current tax liabilities when they relate to taxes levied by the same tax authority, and that authority permits the entity to make or receive single net payments. The offsetting of deferred tax assets and liabilities is not permitted in the statement of financial position, unless they relate to taxes levied by, and refund is due from, the same tax jurisdiction. Amounts due to or from independent taxing bodies cannot be offset. Under this rule, deferred tax assets and liabilities arising in the same legal entity can generally be offset. However, in a consolidation situation, the first condition to overcome is the requirement for the balances to be levied by the same taxation authority. This effectively prohibits the offset of deferred tax assets and liabilities arising in different jurisdictions. Therefore, in practice, offsetting in consolidated financial statements is almost never applied.

## Disclosure

- 2.11 The presentation of both current and deferred tax should be shown in the financial statements separately from the items or transactions to which they relate. Therefore, a considerable number of disclosure requirements in respect of taxation are included in the current standard.
- 2.12 An entity is required to disclose, in respect of each type of temporary difference, the amount of deferred tax assets and liabilities recognised in the balance sheet. Further, deferred tax assets and liabilities of the current and previous period should be analysed by each type of temporary difference and each type of unused tax losses and unused tax credits. IAS 12 is unclear as to what makes a type of a temporary difference. On the one hand, it is possible to present disclosures based on the reason for the temporary difference, e.g. depreciation; on the other hand, disclosures can be based on the statement of financial position captions relating to the temporary differences.

## Statement of comprehensive income

### Presentation

- 2.13 The income tax expense (or benefit) for the reporting period equals the sum of current and deferred taxes and is presented in just one line on the income statement; the additional details are provided in the disclosure notes.
- 2.14 The amount of income tax relating to each component of other comprehensive income (including reclassification adjustments) is required to be disclosed either in the statement of comprehensive income or in the notes. In June 2011, the IASB issued an Amendment to IAS 1 *Presentation of Items of Other Comprehensive Income* that included requirements on the disclosure of the related income tax amounts. Under the Amendment, an entity may present items of other comprehensive income either net of related tax effects, or before related tax effects with one amount shown for the aggregate amount of income tax relating to those components.

### Disclosure

- 2.15 IAS 12 places primary emphasis on disclosure of the components of tax expense or tax income. The total tax expense reported on the financial statement is the sum of the current and deferred taxes.
- 2.16 The following information must be disclosed about the components of tax expense for each year for which a statement of comprehensive income is presented. The components of tax expense (income), which may include some or all of the following (IAS 12.80):

- In respect of current tax:

- The current tax expense (income).
- Any adjustments recognised in the period for current tax of prior periods.
- The amount of the benefit arising from a previously unrecognised tax loss, tax credit or temporary difference of a prior period that is to reduce current tax expense.
- The amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with IAS 8, because they cannot be accounted for retrospectively.

- In respect of deferred tax:

- The amount of deferred tax expense (income) relating to the origination and reversal of temporary differences.
- The amount of deferred tax expense (income) relating to the changes in tax rates or the imposition of new taxes.
- The amount of the benefit arising from previously unrecognised tax loss, tax credit or temporary difference of a prior period that is used to reduce deferred tax expense.
- Deferred tax expense arising from the write-down, or reversal of a previous write-down, of a deferred tax asset due to its review at the balance sheet date.
- The amount of tax expense (income) relating to those changes in accounting policies and errors that are included in profit or loss in accordance with IAS 8, because they cannot be accounted for retrospectively.

- 2.17 Additionally, deferred tax assets and liabilities of the current and previous periods should be disclosed by each type of temporary difference, each type of unused tax losses and each type of unused tax credits.
- 2.18 Another important disclosure requirement relates to an explanation of the relationship between tax expense (tax income) and accounting profit. An explanation of such matters should enable users of financial statements to understand whether the relationship between tax expense and accounting profit is unusual and to understand the significant aspects that could affect that relationship in the future. IAS 12 explains that such a relationship may be affected by the effects of such factors as revenue and expenses that are outside the scope of taxation, the effect of tax losses and the effect of foreign tax rates (paragraph 84). In order to explain this relationship, an entity should, accordingly, use an applicable tax rate that provides the most meaningful information to the users of its financial statements.

#### *Statement of cash flows*

- 2.19 IAS 7 *Statement of Cash Flows* requires that cash flows arising from taxes on income should be classified as operating cash flow. A good reason for such approach is the fact that it is often impracticable to identify tax cash flows in respect of investing and financing activities. Additionally, such cash flows often arise in a different period from the cash flows of the underlying transaction.

#### *Possible improvements on current disclosure requirements*

- 2.20 In the following section we suggest some possible improvements on current disclosure requirements of income taxes. We also show some limitations of the improvement which are based on assumptions of the current approach in IAS 12. Notwithstanding, our aim is to determine whether more informative and more understandable disclosure notes to financial statements would be an improvement to IAS 12. We begin with a discussion of providing a more informative reconciliation of book and tax income.

#### *Reconciliation of tax expense or income*

- 2.21 The challenge of reconciling accounting profit with tax income begins with identifying 'whose book income', single entities or consolidated group of entities. We refer here to both of them.
- 2.22 IFRS and tax laws in different jurisdictions provide different rules for whether and how related entities should be combined. To prepare a single consolidated financial report, the individual lines of income and expense of related entities are combined, eliminating transactions between related parties. The fact that consolidation rules differ for book and tax purposes causes a problem when financial statement are compared to the tax return. The different financial and tax rules for combined reporting can result in either book or tax income being more inclusive, depending on the type of difference. Users cannot easily determine the sources of consolidation differences. Thus we propose some changes in the reconciliation scheme which are intended to help in understanding such consolidation differences.
- 2.23 As mentioned above users are interested in clear and transparent tax notes and other disclosures that explain the reconciliation of the income tax expense without technical complexity. The current version of IAS 12 neither requires a specific structure for such reconciliation nor identifies any reconciliation items. As a result, the wide variation across entities in the level of detail and the terms used to describe their reconciling items potentially introduces a problem for the users of financial statements. Differences in characterisation and aggregation across entities reduce understanding and make the comparison difficult because similar transactions are reported differently and different transactions are reported similarly.
- 2.24 To solve the problems associated with divergent classifications across entities, there may be some benefit in providing some standardisation by grouping similar items together and by using the same terms for the main categories. For categorising the typical items that needed to be reconciled, we have formed the following seven main categories:
1. Income that is exempt from taxation
- 2.25 Most income tax systems exempt certain classes from the taxable income base, and there is a great diversity amongst tax systems. Examples for more commonly excluded items are interest income earned from a subsidiary and income earned outside the taxing jurisdiction (such exemptions may be limited in amount). Some tax systems specifically exclude from income items that the system is trying to encourage. Such exemptions can be quite specific or very general.

## 2. Non-deductible expenses (in determining taxable profit or loss)

2.26 For the purpose of determining taxable profit income tax systems generally allow a tax deduction for expenses incurred to produce income. Often these deductions are subject to limitations or conditions. Some tax systems limit particular deductions, even where the expenses directly relate to the business, e.g. capital expenditures or impairment losses on goodwill.

## 3. Effect of tax losses

2.27 When an entity has incurred tax losses in recent years, IAS 12 states that a deferred tax asset shall be recognised for the carryforward of unused tax losses to the extent that it is 'probable' that taxable profit will be available against which the unused tax losses can be utilised, otherwise a deferred tax asset is not recognised.

2.28 The following effects of tax losses should be reported within the tax-reconciliation:

- Current year losses for which no deferred tax asset was recognised;
- Recognition (de-recognition) of previously unrecognised (recognised) tax losses;
- Utilisation of previously unrecognised tax losses.

## 4. Effect of foreign tax rates

2.29 The starting point for preparing the reconciliation is the determination of an applicable tax rate that provides the most meaningful information to users of financial statements. According to IAS 12.85 the most relevant rate is likely to be the rate applicable in the country of the reporting entity. This rate should be used even if some of the group's operations are conducted in other countries. In that situation, the impact of different tax rates applied to profits earned in other countries would appear as a reconciling item. However, for an entity operating in several jurisdictions, it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction.

## 5. Effect of change in income tax rate

2.30 IAS 12 does not directly address the question of changes to tax rates or other provisions of the tax law which may be enacted that will affect the realisation of future deferred tax or liabilities. The effect of these changes should be reflected as a component of income tax expense from continuing operations in the period in which the changes are enacted. When rate changes occur, the reconciliation of the effective tax rate should include an item for the adjustment of deferred taxes due to change to the rate enacted in the current year.

## 6. Adjustment to current tax of prior years

2.31 Adjustments recognised in the current year in relation to the current tax impacts of prior years.

## 7. Other items

2.32 The category 'other items' should include all items that could not be placed in the main designated categories (points 1 to 6).

2.33 The following illustrates a proposal of a main structure of the tax rate reconciliation. The reconciled items that increase the effective tax rate are listed as positive values and the items that decrease the effective tax rate are listed as negative values:

## Profit before tax

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Income tax expense calculated at XX%

### Current income tax effects:

(-) Income that is exempt from taxation

Examples:

- Income earned outside the taxing jurisdiction
- Interest income earned from subsidiary jurisdictions
- Income consisting of compensation for loss
- Non-taxable dividends
- Equity earnings in affiliates

(+) Non-deductible expenses (in determining taxable profit or loss)

Examples:

- Capital expenditures
- Impairment losses on goodwill
- Non-deductible acquisition costs
- Write-downs of equity investments

(+/-) Adjustment to current tax of prior years

### Deferred income tax effects:

(+/-) Effect of tax losses

Examples:

- Current year losses for which no deferred tax asset was recognised;
- Recognition of previously unrecognised and unused tax losses;
- Utilization of previously unrecognised tax losses

(+/-) Effect of foreign tax rates

(+/-) Effect of change in income tax rate

- Adjustment of deferred taxes due to change in rate enacted in the current year

(+/-) Other items

### Income tax expense

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- 2.34 In each of the main categories any disaggregation further depends on the number of reconciled items. One possibility would be to adopt a ‘5 per cent-rule’—that is, require disclosure of individual reconciling items within the main six categories that are more than five per cent of the amount computed by multiplying income before tax by the statutory tax rate. Reconciling items that are individually less than five per cent of the computed amount may be aggregated in the main categories. Examples of this reconciliation have been applied to the disclosures illustrated in the appendix to Part 1 of this paper.

### Question to Constituents

Q1.5 The reconciliation of the actual tax charge to the charge on profit at the statutory tax rate (tax rate reconciliation) is quite complicated and leads to some misunderstandings

Do you agree that the suggestions made in the paper are helpful by clarifying the explanation why the current tax charge is not equivalent to standard rate of tax applied to the accounting profit? Why or why not? (Paragraphs 1.19 to 1.20 and 2.21 to 2.34)

### Future tax cash flows

- 2.35 The next section deals with the disclosure requirements for future tax cash flows.
- 2.36 Users’ interest in information about future tax cash flows is likely to be no different than it is for future cash flows before tax. Financial statements under the existing Framework do not attempt to report all future cash flows, only those that currently meet the definition of a liability or asset as other future cash flows are dependent of future transactions and events. Users do need information that allows them to assess management’s stewardship of the entity, and for tax this would include information to determine the extent to which the obligation for tax payments has been minimised or deferred to the future or both.
- 2.37 Under the approach in IAS 12, a deferred tax liability (or tax asset) generally exists based on the difference between carrying amounts of assets and liabilities on the balance sheet and their tax bases. The basic premise of IAS 12 is that the future recovery of assets and liabilities at their carrying amounts is implicit in the balance sheet, and recovery of those amounts does not represent future income before tax. The recovery of those balance sheet amounts results in future taxable income (or deductions) if their tax bases differ, and as a result, a deferred tax liability or asset exists.
- 2.38 The amounts recognised under the approach in IAS 12 do provide information about future tax cash flows but the picture is incomplete to users because it only reflects future tax cash flows that are based in part on past transactions and events reflected in current carrying amounts and tax bases of assets and liabilities. There is also little information on the timing of the future tax cash flows. Users often need to make their own assumptions to project future cash flows based upon an entity’s historical financial information, and as discussed in the prior chapter they increasingly rely on determining a sustainable effective tax rate to forecast tax cash flows of an entity.
- 2.39 Some preparers also criticise IAS 12 because they believe it results in recognition of liabilities that will not be settled in the foreseeable future as a result of the mechanical approach of the standard. Most preparer complaints with IAS 12 are not based on future tax cash flows but instead on the complexity of the requirements and on the fact that IAS 12 does not adequately address certain issues. The issues identified by preparers often deal with very complex tax matters that are specific to only certain tax jurisdictions. Some argue that a principles-based approach should overcome both the complexity and the vast differences in requirements of differing tax jurisdictions.
- 2.40 In conclusion, accounting for income taxes is complex under the IAS 12 approach and it does not address all the issues that may arise to determine the tax provision. Tax requirements alone are generally very complex and it is difficult to imagine any approach to deferred income tax that would not also struggle in dealing with the complexity of the various tax requirements globally.



