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European Financial Reporting Advisory Group
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Dear EFRAG members

Discussion Paper: Improving the Financial Reporting of Income Tax

The global organisation of Ernst & Young is pleased to submit its comments on the discussion paper *Improving the Financial Reporting of Income Tax* issued by the European Financial Reporting Advisory Group (EFRAG). We very much support the EFRAG's various proactive outreach projects.

Appendix 1 to this letter lists the questions raised in the discussion paper and our responses. Our overall reaction, as you will see from our response to Q0.1, is that we are not convinced that IAS 12 *Income Taxes* is so seriously flawed or misapplied as to require replacement by a new standard based on fundamentally different principles. We also believe that such a change is not a priority for investors and other users of financial statements, preparers or auditors. Additionally, we urge that the benefit of any additional disclosure requirements be weighed very carefully against their cost.

Instead, we favour limited amendments to IAS 12, which would address or clarify the tax reporting of income taxes in certain specific areas. Our responses in Appendix 1 are written on the assumption that there are no constraints on the IASB's resources. However, given the actual constraints on the IASB's resources, and in the context of other topics currently on the IASB's agenda (in particular revenue recognition and leasing), we do not consider that amendments to IAS 12 should be seen a priority for the IASB at present.

Should you wish to discuss the contents of this letter with us, please contact Leo van der Tas at the above address or on +44 (0)20 7951 3152.

Yours faithfully

Ernst & Young

Appendix 1 – Responses to specific questions

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?

We believe that there are a number of areas of IAS 12 in need of revision or expansion, in particular:

- there should be more guidance on the scope of the standard. Issues that cause particular difficulty in practice include:
  - the characteristics of an 'income tax' that distinguish it from other forms of tax;
  - the characteristics of a tax credit that distinguish it from a government grant; and
  - the accounting treatment to be applied where an entity can elect to be taxed under a system other than the 'normal' corporate tax system, but either retains the option of reverting to the 'normal' system or is compelled to revert to it in certain situations. Examples include the 'tonnage tax' systems applicable to some shipping companies, and the effectively tax-free status enjoyed by some investment vehicles that is conditional upon (for example) making a minimum level of profit distribution;
- there should be more guidance on accounting for uncertain tax positions;
- the scope of the initial recognition exception (IRE) should be reconsidered. Specifically:
  - the IRE should not apply to transactions which involve the initial recognition of assets and liabilities with a net carrying amount of zero (e.g. the establishment of a decommissioning provision with a corresponding increase in PP&E, or the inception of a finance lease with the recognition of an equal asset and liability);
  - the treatment of temporary differences arising on 'split accounting' for compound financial instruments should be reconsidered. The requirement of paragraph 23 of IAS 12 to recognise deferred tax on the issue of such an instrument is difficult to reconcile to the initial recognition exception and some other requirements of the standard. This means that it is not always clear whether, and – if so – to what extent it should be applied by analogy to transactions similar, but not identical to, that in Example 4 in the illustrative examples accompanying the standard;
- with respect to withholding taxes, there should be guidance as to:
  - whether IAS 12 applies to all withholding taxes or only those withheld by the types of entity referred to in paragraph 2; and

    - what is meant by a 'withholding tax', as it is often difficult in practice to distinguish a withholding tax (deducted from equity) from a differential tax applying to a distribution (charged to profit or loss); and

- the criteria for recognition of deferred tax assets are not altogether clear. For example:

    - the level of evidence needed to support the existence of future taxable profits is often influenced by the national GAAP applied by the entity before adoption of IFRS. As a result there is some diversity in practice (all acceptable under IAS 12) that could be reduced with additional guidance on the recognition criteria; and

    - in considering our response to the proposed amendments to IAS 12 in the IASB's exposure draft Annual Improvements to IFRSs 2010–2012 Cycle (ED/2012/1), we expect to highlight as a potentially significant issue of interpretation the question of what IAS 12 means by 'taxable profit' in the context of the recognition of tax assets. Our thinking on this area has not yet been fully developed, and we may write to you on this specific point later in the year.

In our view, all these issues can, and should, be addressed by amendment of IAS 12 rather than by development of a completely new standard. Whilst there are undoubtedly some quite significant imperfections in IAS 12, on the whole we believe that it is well-understood and, our comments above notwithstanding, applied with a good degree of consistency. It is worth noting that, although IAS 12 in its current form was issued over 15 years ago, it has taken a number of years for all its various practical problems to emerge, and more will doubtless come to light when it is applied to more tax systems, as more entities and countries adopt IFRS. Based on this experience, there is a real danger that the development of a new standard would focus on trying to solve perceived problems with IAS 12, but (inevitably) fail to identify different problems created by the new standard.

For all these reasons, we favour relatively minor amendments to the existing framework of IAS 12 than development of a new standard based on different principles.

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?

We believe that the relationship between taxes paid and current tax expense may be of interest to investors and other users of financial statements. However, we question whether this information is best delivered by a reconciliation in this format. Most differences between tax paid and current tax expense arise because, in most jurisdictions, the current tax for a period is not fully paid in that period.

Firstly, current tax expense will be an estimate based upon draft calculations prepared at the balance sheet date, whereas tax paid will depend upon final detailed calculations submitted to the local tax authorities. Secondly, tax paid during any one year will likely relate to any number of previous years as well as the current year, whilst current tax expense relates primarily to the current year only. Moreover, local tax authorities often require corporate income tax to be paid in instalments on account during a company's financial year, with further final payment(s) or repayment(s) made after the year end when the final tax calculation has been prepared and submitted. When any of these payment arrangements applies, there is always likely to be a difference between amounts paid in the year and the current tax expense, much the same as there is almost always a difference between trade debtors and sales income - this is the natural consequence of accrual accounting.

As with many of the additional disclosures proposed by this discussion paper, we believe that the Board should first consider the cost of these additional disclosures compared to the potential benefits, including the fact that financial statements with excessive disclosure run the risk of overloading users with information,. If they conclude that this information is still beneficial, for the reasons outlined above, we believe that it would be more useful for reporting entities, rather than preparing a numerical reconciliation, to provide a brief narrative disclosure explaining the nature and timing of tax payments in the jurisdiction(s) in which it operates. Such qualitative disclosure could assist users in understanding what has been paid in the year and the periods to which it relates.

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?

For deferred tax assets arising from unused tax losses and unused tax credits it is likely that details of geographical location, expiry dates and other similar restrictions would be readily available to the entity, and indeed certain entities already disclose such information within their financial statements. Therefore this would probably not be an onerous request.

We believe it would be beneficial to provide *some* classification of unused tax losses and tax credits carried forward, in relation to their nature, (for example, whether they are trading or capital losses), the jurisdictions in which they may be utilised and the entity's views on whether or not these losses or credits may be used in the future. For example, if an entity has tax losses carried forward of CU100, CU10 of these may relate to capital losses overseas; where no future capital gains are forecast, and no capital assets are held, the possibility of recovering these losses is remote. Also within the CU100 there could be CU50 of trading losses in the local jurisdiction, which are available for offset against future taxable profits, but have not been recognised due to poor trading conditions in the current period, meaning that future taxable profits cannot be reliably predicted. However, the overall likelihood of utilising the CU50 trading losses may be far higher than that of utilising the CU10 capital losses. Drawing out this comparison in the notes to the accounts may be helpful to users.