## Question to Constituents

Q1.6 The amounts currently disclosed provide limited information about future tax cash flows. How would you suggest the disclosures in IAS 12 be improved to provide better information about future cash flows? (Paragraphs 1.13 to 1.14 and 2.35 to 2.40)

## Recognition and Measurement

2.41 As mentioned in the introduction to this paper, the IASB has attempted to address some of the practice issues in its 2009 Exposure Draft. Respondents to the ED had mixed views to each of the proposals that addressed certain technical issues in practice. As a result of the differing views on many of the issues, there was limited support to finalise the proposed amendments. Most did not support the overall ED as reflected in many of the comment letters to the IASB. The following are a few examples of comments made in those letters:

*A new standard might have been the most appropriate outcome if the income taxes project had remained focused on its initial objective of short-term convergence with US GAAP. The principles underlying the current requirements of IFRS and US GAAP are substantially similar, and the differences in accounting treatment are well recognised. We question whether one Board acting without the other can either advance convergence or lead to improved accounting for income taxes. In addition, at the risk of appearing to pre-empt the outcome of the FASB's own consultation process, it is unclear whether the FASB will amend FASB Statement No. 109, Accounting for Income Taxes, or replace it with a standard based on the exposure draft. We question whether it is reasonable for existing IFRS users to shoulder the burden – or, in the present environment, the cost – of implementing a new, and in many respects more complex, standard that does not even achieve its initial goal of convergence with US GAAP<sup>16</sup>.*

*Based on our analysis we are not convinced that the proposals in the ED represent an improvement to the general principles of the existing IAS 12 and therefore we don't think that the ED should be used as a basis for a revised standard on income taxes<sup>17</sup>.*

*We are generally supportive of the Board's attempts to simplify accounting in this complex area, and reduce the number of exceptions to the key principles of the standard. However, we find some of the proposals overly complex to apply without any corresponding improvement in financial reporting<sup>18</sup>.*

*We do not support the proposals set out in the ED because we do not believe that there is a significant improvement on the existing standard<sup>19</sup>.*

The primary stated focus of that ED was to converge with US GAAP and many of the issues were solely convergence issues. IAS 12 and the US GAAP equivalent, FAS 109 *Accounting for Income Taxes* (now Topic 740), are already similar approaches to the accounting for income tax. Most of the respondents to the ED support the goal of convergence but many expressed the view that the overriding goal should be to significantly improve the standard.

- 2.42 If the focus of amendments to the existing approach is to significantly improve the usefulness of the information it provides without regard to convergence there would likely be different considerations than what was proposed in 2009.
- 2.43 Two technical issues stand out and are at the core of many of the problems with IAS 12 that would address users' expressed needs and some preparer criticisms. The first and likely dominant issue is discounting which would adjust for the time value of money and would provide a more realistic amount for users pertaining to future tax cash flows. The second is uncertain tax positions which would address some of the user concerns with the sustainability of the effective tax rate.

<sup>16</sup> Ernst & Young: *Comment Letter on Exposure Draft on Income Taxes* (ED/2009/2), page 1

<sup>17</sup> Siemens: *Comment Letter on Exposure Draft on Income Taxes* (ED/2009/2), page 1

<sup>18</sup> HSBC: *Comment Letter on Exposure Draft on Income Taxes* (ED/2009/2), page 1

<sup>19</sup> Dutch Accounting Standards Board: *Comment Letter on Exposure Draft on Income Taxes* (ED/2009/2), page 1

### Discounting of deferred tax

- 2.44 Perhaps one of the more substantive changes that might be made to the approach under IAS 12 is to reflect the time value of money for deferred income tax amounts on the balance sheet. To meet the needs of users, financial statements need to report faithfully the economic burden of tax. That economic burden is reduced where a charge to tax is postponed. Under IAS 12 discounting of deferred tax assets and liabilities is prohibited. The result is that the reported tax charge for the period is the same irrespective of whether or not an entity takes advantage of an opportunity to defer tax expense.
- 2.45 Supporters of discounting argue that IAS 12's prohibition on discounting deferred tax is inconsistent with other measurement requirements of IFRS that generally require liabilities to be discounted where the effect is material. They also note that some temporary differences, such as those arising on a revaluation or property, may not reverse for a considerable period: the failure to discount assets and liabilities in such cases, in their view, leads to a significant distortion in financial statements.
- 2.46 Those who advocate discounting may also draw attention to the consequences for business combinations. Often the deferred tax amount acquired in a business combination is a liability because the assets acquired have been previously depreciated for tax purposes. Recognition of this deferred tax liability at an undiscounted amount overstates its real economic burden. This overstatement increases the goodwill recognised as a result of the business combination. Since goodwill is not subsequently amortised, some would argue that income in later periods is also improperly measured.
- 2.47 Further, many criticise IAS 12 for the many exemptions that are provided. Some point to the need for all these exemptions as evidence the accounting model is flawed. There are various reasons exemptions are provided in IAS 12. Some exemptions are provided to remove unnecessary complexity. Other exemptions exist because the deferred tax liability recognised under the model would be overstated due to the indefinite nature of the timing of settlement. With discounting of deferred tax amounts for these liabilities, some exemptions would no longer be needed. For example, deferred tax related to investments in subsidiaries, branches, associates, and interests in joint ventures where it is probable that the temporary difference will not reverse in the foreseeable future and there is control of the reversal.
- 2.48 In some cases, deferred tax reported under IAS 12 is effectively discounted because it is the difference between a discounted carrying amount and a tax base of nil. This is the case, for example where tax assets arise because a provision has been recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and tax relief will only be allowed in a future period. Some consider that because such amounts are often set off against amounts that are not discounted (for example, the deferred tax effects of accelerated depreciation) the deferred tax position for many entities is likely to be more significantly misstated economically than is commonly thought.
- 2.49 The main objection to discounting deferred tax is its complexity. It would be necessary to segregate those amounts that are already effectively discounted from those that are not. Discounting would then require the scheduling of the timing of reversal of those temporary differences that are not already effectively discounted. These activities are required for discounting any amount for financial reporting under IFRS. However, what makes discounting of deferred tax much more complex than other provisions is that deferred taxes are broader in scope than other provisions that are discounted and often calculated at the very end of an entity's closing process.
- 2.50 Given the potential significance of the issue, further consideration would seem appropriate. In particular the practical implication for both preparers and users needs to be assessed. This should also address further issues, such as the rate to be applied in discounting deferred tax, and the presentation of the expense arising from the passage of time—that is, the 'unwinding of the discount'. Discounting of deferred tax has been permitted in some jurisdictions, such as the UK, for some time, and a review of experience in those jurisdictions would be instructive.

### Question to Constituents

Q1.7 The possibility of discounting deferred tax balances is discussed in paragraphs 2.44 to 2.50. In your view, should discounting of deferred tax amounts be required? Please explain.

### Uncertain tax positions

- 2.51 In June 2006 the FASB issued guidance (FIN 48 *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109 – currently Topic 740-10-30-7*) in order to address diversity in practice regarding the interpretation and the accounting treatment for any uncertain tax position. FIN 48 requires an entity to recognise tax benefits it has claimed only if it is more likely than not that the tax authorities will accept the claim. If a tax benefit meets the recognition threshold, the amount recognised is the maximum amount that is more likely than not to be accepted by the tax authorities.
- 2.52 As discussed in the previous chapter, IAS 12 currently does not provide guidance on the accounting for uncertain tax positions. IASB attempted to address the issue in its March 2009 exposure draft on Income Taxes that discussed, inter alia, the uncertain tax position. The IASB proposed in their exposure draft that:

*... current and deferred tax assets and liabilities should be measured at the probability-weighted average of all possible outcomes, assuming that the tax authority examines the amounts reported to it by the entity and has full knowledge of all relevant information. (Question 7)*

- 2.53 According to the IASB staff paper on Comment letter analysis<sup>20</sup>, this question received the most responses. The vast majority of respondents, mainly preparers, are opposed to this proposal. On the other hand, the probability-weighted average method was strongly supported by some users:

*We believe that all tax positions should be considered for uncertainty and measured at the weighted-average probability of all possible outcomes. We agree with this expected value approach as conceptually superior to either a 'probable' or 'more likely than not' standard<sup>21</sup>.*

- 2.54 In arguing against the proposal in the ED, many preparers suggested a weighted-average approach would require significantly more work and would not be consistent with US GAAP. For example AstraZeneca indicated in its comment letter:

*It is potentially very onerous in terms of management time to assess every possible outcome (and to explain and agree with auditors) and to then ascribe percentage likelihoods for each. In addition, as it will both be difficult and subjective to determine each percentage likelihood for a particular issue, we consider that it is unlikely that the resulting tax asset or liability will be any more accurate than simply using management's best estimate of the most likely outcome<sup>22</sup>.*

- 2.55 Others argued without a threshold some liabilities would be recognised that do not meet the definition under the Framework. For example, KPMG response to the IASB's ED stated:

*Consistent with our response to the Board's exposure draft of proposed amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets and IAS 19 Employee Benefits dated 28 October 2005, we believe that measuring liabilities at expected value is not consistent with the Framework, under which a probable outflow of economic benefits is a key criterion in the recognition of a liability<sup>23</sup>.*

- 2.56 If an uncertain tax position is viewed as a stand-alone contingent liability the 'more likely than not' approach of the FASB provides a recognition threshold that only recognises uncertain tax positions that are present obligations.
- 2.57 On the other hand, are uncertain tax positions really stand-alone liabilities that need to individually meet the definition under the Framework for recognition? One might view the overall obligation to the tax authorities as the item that needs to meet the recognition requirements of the Framework. If that is the case, an uncertain tax position would be viewed as a measurement issue for the entire amount owed the tax authorities.

<sup>20</sup> Staff paper on Comment letter analysis for IASB/FASB Meeting October 2009, pages 14-16.

<sup>21</sup> CFA Institute: *Comment Letter on Exposure Draft on Income Taxes (ED/2009/2)*, page 36.

<sup>22</sup> AstraZeneca PLC: *Comment Letter on Exposure Draft on Income Taxes (ED/2009/2)*, page 6

<sup>23</sup> KPMG: *Comment Letter on Exposure Draft on Income Taxes (ED/2009/2)*, page 7

- 2.58 As noted above, some suggest that a probability-weighted average approach would be significantly more difficult to apply. However, entities need to consider what is probable under any approach. Management judgment is often needed in order to determine what position to take on the tax filing when significant uncertainty exists with potential future payments and penalties. That judgement probably considered the likelihood of reasonably possible alternative outcomes. In some cases, the additional effort needed is a calculation of a weighted average of those possible outcomes.
- 2.59 When considering alternative measurement approaches, there is also the issue of whether or not the tax authorities will even examine a tax position. For example, an entity may have taken an aggressive tax position that if examined by the tax authorities there is an estimated 80 per cent probability the tax position would be disallowed but there is only a 20 per cent probability that the tax authorities will even examine the transaction associated with the aggressive tax position. As a result, there is an overall probability of just 16 per cent that the entity will pay additional taxes. The amount that reflects 16 per cent probability is arguably more useful to users of financial statements as it includes in measurement the probability of all possible outcomes.

### Question to Constituents

Q1.8 Currently IAS 12 neither provides explicit guidance for accounting for uncertain tax positions nor contains any specific disclosure requirements regarding tax risk position.

- (a) Do you agree required information regarding uncertain tax positions should be disclosed? If so, which alternative do you prefer:

*Alternative 1:* Disclosure requirements should be included in management commentary.

*Alternative 2:* Disclosure requirements should be split in two parts. Part 1 would include disclosure of all positions for which the tax payer must establish a tax provision under IFRS and will be disclosed in notes to the financial statements. Part 2 would include all other uncertainties regarding income taxes for which no provision is recognised. (Paragraphs 1.10 to 1.12)

- (b) Do you agree that IAS 12 should address the recognition and measurement of uncertain tax positions? Why or why not? If you agree, should the measurement be based on the most likely outcome or a probability-weighted method? Should measurement include the likelihood the tax position will be reviewed by the tax authorities or should that review be assumed? (Paragraph 2.51 to 2.59)

### Conclusion

- 2.60 In this Chapter we have noted some changes that could potentially be made to IAS 12 to address the perceived information needs of users. The discussion has not focused on resolving the specific exemptions and anomalies that currently exist in IAS 12 but has taken as the primary consideration the accounting outcome and the extent to which that can be modified to better respond to information users needs to predict future tax cash flows. In Part 2 of this DP we consider some of the alternatives to IAS 12 along with a more detailed discussion of the specific issues encountered in practice with the application of IAS 12. It is worth noting that resolving some of these technical issues has the potential to improve the measurement of deferred tax assets and liabilities and therefore be more relevant to the information needs of users. That said, it is not clear whether dealing with the specific technical issues alone will sufficiently improve the quality of information in the financial statements about deferred tax to significantly enhance the predictive value of the information provided.

### Question to Constituents

Q1.9 Are there any issues with IAS 12, which are not addressed in Part 1, that would significantly improve the standard? What amendments would address these issues?

Q1.10 What is your view on the exemptions that currently exist in IAS 12?

## Appendix to Part 1

### Examples for tax rate reconciliations: examples for current practice and adjustment to the proposed scheme

Below is a proposed reconciliation scheme discussed in paragraphs 2.21 to 2.34 of Part 1 of this paper. Following are examples of the tax reconciliation disclosures from current practice for selected European companies. After each example a pro forma reconciliation is shown for the company that would align with the proposed scheme.

The proposed scheme for tax rate reconciliation is as follows:

#### Profit before tax

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Income tax expense calculated at XX%

#### Current income tax effects:

- (-) Income that is exempt from taxation
  - Examples:
    - Income earned outside the taxing jurisdiction
    - Interest income earned from subsidiary jurisdictions
    - Income consisting of compensation for loss
    - Non-taxable dividends
    - Equity earnings in affiliates
- (+) Non-deductible expenses (in determining taxable profit or loss)
  - Examples:
    - Capital expenditures
    - Impairment losses on goodwill
    - Non-deductible acquisition costs
    - Write-downs of equity investments
- (+/-) Adjustment to current tax of prior years

#### Deferred income tax effects:

- (+/-) Effect of tax losses
  - Examples:
    - Current year losses for which no deferred tax asset was recognised;
    - Recognition of previously unrecognised and unused tax losses;
    - Utilisation of tax losses
- (+/-) Effect of foreign tax rates
- (+/-) Effect of change in income tax rate
  - Adjustment of deferred taxes due to change in rate enacted in the current year
- (+/-) Other items

#### Income tax expense

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Tax rate reconciliation for selected European companies: current practice and adjustment to the proposed scheme.

**BP**

(Annual Report 2010)

Reconciliation of the effective tax rate in the annual report

**UK statutory corporation tax rate**

Increase (decrease) resulting from

UK supplementary and overseas taxes at higher rates

Tax reported in equity – accounted entities

Adjustments in respect of prior years

Current year losses unrelieved (prior year losses utilised)

Goodwill impairment

Tax incentives for investment

Gulf of Mexico oil spill non-deductible costs

Other

**Effective tax rate**

*Reconciliation of the effective tax rate using proposed schemes*

**UK statutory corporation tax rate**

**Current income tax effects:**

- (-) Income that is exempt from taxation
  - Tax incentives for investment
  - Tax reported in equity – accounted entities
- (+) Non-deductible expenses (in determining taxable profit or loss)
  - Goodwill impairment
  - Gulf of Mexico oil spill non-deductible costs
- (+/-) Adjustment to current tax of prior years

**Deferred income tax effects:**

- (+/-) Effect of tax losses
  - Current year losses unrelieved
  - Prior year losses utilised
- (+/-) Effect of foreign tax rates
  - UK supplementary and overseas taxes at higher rates
- (+/-) Other items

**Effective tax rate**

## **Ericsson**

(Annual Report 2010)

*Reconciliation of the effective tax rate in the annual report*

Tax rate in Sweden

Effect of foreign tax rates

Of which joint ventures and associated companies

Current income taxes related to previous years

Recognition/remeasurement of tax losses related to previous years

Recognition /remeasurement of deductible temporary differences related to previous years

Tax effect of non-deductible expenses

Tax effect of non-taxable income

Tax effect of changes in tax rates

## **Taxes**



Reconciliation of the effective tax rate using proposed schemes

**Profit before tax**

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Income tax expense

Tax rate in Sweden

**Current income tax effects:**

- (-) Income that is exempt from taxation
  - Tax effect of non-taxable income
- (+) Non-deductible expenses (in determining taxable profit or loss)
  - Tax effect of non-deductible expenses
- (+/-) Adjustments to current income taxes related to previous years

**Deferred income tax effects:**

- (+/-) Effect of tax losses
  - Recognition/remeasurement of tax losses related to previous years
- (+/-) Effect of foreign tax rates
  - Of which joint ventures and associated companies
- (+/-) Effect of change in income tax rate
  - Tax effect of changes in tax rates
- (+/-) Other items
  - Recognition /remeasurement of deductible temporary differences related to previous years

**Income tax expense**

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## **BHP Billiton**

(Annual Report 2010)

*Reconciliation of the effective tax rate in the annual report*

Profit before taxation

Tax on profit at standard rate

Investment and development allowance

Amounts (over)/under provided in prior years

(Initial recognition)/ derecognition of tax assets

Non-deductible depreciation, amortisation and exploration expenditure

Tax rate differential on foreign income

Tax on remitted and unremitted foreign earnings

Non-tax-effected operating losses and capital gains

Exchange variations and other translation adjustments

Tax rate changes

Other

Income tax expense

Royalty related taxation (net of income tax benefits)

**Total taxation expense**

## Reconciliation of the effective tax rate using proposed schemes

### Profit before tax

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Tax on profit at standard rate

#### Current income tax effects:

- (-) Income that is exempt from taxation
  - Income tax expense
- (+) Non-deductible expenses (in determining taxable profit or loss)
  - Non-deductible depreciation, amortisation and exploration expenditure
- (+/-) Adjustment to current tax of prior years
  - Amounts (over)/under provided in prior years

#### Deferred income tax effects:

- (+/-) Effect of tax losses
  - Non-tax-effected operating losses and capital gains
- (+/-) Effect of foreign tax rates
  - Tax rate differential on foreign income
- (+/-) Effect of change in income tax rate
  - Tax rate changes
- (+/-) Other items
  - Other
  - Royalty-related taxation (net of income tax benefits)
  - Exchange variations and other translation adjustments
  - (Initial recognition)/ derecognition of tax assets
  - Investment and development allowance
  - Tax on remitted and unremitted foreign earnings

### Income tax expense

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## Siemens

(Annual Report 2010)

*Reconciliation of the effective tax rate in the annual report*

### **Expected income tax expense**

Increase (decrease) in income taxes resulting from:

Non-deductible losses and expenses

Tax-free income

Taxes for prior years

Change in realisability of deferred tax assets and tax credits

Change in tax rates

Foreign tax rate differential

Tax effect of investments accounted for using the equity method

Other, net

### **Actual income tax expense**

*Reconciliation of the effective tax rate using proposed schemes*

**Profit before tax**

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**Expected income tax expense**

**Current income tax effects:**

- (-) Income that is exempt from taxation
  - Tax-free income
- (+) Non-deductible expenses
  - Non-deductible losses and expenses
- (+/-) Adjustment to current tax of prior years
  - Taxes for prior years

**Deferred income tax effects:**

- (+/-) Effect of tax losses
  - Change in realisability of deferred tax assets and tax credits
- (+/-) Effect of foreign tax rates
  - Foreign tax rate differential
- (+/-) Effect of change in income tax rate
  - Change in tax rates
- (+/-) Other items
  - Tax effect of investments accounted for using the equity method

**Income tax expense**

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## CHAPTER 1 Introduction

- 1.1 This part of the paper complements Part 1 by providing a discussion of various possible approaches to the accounting for income tax, to assist readers in forming a view as to whether the development of a new standard, based on different principles from those adopted in IAS 12 *Income Taxes*, should be considered and, if so, which approach is the most promising for further development. To provide a complete discussion, the principles of the approach used in IAS 12 (the temporary difference approach) are also addressed.
- 1.2 Under all approaches, it is common that an expense should be reported for the tax that will be assessed on the income of the period and reflected in the statement of financial position as a liability (unless it has been prepaid). It is also common to all the approaches that no adjustment is made to this expense in respect of items that have no tax consequence (that is, items of income that are not assessed to tax, and expenses that are not allowed as a deduction for tax). Such items will cause the tax expense to be a higher or lower proportion of pre-tax profit than the standard rate, but the expense is fairly stated (although there is a case for disclosure of such items in the notes to financial statements).
- 1.3 However, approaches differ markedly in their treatment in respect of income and expense that are taxable, but not for the same period in which they are reflected in the financial statements. These are commonly referred to as timing differences<sup>24</sup>.
- 1.4 There is a risk that financial statements will not be internally consistent if they report accrued income and expenses that will affect the tax for a subsequent period but reflect only the tax payable as assessed for the current period. It might also seem wrong for the reported tax expense to be affected by income and expenses that have yet to be included in reported pre-tax profit.
- 1.5 To give an example: suppose an entity sells a major asset and that tax on the resulting profit is assessed for the year following that in which the sale is reported in the financial statements. (This could arise, for example, if the transaction is recognised in the financial statements when control is passed, but for tax purposes the transaction is deemed to take place on legal completion.) The issue is whether it can be useful to report the profit in the financial statements without also including the tax effect of that sale in the financial statements (except perhaps as a note). If so, the financial statements for the next accounting period will show a large tax charge and no related profit.
- 1.6 Many agree that, in this example, the transaction and its tax effect should be reported in the same financial statements. As a result the reported tax expense for the period in which the sale is reported would include not only the tax assessed on the profits of the period, but also the tax on the sale and a corresponding liability. This additional expense and the liability are usually referred to as 'deferred taxation', and the process of recognising deferred tax is referred to as 'tax allocation'.
- 1.7 Significant timing differences arise in many common circumstances. A particularly common and significant case is accelerated depreciation, where the depreciation of fixed assets is allowed as a tax deduction earlier than it is recognised in the financial statements. Thus, whether the tax effects of timing differences should be recognised in financial statements and, if so, by what method is an important question.
- 1.8 Approaches to tax allocation are discussed in the following Chapters in this part:
- *The temporary difference approach*. This is the approach that is reflected in IAS 12. Under this approach, in principle, the effect of all differences between the carrying amount for financial reporting purposes of an asset (or liability) and its tax basis is recognised. It is reasoned that there is a tax liability where the tax basis of an asset (liability) is less (more) than its carrying amount, and that, conversely, there is a tax asset when the tax basis is greater (less) than the carrying amount of an asset (liability). (Chapter 2)
  - *The flow-through approach (sometimes referred to as 'the current taxes payable approach')*. Under the flow-through approach tax allocation is, in principle, rejected. The tax expense reported for a period is simply the tax assessed on the income of that period as the tax expense. (Chapter 3)

<sup>24</sup> IAS 12 *Income Taxes* uses the term 'temporary differences' rather than 'timing differences'. Differences between the concepts of temporary differences and timing differences are sometimes important.