We believe moreover that there is a need to balance the value of the information given with the cost of collecting it; and a need to recognise that too much disclosure can have the undesired effect of obscuring information that is more relevant to users of financial statements. Disclosure of summary schedules of unused losses and tax credits carried forward (together with the assumptions underpinning their potential future utilisation), and disclosure of uncertainties and risks, even if based on estimates, can be helpful to certain users and would add to the transparency in the accounts.
However, detailed disclosures considering the qualitative elements (for example the judgements applied in determining the periods in which losses will be utilised) could quickly become very complex and lengthy, particularly within large multinational groups. We would question the utility of such complex disclosure to financial statements users. At the same time these disclosures would likely prove very difficult to audit. We would therefore caution against lengthy additional disclosures in this area, but we can see some merit in providing an explanation of the categories of losses carried forward as outlined above.

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

The list of seven categories of tax information included in paragraph 1.7 and then explained in subsequent paragraphs is comprehensive. We challenge whether some of these items are more desirable rather than essential, just because all of this information could be addressed in the financial statements, it does not automatically follow that it should be.

We have given our comments in relation to the identified users' information needs in our answers to other questions in the discussion paper as follows:

Tax strategies and objectives – Q1.4
Clarity on tax risk position – Q1.4
Cash tax and future tax cash flows – Q1.6
A clear explanation of the difference between the taxes paid and the current tax expense reported in the income statement – Q1.1
A clear explanation as to why the current tax charge is not equivalent to the accounting profit at the statutory rate of tax (tax reconciliation) – Q1.5
Improved understanding of the effective tax rate – Q1.5
A reasonable value of losses carried forward (or other deferred tax assets) – Q1.2

We do not have any suggestions for additional information requirements regarding reporting of income taxes.

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?**

We do not believe that there should be a requirement for an entity to disclose its tax strategy. We note from the suggestion in paragraph 1.8 of the discussion paper that inclusion of an entity's tax strategy may give useful context to the other disclosures relating to tax. However, we would argue that the existing tax disclosures in the financial statements are well understood without disclosure of a tax strategy.

Tax planning and transfer pricing are such highly specialised and sensitive areas, that there is a danger that disclosure of such information may be difficult to understand or highly confidential. At the same time tax strategies may be evolving, for example in new entities, and transfer pricing agreements may be under discussion with the local tax authorities. In such cases an entity may not be able to confirm its position with certainty and as such disclosure of tax strategy may be less meaningful. In addition, for entities operating in emerging markets, where the tax code is in its infancy or still evolving, it may be harder to provide any meaningful confirmation of tax strategy.

Any new requirement of IAS 12 for an entity to disclose its tax strategy, specifically in relation to managing tax exposures and policies in significant areas such as tax planning and transfer pricing, is likely to result in 'boiler plate' disclosure affirming that the entity's strategy is to be fully compliant with its tax filing and payment obligations in each relevant jurisdiction.

Where the tax treatment of an entity's transactions has a substantial impact on the overall business strategy of the entity, for example because certain profits are ring-fenced or exempt from tax, then we would expect this to be drawn out in the existing disclosure requirement of paragraph 81(c) of IAS 12 (explanation of the relationship between tax expense (income) and accounting profit).

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 in 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?**

We agree that the suggestions made in the discussion paper are helpful in clarifying the explanation as to why the total tax charge is not equivalent to the standard rate of tax applied to the accounting profit.

We agree that the applicable tax rate for a group carrying on its operations mainly outside its local territory should generally be the average tax rate weighted in proportion to accounting profit earned in each geographical territory. However, loss making entities within a group may distort the average tax rate which is applied to accounting profit making it less meaningful. We would therefore welcome some guidance within the standard on the tax rate to use in this circumstance.

The seven main categories of reconciling items suggested in paragraphs 2.21 to 2.34, provide a sound framework for more standardised disclosures. These categories cover the main areas of divergence between accounting profit at the applicable rate and current and total tax charge, and the proposed split between current and deferred tax effects is helpful. We suggest an additional line item which draws out those reconciling items that relate to structural changes within the entity.

Giving more information in the first section of the reconciliation in relation to current income tax effects should assist users in better understanding total current tax, and then linking this to taxes paid in the year (Q1.1). Further, users should be better able to understand an entity's tax profile (Q1.4) and effective tax rate by considering each of the proposed reconciling items.