- *Partial tax allocation.* Under a partial allocation approach, the effect of timing differences are recognised only to the extent to which they are expected to lead to future cash flows—usually the payment of additional tax in a future period. In assessing the extent to which a future cash flow is expected, the effect of future timing differences is taken into account. (Chapter 4)
- *Valuation adjustment (also sometimes referred to as the ‘net of tax approach’).* This reflects the view that the effects of timing differences are more properly dealt with by adjusting the amounts at which assets and liabilities are reported rather than by recognising as separate items liabilities and assets for ‘deferred tax’. (Chapter 5)
- *Accruals approach.* Under this approach, the reported tax expense reflects the tax effect of all transactions and events that are reported in the period. No formal distinction is required between amounts that form part of the current tax assessment and those that affect future tax assessments, although, if tax effects are discounted, the amount of more distant tax effects will be smaller.

The accruals approach is essentially the same as a ‘timing difference approach’ which is usually described as requiring the reported tax expense to be the sum of the tax assessed on the income of the current period and the tax effect of timing differences. This characterisation, however, does not make it clear that the same principle is applied to all items of income and expense.

The accruals approach differs from the temporary difference approach in that some temporary differences (such as those arising on the initial recognition in a business combination of an asset at an amount in excess of its tax basis) are not timing differences, and accordingly no tax effect is recognised for such items. (Chapter 6)

- 1.9 It may be possible to devise a system that uses a combination of approaches. For example, some who support a flow-through approach to most timing differences would nonetheless agree that tax allocation is appropriate in respect of some timing differences. If a combination of approaches is to be used, it is clearly necessary that the circumstances in which each approach is to be used be clearly defined, and that the rationale for using different methods be clear.
- 1.10 It should be emphasised that the objective is not to identify whether any particular approach is preferable to any other: rather the discussion aims to assist readers in forming their own evaluation of which approaches (if any) merit further development as candidates for the foundations of a future accounting standard. Given this limited objective, the Paper does not provide a complete discussion of the many issues that would need to be addressed in developing proposals for an accounting standard based on a new approach.
- 1.11 Some significant issues in the accounting for tax are not essentially linked to the particular approach adopted, but arise under most approaches<sup>25</sup>. Examples of such issues are: the circumstances in which deferred tax assets should be recognised; the treatment of uncertain tax positions; and whether amounts in respect of future tax should be discounted. As consideration of such issues would not assist in choosing between methods, they are not addressed in this Part.
- 1.12 Irrespective of the approach adopted, requirements in respect of presentation and disclosure require consideration. Appropriate disclosure may lessen some of the drawbacks of particular methods, and some such cases are noted in the individual chapters. However, detailed discussion of issues of presentation and disclosure is not attempted in this Part.

<sup>25</sup> The main exception to this statement is the flow-through method under which no assets or liabilities are recognised in respect of deferred tax.

## CHAPTER 2 The temporary difference approach

### Overview of the temporary difference approach

- 2.1 The temporary difference approach is the approach that underlies IAS 12. It has also been adopted in other jurisdictions, notably the United States, whose standard, FAS 109 *Accounting for Income Taxes* provided the basis for the current version of IAS 12, which was adopted in 1996<sup>26</sup>.
- 2.2 A 'temporary difference' is defined in IAS 12 as 'differences between the carrying amount of an asset or liability in the statement of financial position and its tax base'. The 'tax base' of an asset or liability is defined as 'the amount attributed to that asset or liability for tax purposes'.
- 2.3 In principle, under the temporary difference approach, the tax effects of all temporary differences are recognised in the financial statements. Thus where the carrying amount of an asset is higher than its tax base, a liability is recognised.
- 2.4 IAS 12 (paragraph 16) explains the rationale for this as follows:

*It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. When the carrying amount of the asset exceeds its tax base, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability. As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. This makes it probable that economic benefits will flow from the entity in the form of tax payments.*

- 2.5 Similarly, a deferred tax liability is recognised where the carrying amount of a liability is lower than its tax base. The same reasoning applies to deferred tax assets, except that IAS 12 restricts their recognition to the extent that it is probable that taxable profit will be available against which the difference can be utilised.

### The case for the temporary difference approach

- 2.6 In the opinion of proponents of the temporary difference approach, it is necessary that assets and liabilities resulting from temporary differences are recognised in financial statements if the financial statements are to be representationally faithful and, in particular, complete. Financial statements that omit assets and liabilities cannot be depended upon by users as providing all the information that users need and can reasonably expect financial statements to provide. For example, if an asset's carrying amount exceeds its tax base and no liability is recognised, those who support the rationale of the temporary difference approach would argue that the net assets of the entity are overstated.
- 2.7 All timing differences result in temporary differences, since the carrying amount of assets and liabilities are affected by the income and expenses that are recognised in respect of them, and the tax base is generally affected by tax deductions. Because it addresses all timing differences, the temporary difference approach (broadly) ensures that the total tax expense recognised in a period generally equals the standard rate of tax applied to pre-tax income, except for the effect of items that have no tax consequence and the impact of tax rate changes. This relatively stable relationship may be useful in assessing the likely future reported effective tax rate that will apply to the entity's income.
- 2.8 But not all temporary differences are timing differences. For example, where an asset is acquired in a business combination, its carrying value will reflect its fair value at the time of acquisition, while its tax base may be only the lower cost incurred less any tax depreciation taken by the acquired entity. The position is the same as if the difference related to accelerated depreciation allowed for tax—the carrying amount of the asset is not fully deductible for tax purposes. Advocates of the temporary difference approach would suggest that, because the economic position is similar in these two cases, comparability requires that the financial reporting reflect that similarity. The temporary difference approach achieves that.
- 2.9 The temporary difference approach may also be argued to be easy to apply when compared to most alternative approaches. The carrying amount of assets and liabilities is objectively known, as also, in most cases, is the tax base. There is thus little

<sup>26</sup> An account of the development of the current version of IAS 12 may be found in Kees Camfferman and Stephen A. Zeff *Financial Reporting and Global Capital Markets: A History of the International Accounting Standards Committee, 1973-2000* (Oxford, 2006) at pages 357-361.



need for the exercise of subjective judgement. Although the concept of a 'tax base' was unfamiliar in some jurisdictions when the temporary difference approach was introduced, workable solutions have, in most cases, been developed as preparers and users have become familiar with the standard. Some may consider that it would be a mistake to jeopardise the common understanding that has been gained by working with the temporary difference approach by changing to an accounting standard based on different principles.

### Comments on the case for the temporary difference approach

- 2.10 Some contend, however, that application of the temporary difference approach is sometimes complex in practice, and leads to results that are considered difficult to justify. Some of these situations are addressed by exceptions in IAS 12, which mean that assets and liabilities are not recognised in respect of all temporary differences. This seems to cast doubt on the basic principle: if all temporary differences give rise to assets and liabilities, why should there be a need for exceptions?
- 2.11 Some consider that the basic rationale of the temporary difference approach is, indeed unsound, and do not agree that all temporary differences give rise to assets and liabilities.
- 2.12 The rationale for the temporary difference approach relies on the assumption that reporting an asset implies that the amount at which it is stated is recoverable before tax, and that any tax consequences stemming from recovery will be at a standard rate of tax. Thus if recovery of an asset will lead to a greater tax expense than that which would arise if it were wholly tax-deductible, it is necessary to record a liability.
- 2.13 Critics of the temporary difference approach may disagree. In their view although it is true that, to the extent an asset is not tax-deductible, future tax expense will be higher than it would otherwise be, it does not follow that the carrying amount of the net assets of the entity are overstated unless a deferred tax liability is recognised. The following example, although stylised, illustrates the point.

Entity A pays tax at 30%. It has an opportunity to buy an asset at a cost of CU100, and is confident that it can sell it for CU180. Because it is unable to deduct the cost of the asset for tax purposes, its sale at the expected amount will incur a tax liability of CU54 (CU180 @ 30%). Hence the pre-tax profit on the purchase and sale will be CU80 and the after tax profit will be CU26.

If the purchase and sale of the asset take place in different accounting periods, and the asset is reported as inventory at a cost of CU100, then (unless there is an exception for initial recognition) the temporary difference approach would require Entity A to record a deferred tax liability of CU30 (carrying amount of CU100, less the tax base of nil, at 30%). In the period in which the asset is sold, it will report a net tax charge of CU24, being the net of a current tax charge of CU54—the tax assessed on the sale—and the release of the deferred tax liability of CU30.

Assuming an expense corresponding to the liability is recognised, Entity A will report an after-tax loss in the period in which the purchase takes place of CU30 and an after-tax profit of CU56 in the period of the sale.

- 2.14 Critics of the temporary difference approach may contend that there is no liability to be recognised on acquisition of the asset: the financial statements should simply show inventory at cost of CU100. In the following period the pre-tax profit of CU 80 and the tax charge of CU54 (leading to an after-tax profit of CU26) would fairly state the economic events of the period.
- 2.15 In particular, critics of the temporary difference approach would deny that there is a liability at the end of the period in which the asset is acquired. The Framework's definition of a liability requires there to be a present obligation, which is expected to result in an outflow of resources<sup>27</sup>. In their view, the future obligation to pay tax is not a present obligation because it is contingent on the earning of future income, which is not recognised until it is made.

<sup>27</sup> The Framework's definition of a liability in full is: 'A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits' (paragraph 4.4).

- 2.16 To complete the case for the temporary difference approach it is necessary to have regard to a further premise on which its proponents rely. They see a failure to make provision as assuming the earning of future income. In other words, the tax liability needs to be calculated on the basis that an asset will be recovered at its carrying amount and no more<sup>28</sup>. Therefore, no matter how strong the evidence to the contrary, Entity A must draw up its financial statements on the basis that the asset will be recovered at its carrying amount of CU100. On that assumption, the sale of the asset would give rise to a tax expense of CU30. That is the amount of the liability that application of the principles of the temporary difference approach would require.
- 2.17 There is, however, no clear basis for this additional assumption. Indeed a prohibition on considering future income is contrary to the normal way in which the recoverability of assets is assessed. IAS 36 *Impairment of Assets*, requires that an asset be stated at no more than its value in use (unless fair value less costs to sell is greater), and in calculating value in use the aggregate net cash flows attributable to the asset are taken into account. This includes both future income and future expenses which are not reflected as liabilities and assets.
- 2.18 Although IAS 36 requires that value in use is calculated on pre-tax amounts, it demonstrates the principle that the value of assets is justified by future cash flows. Indeed the reason that IAS 36 prohibits consideration of tax cash flows in determining value in use is because it is assumed that tax effects are taken into account by the application of the temporary difference approach. Appeal to IAS 36's prohibition cannot therefore be used to justify the temporary difference approach.
- 2.19 In short, the objection to the temporary difference approach is that even where the tax base of an asset is lower than its carrying amount, that carrying amount may be recoverable in full. This will be the case where the net expected cash flows (including the expected payment of tax) is greater than the carrying amount. If this is right, it is a fatal objection to the invariable recognition of a deferred tax liability in all such cases.
- 2.20 However, it does not show that there is never such a liability. For example, if income is accrued and a corresponding debtor is recognised where the income will be assessed to tax only in a later period when the debtor pays, some would consider it odd not to recognise the tax effects in the same period as that in which the income is recognised. Other approaches suggest ways in which this should be done, but do not require tax allocation in respect of all temporary differences.

### Practical implications of the temporary difference approach

#### *Meeting the needs of users*

- 2.21 As noted in paragraph 2.7 above, in principle under the temporary difference approach, the total tax expense recognised in a period equals the standard rate of tax applied to pre-tax income, except for the effect of items that have no tax consequence. This relatively stable relationship may be useful in assessing the likely future reported effective tax rate that will apply to the entity's income. Some, however, would consider that the most relevant information is that which assists assessment of future cash flow rather than future reported income.

#### *Manner of recovery*

- 2.22 As noted above (paragraph 2.9) as preparers have become familiar with the IAS 12, workable solutions have been found to many issues, including those associated with the concept of a 'tax base'. Some difficulty remains, however, with the need to consider what 'manner of recovery' should be assumed, for example where different tax implications arise on sale of the asset from those that arise if its use is continued<sup>29</sup>.

<sup>28</sup> This assumption was stated clearly in FAS 96 *Accounting for Income Taxes* (a predecessor of FAS 109) that also was based on the temporary difference approach. It stated as one of its 'basic principles' that '*the tax consequences of earning income...in future years... are not anticipated for purposes of recognition and measurement of a deferred tax liability*' (paragraph 7). This was the subject of the dissenting opinion of FASB Board member David Mosso.

<sup>29</sup> This has most recently resulted in an amendment to IAS 12 *Deferred Tax: Recovery of Underlying Assets* (December 2010).

- 2.23 One instance in which this issue arises is in connection with legitimate tax-planning opportunities and strategies. It is, for example, common in some industries for assets to be held in a single-purpose entity (referred to as a ‘wrapper’) rather than being directly owned by the reporting entity. One of the reasons for using this structure is that it enables a sale to be made of the entity, which may have significantly smaller tax consequences than would arise on the sale of the asset itself. However, the temporary difference approach requires tax effects to be quantified based on the disposal of the underlying asset, creating a reported deferred tax liability that is considerably greater than the amount that is expected to arise in practice.

#### *Application of the principles of the temporary difference approach*

- 2.24 Some question the relevance of amounts reported under the temporary difference approach to cash flows, and therefore whether it provides information that is helpful to users. In their view there are some cases where the relationship between the tax effect of a temporary difference and a future cash flow is obscure and seems remote. The significance of this issue would be reduced, but perhaps not fully resolved, if the amounts recognised in the balance sheet were discounted.
- 2.25 The remainder of this Chapter discusses some of the cases where this criticism is sometimes made. For some of these, IAS 12 provides exceptions. Critics of IAS 12 would point out that exceptions increase the complexity of the standard and call into question the validity of the fundamental principles of the temporary difference approach. Exceptions in a standard also make it difficult to understand the meaning and significance of information resulting from its application.

#### *The exception on initial recognition*

- 2.26 One example is that of the exception allowed by IAS 12 for temporary differences arising on the initial recognition of an asset. Application of the principle of the temporary difference approach would require the recognition of a tax liability on the acquisition of an asset that will not be fully deductible for tax purposes and is recorded at cost. (An illustration of this appears at paragraph 2.13 above.)
- 2.27 If there were no exception, it would be necessary to specify the accounting treatment of the debit corresponding to the liability. The most obvious possibilities are:
- (i) to report it as an expense arising on acquisition of the asset. But this seems not to reflect economic reality. Businesses rarely acquire assets that lead to an immediate expense: the usual position is that the asset is expected to provide a return greater than its cost after considering all implications, including tax. Hence recognition of a loss would seem to be inappropriate.
  - (ii) to adjust the carrying amount of the asset by the amount of the liability. As IAS 12 notes, ‘such adjustments would make the financial statements less transparent’.
- 2.28 The 2009 Exposure Draft proposed that assets should be recognised at an amount that excludes any entity-specific tax effects, and report as deferred tax (i) the effect of a temporary difference; (ii) the entity-specific tax effects and (iii) the difference between the consideration paid and the total amount recognised for the asset and other elements of deferred tax. Respondents rejected this proposal, mainly because of its complexity.

#### *Revaluations and foreign currency translation differences*

- 2.29 The measurement basis that is used for financial reporting may differ from that for tax purposes. For example, assets may be measured at fair value whilst tax is based on historical cost. In such a case, application of the temporary difference approach requires that a liability be recognised for the difference between fair value and a lower historical cost amount.
- 2.30 In some cases, for example where financial investments are recorded at fair value through profit or loss, then few would question providing for the tax liability that would arise on the disposal of the investment at its carrying amount.
- 2.31 The position is not as clear-cut in other cases. For example, under IAS 16, property plant and equipment may be revalued to fair value. The following example illustrates the point:

Entity A revalues its production plant above its original cost because its accounting policy is to measure property, plant and equipment under IFRS at fair value. The original cost is CU100 and entity A revalues it to CU150. The tax balance sheet reflects no such revaluation and the revaluation itself will not be taxed. The tax base of CU100 is deductible as the asset is used. Entity A has no intention to sell the asset, and indeed could not do so without considerable disruption to its business. But if the asset were sold, the tax base would be the same (CU 100) and the same rate of tax would apply.

Under the temporary difference approach, the revaluation difference of CU50 results in a taxable temporary difference for which a deferred tax liability is recognised

- 2.32 The rationale for providing the tax is that entity A will use the production plant to generate future economic benefits that are expected to result in taxable profits, but the corresponding tax deduction (i.e. the depreciation charge) will be limited to the original cost of the plant. Therefore, the revaluation will be taxed indirectly (as it is realised through use) and a deferred tax liability arises.
- 2.33 Some argue that it is inappropriate to recognise a deferred tax liability in these circumstances. They argue that the financial statements should represent the tax position at the reporting date and should not take into account events that may occur after the reporting date. As there is (in this example) no possibility of sale, the only prospect of tax becoming payable in respect of the revaluation is when future revenues are earned. In their view, recognising a tax liability on future revenues is contrary to the fundamental principle that a liability is recognised only when an obligation exists.
- 2.34 Those who support providing a deferred tax liability would counter that the future profits represented by the asset have already been recognised by means of the revaluation. The increase in value represented by the revaluation will only be realised through future use, which will yield profits that will be taxable, and it would therefore be inconsistent not to recognise the tax on the revaluation.
- 2.35 A similar situation arises in respect of assets that are held in a foreign operation. When such assets are retranslated at current exchange rates, the amount at which they are reported changes, and the effect of this change is reported in 'other comprehensive income'. Where, as is usually the case, such changes have no tax effect, a temporary difference arises. As a result, the tax effect is reported with the effect of the change in the asset in other comprehensive income. However, some contend that the tax effect of such differences is so remote that recognition of a deferred tax asset or liability is inappropriate. (A similar issue may arise when an entity's functional currency is different from its local currency, and the tax basis is determined in local currency.)

#### *Business combinations*

- 2.36 IAS 12's exception for temporary differences arising on initial recognition does not extend to assets and liabilities arising from a business combination. Accordingly, deferred tax is recognised for the differences between the tax bases and the fair values of the identifiable assets acquired and liabilities assumed. As a result, significant deferred tax liabilities are often recognised at the acquisition date.
- 2.37 A consequence of this is to increase the amount at which goodwill is recognised. Therefore goodwill represents the difference between the consideration paid and the after-tax value of the assets and liabilities acquired, which is usually lower than their pre-tax values.
- 2.38 IAS 12 acknowledges that goodwill is often not deductible for tax purposes and that therefore a temporary difference arises. But it does not permit the recognition of the tax effect on this difference because 'goodwill is measured as a residual and the recognition of a deferred tax liability would increase the carrying amount of goodwill' (IAS 12, paragraph 21).

### *Intragroup transfers of assets*

- 2.39 The transfer of an asset (such as inventory) may give rise to a net reported tax gain or loss in the consolidated financial statements. This seems counter-intuitive because, in accordance with the established principles of consolidation, the gain or loss on the sale is eliminated, and yet there is a tax effect.
- 2.40 For example, assume Subsidiary A sells inventory to Subsidiary B. Subsidiary A previously recorded the inventory at its cost of CU80, and the transfer price is CU100. Subsidiary A pays tax at 25%, and so the transaction increases its tax for the period by CU5. Subsidiary B records the purchase at CU100, which is cost to Subsidiary B and also its tax base. On consolidation the sale (but not the tax paid) is eliminated, and so there is a current tax charge for the tax paid by Subsidiary A of CU5. The inventory is stated at cost to the group of CU80, but it has a tax base of CU100. Thus there is a temporary difference, which is quantified at the tax rate applicable to Subsidiary B, say, 40%. Hence the group recognises a deferred tax asset of CU8 (CU100-CU80 at 40% assuming it can be shown the asset is recoverable). This exceeds the group's current tax charge of CU5, and so there is a net tax gain of CU3.
- 2.41 This conclusion is sometimes controversial, but perfectly consistent with the principles of the temporary difference approach.

### *Outside basis differences*

- 2.42 A temporary difference may arise between the tax basis of investments in subsidiaries, branches, associates and joint ventures (often cost) and its carrying amount in the financial statements (which may reflect, for example) undistributed profits. Such differences may also arise due to changes in foreign exchange rates and the recognition of impairment for financial statement but not for tax purposes.
- 2.43 As the IASB confirmed in its 2009 Exposure Draft (BC 42), the principles of the temporary difference approach require the tax effects of such differences to be recognised. However, IAS 12 contains an exception so that such tax effects are not recognised where the parent is able to control their reversal and reversal is not probable in the foreseeable future. In its 2009 Exposure Draft, the IASB proposed to retain the exception for practical reasons.

### *Change in tax basis*

- 2.44 Sometimes the tax basis of an asset (or liability) changes without any change in the carrying amount. For example, the tax law may provide for the tax basis of goodwill to be increased to reflect price changes, or the extent to which the cost of previously acquired assets is deductible for tax purposes may be reduced. Strict application of the temporary difference approach requires that the tax effect of the change in the temporary difference is recognised (subject, in the case of a deferred tax asset, to recoverability).
- 2.45 This is particularly controversial when the temporary difference reflects consequences that will arise only on the sale of the asset and that sale is only a remote possibility.

## CHAPTER 3 Flow-through

### Overview of the flow-through approach

- 3.1 This Chapter discusses the ‘flow-through’ approach to accounting for income tax, which is also sometimes referred to as the ‘current taxes payable approach’. Under this approach, the only tax expense that is recognised in the financial statements is current tax—that is, the amount assessed on profit of the current period. The result is that the current tax assessment ‘flows through’ to the expense shown in the profit and loss account.
- 3.2 No attempt is made to allocate the tax effect of timing differences. For example, no liability is recognised when, as with accelerated depreciation, greater tax relief is given in an accounting period than is recognised for accounting purposes and the position will reverse in a later period. The premise of flow-through accounting is that no such liability exists at the end of the reporting period. It is argued that, although future tax charges will be expected to be higher than normal, it is contingent on future events, such as the earning of profits and no change in the tax laws before the expected reversal.
- 3.3 In the view of its proponents, flow-through accounting provides the most meaningful information on the tax effect of the profit for the current year by reporting the amount of tax actually payable in respect of those profits. In their view, flow-through accounting is faithful to the fundamental nature of income taxes, because it treats it as a charge on the whole of an entity’s income, and does not seek to portray the tax as relating to individual transactions or events.

### The case for the flow-through approach

- 3.4 Perhaps the most obvious advantage of flow-through accounting is its simplicity. The amount of tax that falls to be assessed on the current year’s income will often be known with a high degree of verifiability and little subjectivity.
- 3.5 It is also easy to understand the amounts that are reported in the financial statements. The liability represents an amount that is actually due to the tax authorities. The tax charge in the income statement represents the amount of this liability that has been incurred as a result of the profit made during the period. Because financial statements are prepared for reasonably knowledgeable users, they should understand that flow-through accounting does not attempt to portray the future tax implications of transactions and events of the current period<sup>30</sup>.
- 3.6 An implication of flow-through is that the total tax expense recognised in a period is affected by timing differences: for example, the tax expense is lower than the standard rate of tax in the period in which an accelerated tax relief arises and higher in a later period. Advocates of flow-through accounting argue, however, that this reflects the economic reality, and that allocation of tax on timing differences is simply a device to produce an artificially smoothed number, which is relevant only to the prediction of future artificially smoothed numbers. They may add that no useful purpose is served by smoothing the tax expense as it is simply the consequence of government policy which is inherently unpredictable and outside the control of the entity.
- 3.7 Sometimes flow-through advocates draw an analogy between distributions and tax. Both are unlike expenses, which are generally incurred with a view to the making of profits. In contrast, taxes and distributions are paid, they contended, to give parties outside the company a share of the company’s profits. For both taxes and distributions there is only an indirect relationship between the profits for the period and the amount paid. In their view, the case for anticipating future tax charges (and reliefs) is not stronger than that for anticipating future distributions.
- 3.8 Flow-through supporters may also argue that tax allocation is an incorrect concession to the practice of investors of focussing on after-tax earnings. Investors would, it is contended, be better served by focussing on pre-tax earnings, and then making an adjustment for tax, in a manner somewhat similar to valuing a company before interest and then deducting the value of debt (or adding the value of cash and marketable investments) to arrive at the value of equity.

<sup>30</sup> IASB’s *Framework* states that financial reports are prepared for users who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently (paragraph QC32). The original 1989 *Framework* also assumed a reasonable knowledge of accounting.