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?

Paragraph 1.13 of Part 1 of the discussion paper refers to users having expressed a wish for disclosure of 'an explanation of the timing of reversing [of] significant deferred tax assets and liabilities and the probability for such amounts to have an impact on a cash tax position'. As we discuss further in our response to Question 1.7 below, we consider that disclosure of the estimated timing of reversal of temporary differences and their combined impact upon tax cash flow is unlikely to provide useful information commensurate with the burden of collating that information. Further, consideration of the probable impact upon tax cash flow could be highly subjective, dependent upon a number of combined factors, and therefore not necessarily useful to users in making decisions.

It is therefore difficult to propose meaningful disclosure in this area.

In our experience, what users would like is an estimate of tax cash payments in the medium term; this may be a preferable alternative for providing better information about future tax cash flows. The difficulty is that these payments will include tax on profits to be earned in future periods, which adds a further level of subjectivity (and problems in 'auditability') to the process.

Alternatively, below the breakdown of deferred tax assets and liabilities by category, some qualitative disclosure could be included about the expected maturity of each component of deferred tax, explaining for example that certain provisions, (year end accruals), will reverse, and then arise again each year.

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.

There are limited situations where the discounting of deferred tax might be appropriate (e.g. in respect of deferred tax assets whose recognition depends on future forecast taxable profits). However, there are many more where it would not be appropriate (e.g. where the temporary difference relates to an item that is already discounted).

A further problem is that the reversal of temporary differences will not necessarily result in a cash inflow or outflow at the date of reversal, since it will almost certainly be offset by new temporary differences or tax losses arising in those future periods, postponing the eventual cash flow effect of the temporary difference in to a much later period. However, to take account of such future transactions in estimating future tax cash flows is difficult to reconcile to the basic principles of IAS 12. On the other hand, simply to discount reversing differences would not produce the information on future tax cash flows that users apparently want (see our response to Q1.6 above). Moreover, the scheduling of reversing temporary differences that would be required for this purpose would itself be a complex and highly subjective exercise (as acknowledged by IAS 12, paragraph 75). Some of these difficulties are referred to in paragraphs 2.48 and 2.49 of the discussion paper and have also been highlighted in many earlier studies.[1]

For all these reasons, together with the cost of preparing such information as compared to its usefulness to investors, we do not support the discounting of deferred tax balances.

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.

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[1] A summary of these studies can be found in *SSAP 15 Accounting for Deferred Taxation*, Institute of Chartered Accountants of Scotland (edited Pauline Weetman), June 1992, section 5.4.

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

Alternative1: Disclosure requirements should be included in management commentary.
Alternative 2: Disclosure requirements should be split in two parts. Part 1 would include disclosures 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.

(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?

As noted in our response to Q0.1 above, we observe that the lack of guidance in IAS 12 on accounting for uncertain tax positions allows a number of acceptable, but different, methodologies to be applied in practice, reducing comparability between entities. We therefore agree in principle that some guidance on this issue would be desirable.

We are slightly confused by the two proposed 'alternative' disclosure requirements, as they do not represent mutually exclusive alternatives. Alternative 1 focuses on where the disclosures are made, whereas Alternative 2 focuses on whether the disclosures should distinguish between uncertain tax positions which have been provided for and those which have not. We believe that this distinction is useful, and that where it is determined in IFRS that disclosure is required, information should be given in the financial statements rather than in the management commentary.

With respect to the question of measurement, we find it difficult to answer the question as posed since it appears to ignore, or prejudge, a fundamental preliminary question, namely what should be regarded as the 'unit of account' in recognising and measuring uncertain tax positions. Examples could include (this is not an inclusive list):

- an individual uncertain tax position;
- the tax return for a single period for a single entity in the group;
- the tax exposures for all outstanding periods for a single entity in the group; or

- the tax returns filed in a particular jurisdiction for a single period by all group entities filing in that jurisdiction.