### Comments on the case for the flow-through approach

- 3.9 Not everyone would agree that it is plausible to see income tax simply as the arbitrary result of government policy of an external party, inherently unpredictable, outside the taxpayer's control and with no necessary relationship to the profits made in the period. Although the profit on which tax is assessed often differs significantly from the profit for accounting purposes, it is essentially a charge on that profit, and it seems to be necessary for financial reporting to report not only the profit but its tax implications if a full picture of the consequences of transactions and events in the period is to be given.
- 3.10 It may be considered implausible to assume that tax is wholly beyond the company's control. Management should be aware of the tax implications of the transactions they engage in and consider means by which both current and future tax expense may be minimised, and hence after-tax profit maximised. The role of management is to maximise after-tax profit rather than pre-tax profit from which the share taken by government has to be deducted.
- 3.11 This, however, does not imply that users do or should focus exclusively on after tax profit. It is agreed that such a focus is likely to be deceptive and unreliable, because the relationship between tax and pre-tax profits is not constant, but varies for a number of reasons. But the need for thoughtful analysis of profit and tax makes the case for disclosure about factors that have affected the current tax charge and those that may affect it in the future. It does not establish that allocation in respect of timing differences is inappropriate.
- 3.12 Tax planning strategies may minimise the burden of tax either by avoiding a liability completely or, less successfully, by postponing it to a future period. A consequence of flow-through accounting is that the financial reporting is similar for the two cases. Opponents of flow-through would suggest that the difference between the two cases should be reflected in the financial statements. Their point might be expressed as saying that flow-through accounting does not assist comparability, because it reports dissimilar transactions as if they were similar<sup>31</sup>.

### Practical implications of the flow-through approach

#### *The case for exceptions*

- 3.13 Most advocates of flow-through concede that some exceptions would be required. Some cases where exceptions might be considered are:
- Where income is accrued—for example by recognising a debtor for interest receivable—and tax will be payable in the event that the debtor pays—an event that is assumed in the recognition of the debtor.
  - Where pension contributions are allowed for tax on a cash basis, and a difference of a single day in the receipt or payment of a large contribution would make a significant difference to the reported tax charge.
  - Where profit on long-term contracts is taxed on completion, but recognised for financial reporting purposes as work is done, it is questionable whether it is useful to report the tax only in the period in which the contract is completed.
- 3.14 The need for such exceptions would have to be considered if proposals for a flow-through approach to the accounting for tax were to be developed. It may be possible to confine the need for exceptions to a few relatively large categories such as 'short-term items' or 'large non-recurring items'. Such exceptions would need to be robustly defined.
- 3.15 The accounting approach for items that fell within such exceptions would need to be specified—so the standard would have to contain requirements for tax allocation, even if they were applicable only to relatively few situations. It would also be difficult to claim that a standard that required flow-through accounting with exceptions was soundly based on firm principles, unless principles justifying the exceptions could be identified.

<sup>31</sup> IASB's *Framework* says 'Comparability is the qualitative characteristic that enables users to identify and understand similarities in, and differences among, items'. (Paragraph QC21)



## Disclosures

- 3.16 Like any accounting standard on tax, a standard that required a flow-through method to be used to account for tax would need to require supplementary disclosures to assist users in their assessment of the future tax burden facing the company. It would seem plausible that such disclosures would include information about timing differences. If so, then all such differences and their implications would have to be identified. It would appear that the consequence would be that the burden on the preparer might be about as great as that required by methods that require the effect of timing differences to be reported in the primary financial statements, thus removing one of the main advantages of the flow-through method.
- 3.17 Some may consider that such disclosures are an attempt to correct rather than supplement the main financial statements: they are alerting the reader to misstated assets, liabilities, income and expenses. On this view flow-through accounting is unacceptable, as contradicting the well-established view that the role of note disclosure is to supplement the main financial statements and not make good any deficiencies in their preparation. Furthermore, at least anecdotal evidence suggests that information that is presented in the notes to the financial statements is often prepared with less care, and is less influential with users, than information presented in the main financial statements. Those who take the view that tax effects are assets and liabilities (or affect the measurement of other assets and liabilities) would presumably consider that reflecting the effects of timing differences in the main financial statements is a superior solution to flow-through accounting, even if supplemented by disclosures.

## CHAPTER 4 Partial tax allocation

### Overview of the partial allocation approach

- 4.1 A criticism of recognising deferred tax for all timing differences is that it may result in a large and growing liability being reported, although the prospect of any future payment in respect of it seems to be remote. A partial allocation approach responds to this, by requiring that deferred tax liabilities be recognised only to the extent that they are expected to become payable.
- 4.2 The criticism of full allocation for deferred tax may be illustrated by the example of temporary differences arising where accelerated depreciation on fixed assets is allowed for tax purposes, but a straight-line method is used for financial reporting purposes. It may be shown that, where a business is stable or expanding, new timing differences will arise each year, which will offset the effect of reversing timing differences. In a stable business, the effect will be that the current tax charge approaches a limit of the standard rate of tax on profits for the year, but will never exceed it. Where the business is expanding the current tax charge will never be as great as a standard rate<sup>32</sup>.
- 4.3 In such cases, under a partial allocation approach, no provision would be made for deferred taxes. Provision would, however, be made in other cases where, and to the extent that a net reversal of timing differences was foreseeable—that is, if it could be foreseen that in the future reversing timing differences would be greater than newly-originating differences.
- 4.4 A form of partial allocation was permitted in the United States under Accounting Research Bulletin 43, which did not require tax allocation “where there is a presumption that particular differences between the tax return and the income statement will recur regularly over a comparatively long period of time” (Chapter 10B, paragraph 1). More recently a partial allocation approach has been required or permitted in the United Kingdom, South Africa, and New Zealand, and in the original version of IAS 12 (1979). However, such requirements have now been superseded.

<sup>32</sup> The position has been demonstrated more formally with worked examples in ‘Accelerated Depreciation and the Allocation of Income Taxes’ by Sidney Davidson, in *The Accounting Review*, Vol. XXXIII, No.2, April 1958 at pages 173-180.



### The case for the partial allocation approach

- 4.5 The argument in favour of the partial allocation approach is that the amount reported in the statement of financial position has a clear meaning—it is the effect on future tax payments attributable to past transactions and events. It has clear relevance to the assessment of future cash flows, which is one of the main concerns of users of financial statements.
- 4.6 This contrasts with the liability resulting from the application of a comprehensive allocation approach, some of which may result in cash effects over widely varying future periods, and some of which may be unlikely to result in any cash effects at all.
- 4.7 Advocates of partial allocation may contend that the only liability is to the tax authorities, and that while it is reasonable to recognise the extent to which timing differences are likely to result in a future cash outflow, there is no case for recognising further amounts, where any future outflows are at most uncertain as to their timing and dependent on a number of future contingencies.
- 4.8 In a growing business other liabilities, such as those for trade payables, may increase indefinitely. No one suggests that such liabilities should not be recognised. Supporters of partial allocation consider, however, that the two cases are not analogous. One has made the point as follows:

*“Accounts payable arise from actual, specific transactions in which identifiable goods and services are received. Each account is owed to a designated party and the amount of the obligation and the due date are usually set forth unambiguously on the written document that serves as the basis for the recognition of the payable. Actual cash payments to creditors are made regularly, even though other payables may at the same time be taking the place of those liquidated. The legal necessity to make those payments is not conditioned by any question about future operations being profitable. The “roll over” of transactions in accounts payable is real and undeniable.<sup>33</sup>”*

- 4.9 Advocates of partial allocation may view other methods of tax accounting as involving a mechanical or arithmetic exercise, which may provide results that are removed from the economic environment in which the entity operates. By requiring a focus on the amounts that will actually be paid, the partial allocation approach, in their view, ensures that the financial reporting is relevant to, and faithfully reflects, the economic position of the entity.

### Comments on the case for the partial allocation approach

- 4.10 Those who oppose the partial allocation approach note that, whilst the amount reported in the statement of financial position may have a clear significance, this is not as clear for the reported tax expense. It will, of course, include the tax assessed for the period, and to this will be added the effect of some, but not all, timing differences arising in the year. Whilst clear presentation and disclosure would assist users, the risk of some incorrect inferences being drawn from the reported tax expense would still remain to some extent.
- 4.11 Some consider that the most fundamental objection to the partial allocation approach is that at least some timing differences do give rise to liabilities and assets. These need to be reflected in financial reporting if it is to be representationally faithful and complete. Those who hold this view may note that other balance sheet items are continually replaced, but this is not a valid reason for omitting them from the statement of financial position. They may agree that where the effect of timing differences is to defer the payment of tax for a long period, recognising the resulting liability in full would overstate its economic significance, but would counter that it is more conceptually sound to discount the liability than not to recognise it.
- 4.12 The discussion on partial allocation so far has focused on accelerated depreciation, as that is the case to which partial allocation seems particularly well suited. It is not clear whether it would lead to useful and appropriate results in other cases: this would require a detailed consideration that is not attempted here.

<sup>33</sup> Comments by Sidney Davidson in “Interperiod Allocation of Corporate Income Taxes” by Homer A. Black (Accounting Research Study No. 9). AICPA, New York, 1966.

- 4.13 It may be recalled, however that in the UK the original version of SSAP 15 *Accounting for Deferred Taxation*, although generally requiring a partial allocation approach, required full allocation for short-term timing differences. Thus if partial allocation is to be adopted, one should consider whether it is necessary to differentiate between different classes of timing differences.

#### Practical implications of the partial allocation approach

- 4.14 The cost of preparing financial statements under a partial allocation approach will be greater than under a comprehensive allocation approach, such as the temporary difference approach. This is because it would be necessary both to identify all timing differences, and to forecast not only when existing differences will reverse, but also the future differences that will offset those reversals. This may sometimes be a significant exercise.
- 4.15 However, users might be expected to be interested in the distinction between those timing differences that will reverse in the foreseeable future and those that will not. Users who are interested in assessing future cash flows will have to estimate the amounts of these. The use of a partial tax allocation approach might therefore be expected to reduce the costs incurred by such users: it will also arguably provide more relevant and reliable information if the distinction is made by management who have detailed knowledge of the entity's circumstances and plans.
- 4.16 Nonetheless, some users will wish to make their own assessment of the likely incidence of future reversals of timing differences. If it is accepted that financial statements should contain sufficient information to meet the needs of such users, disclosures would be necessary of all timing differences, with separate information on the amounts for which provision has been made and those for which it has not. There is a risk that such disclosures would be voluminous and costly to prepare.
- 4.17 Forecasting also involves reliance on subjective estimates. If a partial allocation approach were to be required, it may be necessary for an accounting standard to set out specific requirements for the nature of the information to be used and the period that it might cover. This would add to the complexity of the standard. There are, however, some precedents for material of this nature in accounting standards, for example, in IAS 36 *Impairment of Assets*.
- 4.18 A partial allocation approach faces the challenge of reporting changes in circumstances. When a business can no longer be confident that, due to continued expansion, the reversal of timing differences can be postponed indefinitely, provision will be required. This may have a significant adverse effect on the reported profits and financial position, perhaps at a time when the company is already under financial pressure. This may cast doubt as to whether the financial statements for earlier periods gave a fair presentation.