The choice of unit of account can make a significant difference to the outcome if the chosen methodology includes a 'recognition threshold'. The larger the unit of account, the more likely it is that the threshold will be reached (i.e. it may be clear that a whole tax return will result in a payment of tax, but it may not be clear that a particular disputed item will do so).

We suggest that the most appropriate unit of account is that effectively used by the particular tax authority concerned, which may differ between jurisdiction and, potentially, between entities in the same jurisdiction.

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?

Please refer to our response to Q0.1 above, which notes a number of areas where we believe the standard could be improved.

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

We assume that the 'exemptions' referred to in this question are:

- the so-called 'initial recognition exception' (IRE) in paragraphs 15 and 24 of IAS 12; and

- the restrictions in paragraph 39 on recognition of deferred tax on 'outside' temporary differences associated with subsidiaries, branches and associates and interests in joint ventures.

We support the objective of the IRE of avoiding 'day one' tax gains or losses in circumstances where no such gain or loss has economically occurred. However, experience has shown that it would be desirable - and consistent with the overall objective of the IRE - to exclude from the IRE (i.e. to recognise deferred tax on) transactions which involve the initial recognition of assets and liabilities with a net carrying amount of zero (e.g. the establishment of a decommissioning provision with a corresponding increase in PP&E, or the inception of a finance lease with the recognition of an equal asset and liability). This is more fully explained in Appendix 2 below.

Although not strictly regarded by IAS 12 as part of the IRE, the related issue of the treatment of temporary differences arising on 'split accounting' for compound financial instruments should, in our view, be reconsidered. The requirement of paragraph 23 of IAS 12 is difficult to reconcile in some respects to other requirements of the standard, so that it is not clear whether, and – if so – to what extent it should be applied by analogy to transactions similar, but not identical to, that in Example 4 in the illustrative examples accompanying the standard.

We believe that the exemptions from recognition in paragraph 39 are generally appropriate.

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?

As indicated in the introduction to this letter, we do not favour the wholesale replacement of IAS 12. We accept that that the temporary difference approach is not without its challenges, as illustrated by the number of areas where we have indicated that we believe that the standard could be improved. However, most of these suggested improvements involve either enhancements of disclosure or clarifications of the methodology to be applied in meeting some specific requirements of the standard, rather than fundamental changes to the underlying accounting model. We are not convinced that any of the alternative approaches would be free from their own significant challenges in application.

Our views on the other approaches described in Part 2 can be summarised as follows.

Flow-through

We recognise that the flow-through approach has the attraction of being straightforward to apply and results in the recognition of assets and liabilities actually receivable from or payable to the tax authority in the near future, which, to many people, appear more consistent with the definitions of the 'asset' and 'liability' in the IASB's Conceptual Framework than those recognised under the temporary difference approach. However, in the final analysis we consider that the approach is too simplistic, and ignores that fact that in reality the tax systems of mature economies are essentially stable (albeit with periodic significant long-term structural changes), rather than the random acts of appropriation in each period that the flow-through approach implies. Application of this approach in any large multinational entity could lead to widely fluctuating effective tax rates which, in our view, cannot be rectified by disclosure and are likely to confuse financial statement users and investors. Moreover, it could encourage inappropriate short-term decision making by entities.

Partial allocation

The partial allocation approach is, in our view, conceptually flawed for the reasons set out in the discussion paper. In illustration of this, it is noteworthy that the approach was in operation in the United Kingdom from 1979 to 2002, during which time it became increasingly discredited, particularly as the result of a number of conceptually dubious amendments to the original standard that became pragmatically necessary in response to changes in the UK tax system and accounting standards.