## CHAPTER 5 The Valuation Adjustment approach

### Overview of the valuation adjustment approach

- 5.1 The valuation adjustment approach, which is sometimes referred to as the net-of-tax approach, is based on the premise that timing differences do not give rise to deferred tax assets and liabilities. They do, however, affect the amount of assets and liabilities, which should be adjusted accordingly.
- 5.2 An asset, on this view typically provides two distinct streams of benefit: (i) its ability to provide service and (ii) tax benefits. Because these will not arise in the same accounting periods, it is necessary to account for these separately. For example, where accelerated depreciation is received, the tax benefit would reduce the carrying amount of the asset.
- 5.3 The following example is based on one provided in FAS 109. Suppose equipment which has a four-year life is purchased at a cost of CU1,000. A tax rate of 40% applies. Under the valuation adjustment approach, the asset would be seen as providing services of CU600 and tax benefits of CU400. It is assumed that the amount deducted for tax and hence the value of the relief is as follows:

	Tax deduction	Relief at 40%
	CU	CU
Year 1	400	160
Year 2	300	120
Year 3	200	80
Year 4	100	40
<b>Total</b>	<b>CU1,000</b>	<b>CU400</b>

5.4 Assuming the services consumed are recognised on a straight-line basis, the asset would be written off as follows:

	Services consumed	Tax benefit	Total recognised expense	Tax relief	Expenses after tax
	CU	CU	CU	CU	CU
Year 1	150	160	310	(160)	150
Year 2	150	120	270	(120)	150
Year 3	150	80	230	(80)	150
Year 4	150	40	190	(40)	150
<b>Total</b>	<b>CU600</b>	<b>CU400</b>	<b>CU1,000</b>	<b>CU(400)</b>	<b>600</b>

5.5 The carrying value of the asset is as follows:

	Beginning of year	Written off in year	End of year
	CU	CU	CU
Year 1	1,000	310	690
Year 2	690	270	420
Year 3	420	230	190
Year 4	190	190	
<b>Total</b>		<b>CU1,000</b>	

## The case for the valuation adjustment approach

5.6 Supporters of the valuation adjustment approach may argue that it reflects more faithfully than other methods the economic results of investment. Rational investment decisions are made by reference to the expected after-tax return. Management should be willing to pay a higher price for an asset that provides early tax deductions than for an asset that cannot be deducted for tax, or where any deductions arise later. The valuation adjustment faithfully reflects the economic consequences of owning a tax-deductible asset. In particular, it may be noted that the carrying amount of the asset reflects the value (as represented, in this example, under the historical cost convention) of services and tax benefits to be derived in the future.

## Comments on the case for the valuation adjustment approach

### *Presentation of pre-tax and post-tax amounts*

5.7 Whilst it appears difficult to challenge the point that assets typically provide both service potential and tax benefits, there are a number of objections to attempting to reflect these separately in the carrying amount of assets and liabilities.

5.8 One of the main reasons that users require distinct reporting of pre-tax amounts and their tax consequences is that the factors that affect an entity's pre-tax results are different from those that affect its tax position. However, as the alternative name of 'net-of-tax' reporting suggests, this information is obscured under the valuation adjustment approach.

5.9 The carrying amount of assets under the valuation adjustment approach is a combination of amounts to be derived from future service and future tax reliefs. The presentation of the amount written off assets to reflect the consumption of tax benefits (CU160 in the example given above) is an even greater challenge under the valuation adjustment approach. There are various approaches, all open to possible objections, as follows:

- It cannot meaningfully be presented as part of the charge against pre-tax income, as to do so would imply that pre-tax expenses are greater in earlier periods of the asset's life than in later periods.
- If it is dealt with in the tax line (so that the reported tax expense would represent the current tax charge, plus the cost of purchasing tax benefits utilised in the period) then only the part of the purchase cost deemed to be in respect of services would be charged against pre-tax profits. Some would object that this is incorrect: CU600 is the after-tax cost of the services of the asset over its whole life; the correct charge against pre-tax profit is the pre-tax cost, which is clearly CU1,000.
- The pre-tax charge could be found without regard to tax. Assuming a straight-line basis is used, the charge against pre-tax profit would be CU250 in each year, and the difference between that amount and the tax benefit would be recorded as tax expense or income. The result would be that pre-tax expense, total tax expense and post-tax expense would be equal in each of the four years. This approach effectively treats the difference between book and tax depreciation as a timing difference, which is similar to the requirements of IAS 12. The only difference is that the credit is presented as a reduction in the asset rather than as a liability. Black's observation<sup>34</sup> that this 'avoids misleading presentation in the income statement but denies the basic assumption of the net-of-tax method' seems valid.

5.10 The above discussion has illustrated the valuation adjustment approach by reference to property, plant and equipment. It would seem that a meaningful presentation of the income statement under the valuation adjustment approach is even more difficult to devise in other cases, for example, accrued income that will be taxed in the following accounting period.

### *Analysing the carrying amount of an asset*

5.11 It is a central premise of the valuation adjustment approach that the carrying amount of an asset can be analysed between service potential and tax benefits. One method of doing this is to quantify the tax benefits and assume that the balance represents service potential. This pragmatic method seems arbitrary and without a conceptual foundation<sup>35</sup>. The full cost of an investment may be fully justified by its pre-tax return: in such a case writing down the asset simply because it has incidentally yielded a tax benefit would (at least arguably) understate its value.

<sup>34</sup> "Interperiod Allocation of Corporate Income Taxes" by Homer A. Black (Accounting Research Study No. 9). AICPA, New York, 1966, page 57.

<sup>35</sup> FAS 109 suggests "That approach seems to allocate too much cost to tax benefits and too little cost to benefit from use of the asset" (paragraph 215).

- 5.12 Critics of the valuation adjustment approach may also draw attention to the multiplicity of economic benefits and expenses that may flow from ownership of an asset. Although IFRS require each part of an asset to be depreciated separately where they are significant and have different useful lives<sup>36</sup>, in practice uncertainties are so pervasive that only the most general approximation of depreciation can be made, using depreciation methods such as straight-line and reducing balance. In particular, widely used depreciation methods do not reflect the time value of money, which will often be as significant as tax benefits. It may be thought unwise to build a steeple of perfection on such marshy foundations.

*A focus on individual assets and liabilities*

- 5.13 Although it is often useful to provide information on the tax effect of individual transactions and events, income tax is assessed on the whole of an entity's income. The valuation adjustment approach requires consideration of the tax effects of individual assets and liabilities, and this seems to raise new questions. For example, if part of the cost of an asset is deducted for tax purposes, but the entity is unable to benefit because it makes a tax loss, should the carrying asset be reduced? Would it be necessary to confirm that the future tax benefits that are part of the carrying value of an asset under the valuation adjustment approach are likely to be realised? Difficulties may be especially acute where for tax purposes capital expenditure is pooled into broad classes and relief is calculated on the whole pool.
- 5.14 A valuation adjustment approach would also not seem to deal easily with timing differences where income or expenditure is recognised immediately for tax purposes, but assessed to or allowed for tax over a number of future periods.

*Current values*

- 5.15 Under IFRS assets are sometimes stated at fair value. Fair value is defined as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date'.<sup>37</sup>
- 5.16 Clearly, where fair value is used, tax reliefs obtained by the entity in the past and to be obtained in the future are irrelevant (although the tax relief that would be obtained by another market participant may be relevant). Hence the valuation adjustment approach is inconsistent with the use of fair value as a measurement basis.
- 5.17 It would in principle be possible to apply the valuation adjustment approach to assets that are stated at current value, by adjusting the market price of an asset to reflect differences between the tax deductibility of the asset that is owned and that which could be obtained on the market. However, this may be thought excessively hypothetical. It may also be objected that, because the measurement will depend on the circumstances of the entity, it is entity-specific rather than market-based and therefore inconsistent with the principles of fair value accounting, as set out in IFRS 13 Fair Value Measurement.

**Practical implications of the valuation adjustment approach**

- 5.18 As noted above, the valuation adjustment approach is challenged in presenting information in the financial statements that clearly distinguishes pre-tax amounts from the associated tax effect. This seems to limit the usefulness of information as the factors that affect the future financial performance and position differ from those that affect the future tax burden. Providing separate information about items and their tax effects in the notes to the financial statements is likely to be complicated and burdensome.
- 5.19 Preparing financial statements under the valuation adjustment approach requires records to be kept of the tax effects of all assets and liabilities. However, this is already required by the temporary difference approach of IAS 12, and it may therefore be that preparation of financial statements under the valuation adjustment approach would not cause a significant increase in the burden.

<sup>36</sup> IAS 16, paragraphs 43-47.

<sup>37</sup> IFRS 13 Fair Value Measurement, paragraph 9.

## CHAPTER 6 The accruals approach

### Overview of the accruals approach

- 6.1 Under the accruals approach the tax effects of all income and expenses are recognised. This principle is applied whether or not the tax effect is taken account of in the assessment to tax of the current or a future period. Thus there is no fundamental distinction between current and deferred tax (although the information on the current tax assessment would probably be disclosed, as it has cash flow implications). The result of applying this approach is that the reported tax expense is equal to tax payable at a standard rate on the pre-tax profit for the year, apart from the effect of transactions that have no tax consequence, adjustments to taxes for prior years and discounting.
- 6.2 For example, the accruals approach requires that the tax that will be payable as a result of a taxable sale should be recognised when that sale is recognised in the financial statements. The period in which the sale is assessed to tax is irrelevant to recognition of the tax effect.
- 6.3 The accruals approach also requires that any part of the tax assessment for the current period that relates to income or expense of a future period is treated as an asset or liability and recognised as income or expense in the same period as the related item.
- 6.4 The accruals approach is similar to the ‘liability method’ approach set out in the original, 1979, version of IAS 12<sup>38</sup>. In this chapter it is characterised as ‘the accruals approach’ to emphasise that it is simply the application of the concept of accruals to all tax effects, rather than assuming that the process is first to recognise an expense for the current tax assessment and then make adjustments for timing differences. Moreover, the ‘timing difference’ approach was usually seen as a mechanical exercise under which deferred tax assets and liabilities were created as the result of a purely arithmetical procedure. Emphasising that the method involves the application of the accruals concept highlights the point that assets and liabilities should be recognised only where it is clear that they will have an impact on the future cash flows of the entity.
- 6.5 Under the accruals approach, the tax effect of marking-to-market is recognised, as this is regarded as an application of the accruals concept. Tax effects are also recognised on revaluations and foreign currency translation differences that are reported in other comprehensive income, as their recognition is also the recognition of income.
- 6.6 Tax effects are not recognised under the accruals approach for temporary differences that are not timing differences, for example, on the initial recognition of an asset at an amount in excess of its tax basis in a business combination.
- 6.7 It would be consistent with the rationale of the accruals approach to discount amounts that will not impact cash flows immediately, as they represent future increases or decreases in a payment of tax.

### The case for the accruals approach

#### *Application of accruals to tax*

- 6.8 The accruals approach is founded on the premise that the financial reporting of income tax should be based on the same accrual convention that is used for other items of income and expense. Its supporters, whilst acknowledging that the complexity of tax gives rise to difficult financial reporting issues, do not believe that it is necessary to devise special accounting techniques to deal with tax. In their view application of the usual conventions will provide conceptually correct solutions that provide useful information to users.

<sup>38</sup> That version of IAS 12 also permitted the deferral method, under which deferred amounts were not considered to represent rights to receive or obligations to pay money, and accordingly were measured at the rate applying when originally recognised. Because this method requires the recognition of items in the statement of financial position that are not assets and liabilities, it is inconsistent with IASB’s Framework and is not discussed in this paper. The 1979 version of IAS 12 also permitted the partial allocation approach, which is discussed in Chapter 4.

6.9 The IASB's *Conceptual Framework for Financial Reporting* 2010 states:

*Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the same period in which those effects occur, even if the cash receipts and payments occur in a different period.(Paragraph OB17)*

- 6.10 Supporters of the accruals approach note that, although accruals accounting involves a departure from the cash receipts and payments for the period (and therefore is usefully supplemented by a statement of cash flows), it nevertheless assists in the assessment of future cash flows. For example, a cash receipt is reported as a liability rather than income if it will lead to a future cash outflow, and cash payments are recognised as assets rather than expenses if they will lead to future cash inflows.
- 6.11 A simple application of accruals arises when an entity recognises taxable income, such as a sale. The accruals approach holds that it would be inconsistent to recognise a taxable sale without also reporting the tax that will be payable. Supporters of the accruals approach maintain that should be the case irrespective of whether the tax effect will be reflected in an assessment of the tax payable for the current or a future period.
- 6.12 The same reasoning requires the tax deductibility of expenses to be reflected in the financial statements in the period in which the expenses are reported. For example, if expenses have been accrued in the financial statements but will be allowed for tax purposes only in a later period (perhaps when the cash outflow occurs), the related increase in the tax assessment for the current period is treated as a prepayment of tax that will be payable in a later period.
- 6.13 The accruals approach also requires elements of the tax assessed for the current period to be treated as accruals and prepayments where they relate to items of income and expense that will be included in financial reports for a later period. For example, development costs may be allowed for tax purposes in the period in which they are incurred, but capitalised for financial reporting purposes, and amortised in later periods. Under the accruals approach the reduction in tax is deferred and reported as an expense in the same period as the development costs are amortised. Accelerated depreciation is a relatively common example of expenses being recognised for tax earlier than for accounting purposes. To the extent the current tax assessment has been reduced by such items, the reduction should be deferred by an accrual for future tax.
- 6.14 Similarly, if the current tax assessment includes income that will be reported for financial reporting purposes in a later period, the tax effect should be treated as prepayment of future tax.
- 6.15 To summarise, under the accruals approach the amount reported as 'tax on profit for the year' should include all and only the tax consequences of income and expenses that are recognised in the period. Where the tax consequences are not reflected in the current period's tax assessment they should be accrued, and to the extent that the tax assessment includes items of income and expenses that will be included in profit and loss in future years, it should be adjusted for the accrued and prepaid elements.

#### *Assets and liabilities*

- 6.16 Supporters of the accruals approach believe that the prepayments and accruals that it requires to be recognised are consistent with the definitions of assets and liabilities that are set out in IASB's *Framework*. They reject the view that is held, for example, by some supporters of the flow-through approach, that a liability does not exist before the end of the reporting period. In their view, a liability to tax arises when taxable income arises, and an asset arises when tax deductible expenses are incurred.
- 6.17 Although the accrual of income and expense takes place in the same period, in the opinion of supporters of the accrual approach, the recognition of the tax effect is not merely an accounting device to artificially smooth reported income. They argue that, while reporting of income and expenses must be consistent, their justification is the economic circumstance, not the reporting of the other item. If the circumstances justify the reporting of taxable income and expenses, they will also justify the reporting of the tax effect.

- 6.18 For example, if it is justifiable to report a sale and a related debtor, it is also necessary to report the tax effect of the sale. If the sale is taxable only on the receipt of cash, which will take place in a later accounting period, then it is contingent only on an event (the receipt of cash) that has been assumed in the recognition of the debtor. Thus the same events require recognition of the sale and its tax effects, but the tax effect arises because the sale has occurred, not because it has been recognised.
- 6.19 Similarly where the current tax assessment includes items that relate to income and expenses that will be reported in future periods, there is also, in the view of those who support the accruals approach, an asset or liability that should be recognised.

#### *Remeasurement of assets and liabilities*

- 6.20 Assets and liabilities are sometimes remeasured to reflect current values. For example, many financial instruments are stated at fair value. The recognition of increases in fair value is one means of implementing an accruals approach to accounting, and accordingly, under the accruals approach, the tax effect of such increases and decreases is recognised.
- 6.21 Some remeasurements are recognised in other comprehensive income rather than in profit and loss. These include revaluations under the revaluation model in IAS 16 *Property, Plant and Equipment* and foreign currency translation differences recognised under IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Because these too represent the recognition of income, their tax effects are also recognised under the accruals approach<sup>39</sup>.

### Comments on the case for the accruals approach

#### *Consistency with the Framework*

- 6.22 An important motivation for the development of the temporary difference approach was the apparent failure of an approach that recognised the tax effects of timing differences to comply with the balance sheet perspective required by standard-setters' conceptual frameworks. The frameworks require that only assets and liabilities are reported in the statement of financial position. A temporary difference approach therefore seemed to align better with a balance sheet conceptual framework because it is built on the values of assets and liabilities.
- 6.23 Although this was clearly a valid criticism of the timing difference method, whose objective was 'proper matching' without considering whether the deferred amounts were assets or liabilities, supporters of the accruals approach argue it is not a valid criticism of that approach. They insist that the amounts reported in the statement of financial position are assets and liabilities as defined in the Framework. Although cases where recognition of tax effects is required may in practice be identified by considering the flows of the period (income, expenses and amounts assessed to tax) their recognition in income is deferred only where there is an evident effect on future results, which will affect future cash flows. (The consistency of accrued liabilities under the accruals approach with the Framework is considered further in paragraphs 6.29-6.32 below).

#### *Failure to recognise the tax effect of all temporary differences*

- 6.24 Supporters of the temporary difference approach would criticise the accruals approach because it appears to lead to inconsistencies. They might note that the carrying amount of an asset may exceed its tax base (that is there is a temporary difference) for a number of different reasons, for example:
- (a) accelerated depreciation has been received for tax purposes, while the basis used for depreciation for financial reporting is straight-line;
  - (b) the asset has been revalued to fair value, whilst its tax base is its lower cost;
  - (c) an asset on which no depreciation is allowed for tax, in which case its tax base is nil;
  - (d) the asset was acquired in a business combination and is stated at its fair value at the acquisition date, whilst its tax base is the lower cost incurred on its purchase by the acquired entity.

<sup>39</sup> It is outside the scope of this paper to consider whether classification of these items as income is appropriate.



- 6.25 These critics would note that in each case a future tax assessment will include deductions only for the tax base of the asset, whilst the expense charged for financial reporting purposes will be the asset's greater carrying amount. As a result a future tax assessment will be higher than that of a standard rate of tax applied to pre-tax profits. However, under the accruals approach the tax effect is recognised in cases (a) and (b) but not (c) and (d). These four cases appear to be economically similar, and yet under the accruals approach the financial reporting is different.
- 6.26 Supporters of the accruals approach would justify the position by noting that the accruals approach requires provision for future tax restrictions where they are inevitable. Specifically:
- (a) In the case of accelerated depreciation, it is inevitable that a future tax deduction will be restricted (and hence a future tax payment increased): this would be the case whether the asset is sold or used, because tax relief for part of the asset's cost has already been given.
  - (b) In the case of a revalued asset, it is also inevitable that future tax deductions will be restricted compared to the carrying amount when that amount is realised. The restriction would again apply irrespective of whether the asset is sold or held.
- 6.27 They would also note that in the case of an asset on which no depreciation is allowed for tax purposes, the restriction on future tax deductions will have an effect only if the asset is used in the business. In such cases, the cost is generally deductible for tax when the asset is sold. Hence the tax burden arises from use of the asset. They would argue that the purchase and use of a non-deductible asset should be seen as similar to other cases where an entity incurs non-deductible expenditure, where no adjustment is generally made.
- 6.28 Supporters of the accrual approach may also suggest that the same reasoning extends to the case of assets acquired in business combinations, which are accounted for as the acquisition of assets that are partly non-deductible.

*There is no liability*

- 6.29 An opposite criticism of the accruals approach is that it requires liabilities to be reported that do not exist because liabilities are recognised at the same time as taxable transactions. This criticism is consistent with the flow-through approach (discussed in Chapter 3 above) and would be advanced by those who do not believe that a tax liability comes into existence at the end of the period for which tax is not assessed, and that only the amount that will be assessed should be recognised.
- 6.30 This objection may be assessed in the light of the definition of a liability set out in IASB *Framework*, which is as follows:  
*A liability is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. (Paragraph 4.4)*
- 6.31 Supporters of the accruals approach would concede that, at the time a taxable transaction is entered into, there is no amount currently due to the tax authorities. In their view, however, the term 'present obligation' should be interpreted more broadly than this. Once taxable income has been made, an entity does have an obligation to account for that income to the tax authorities and pay tax based on that account. They conclude that there is a present obligation.
- 6.32 They would also argue that there is some possibility of an outflow of economic benefits, because a future tax assessment will be greater than it otherwise would have been. In their view, this is sufficient for the case to fall within the intended definition of a liability. They would acknowledge that the amount of the outflow will be contingent on future events (for example, earning future profits), but take the view that this should be reflected in the measurement of the liability rather than its recognition.
- 6.33 In the view of the supporters of the accruals approach, similar arguments can be advanced that show that deferred assets arising from the proper application of the accruals approach are assets as defined in the Framework. They will provide economic benefits by reducing a future tax payment.

### Practical implications of the accruals approach

- 6.34 Under the accruals approach the reported tax expense is directly based upon the income and expenses that are reported for the period. It is composed entirely of amounts that will affect future cash flows. Whilst, like any method of accounting for tax, note disclosures would be necessary to amplify the amounts reported in the primary financial statements, the approach would appear to provide information that is transparent, understandable and useful to users in assessing the results of the period and likely future results.
- 6.35 It might be expected that the preparation of financial statements under the accruals approach would be less onerous than under the temporary difference approach, as there is no need to take into account the tax effects of temporary differences.
- 6.36 It would appear that under the accruals approach few if any exceptions would be required, thus increasing the certainty of application of the standard. The position under the temporary difference approach and the accruals approach for cases where IAS 12 contains an exception, or where some have argued for an exception, is summarised in an Appendix to this Chapter.
- 6.37 However, it would still require an assessment of the manner and (if the accruals are to be discounted) timing of future tax effects. For example, where accelerated depreciation has been received it will be necessary to determine whether the tax effect should be calculated on the assumption that the asset will be sold or used, if these are taxed differently. This is the same issue as the 'manner of recovery' question that is discussed above in the context of the temporary difference approach.
- 6.38 It also may not be clear when an accrual reverses and should be released to income. For example it was noted above that under the accruals approach tax effects of fair value gains on investments are recognised: for financial reporting purposes, income may be recognised when dividends or capital gains are realised, but it is not immediately apparent which type of income should be regarded as the reversal of a previously-accrued fair value gain. It might be necessary to adopt an arbitrary rule in such cases, for example by requiring that an accrual is assumed to reverse when income, however described, is first received.
- 6.39 More generally, it may be onerous and difficult to reconcile the balance of accruals and prepayments with individual items, especially as some accruals, such as those relating to accelerated depreciation can persist over many years. This is required in order to prove the total amount of such items is correctly stated. Some believe that this is easier under the temporary difference approach, as the carrying amount of assets and liabilities and their tax bases are ascertainable with a high degree of certainty. However, even under the temporary difference approach such an exercise is significantly complicated if exceptions require that the tax effects of not all items be recognised.

## Appendix to Chapter 6

### The application of the temporary difference and accruals approach to certain issues

Issue	Temporary difference (IAS 12) approach	Accruals approach
Initial recognition of a non deductible asset	Exception applies – tax effects not recognised	No accrual – tax effects not recognised
Business combinations: assets and liabilities other than goodwill	No exception – tax effects recognised	No accrual – tax effects not recognised
Goodwill arising on a business combination	Exception applies – tax effects not recognised	No accrual – tax effects not recognised
Revaluation and foreign currency translation differences	No exception – tax effects recognised	Tax effects recognised (as gains are part of 'comprehensive income')
Profits on intra-group transfers of assets	No exception – tax effects recognised, quantified at buyer's rate.	It would be logical for tax effects to be deferred and quantified at the seller's rate.
Outside basis differences	Exception applies – tax effects not recognised	No accrual – tax effects not recognised
Change in tax basis	Tax effects of changes in temporary differences recognised.	No accrual – tax effects not recognised

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## ACKNOWLEDGEMENTS

This paper has been prepared jointly by the staff of the UK standard setter, the Accounting Standards Board (ASB), the German standard setter, the German Accounting Standards Board (GASB), and staff of the European Financial Reporting Advisory Group (EFRAG) as part of Europe's proactive work in financial reporting. The writing of this paper included significant contributions from the Corporate Income Tax project team (Andrew Lennard (ASB Director of Research), Mario Abela (EFRAG Research Director), Isabel Batista (a Senior Project Manager at EFRAG), Dr. Iwona Nowicka (a Project Manager at ASCG) and Jeff Waldier (a Senior Project Manager at EFRAG).

The Corporate Income Tax project team was also assisted by an international Tax Advisory Panel - Carl-Eric Bohlin (Swedish Financial Reporting Board), Elizabeth Chrispin (Deloitte), Matthew Curtis (Ernst&Young), Stig Enevoldsen (Deloitte), Edouard Fossat (Mazars), Norbert Herzig (University of Cologne), Peter Holgate (PricewaterhouseCoopers), Andrew Jones (Makinson Cowell), Olivia Larmaraud (PSA Peugeot Citroën), Ugo Marinelli (OIC-Organismo Italiano di Contabilità), Anne McGeachin (University of Aberdeen Business School), Joanna Osborne (KPMG), Hugh Shields (Credit Suisse), Thomas Senger (Warth & Klein), Alfred Simlacher (Siemens AG), Mitsuhiro Takemura (IASB).