Valuation adjustment approach

The valuation adjustment approach should, we believe, be rejected because it fails to meet a fundamental information need of nearly all current users – namely to understand the performance of an entity before and after tax. Moreover, in order to apply the approach, it would be necessary to keep track of individual assets and liabilities such as PP&E at a much lower level than is required for the temporary difference approach, which would make the approach quite impractical.

Accruals approach

We could see some merit in the accruals approach, if there were seen to be a real need to move away from IAS 12.

However, as noted in the discussion paper, it is much more difficult to track cumulative charges and credits in the financial statements and tax returns than it is to determine differences between the carrying amount of assets and liabilities and their tax bases at each balance sheet date – this was certainly found to be the case in practice in applying 'income statement' approaches to deferred tax accounting in a number of countries. Overall, therefore, we see no compelling case for this approach to supersede the current temporary difference approach of IAS 12.

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?

As noted above, we advocate retention of the temporary difference approach in IAS 12, and have set out what we see as the difficulties with that approach elsewhere in this letter.

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

No.

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

No.

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

No.

Appendix 2 – Extract from *Ernst & Young's International GAAP 2012*, chapter 31

7.2.7 Transactions involving the initial recognition of an asset and liability

As noted at 7.2 above, the initial recognition exception is essentially a pragmatic remedy to avoid accounting problems that would arise without it, particularly in transactions where one asset is exchanged for another (such as the acquisition of PP&E for cash).

However, experience has shown that the exception creates new difficulties of its own. In particular, it does not deal adequately with transactions involving the initial recognition of an equal and opposite asset and liability which subsequently unwind on different bases. Examples of such transactions include:

- recording a liability for decommissioning costs, for which the corresponding debit entry is an increase in PP&E (see 7.2.7.A below); and
- the inception of a finance lease by a lessee, which involves the recording of an asset and a corresponding financial liability see (7.2.7.B below).

7.2.7.A Decommissioning costs

The underlying issue is illustrated by the following example.

Example 31.18: Asset and liability giving rise to equal temporary differences on initial recognition

On 1 January 2012 an entity paying tax at 40% recognises a provision for the clean-up costs of a mine that will require expenditure of €10 million at the end of 2016. A tax deduction for the expenditure will be given when it is incurred (i.e. as a reduction in the current tax liability for 2016).

In accordance with IAS 37, this provision is discounted (at a rate of 6%) to €7.5m, giving rise to the following accounting entry (see Chapter 29 at 5.5):

	€m	€m
PP&E	7.5	
Provision for clean-up costs		7.5

On initial recognition, the tax base of the PP&E is nil, since no deductions are available as it is recovered through future taxable profit of €7.5 million. The tax base of the provision is also nil (carrying amount of €7.5 million, less the amount deductible in future periods, also €7.5 million). Although deductions of €10 million are expected to be received, if the liability were settled at its carrying amount of €7.5 million, a deduction of only €7.5 million would be received – see 8.3.2.below.

There is therefore a taxable temporary difference of €7.5 million associated with the PP&E and a deductible temporary difference of the same amount associated with the provision. However, the initial recognition exception in IAS 12 prohibits recognition of deferred tax on either temporary difference.

Over the next five years an expense of €10 million (equivalent to the ultimate cash spend) will be recognised in profit or loss, comprising depreciation of the €7.5 million PP&E and accretion of €2.5 million finance costs on the provision. Given that this €10 million is fully tax-deductible, it would seem reasonable for the income statement to reflect €4 million of deferred tax credits over this period, giving rise to an effective tax rate of 40% in each period. However, the result is somewhat different.

Under the general approach of IAS 12 summarised in 7.2.4 above, the depreciation of the PP&E is regarded as reducing the temporary difference arising on initial recognition of the asset, and therefore gives rise to no tax effect. However, the accretion of €2.5 finance costs on the provision gives rise to an additional temporary difference arising after initial recognition, requiring recognition of a deferred tax asset (assuming that the general recognition criteria for assets are met – see 7.5 below). This gives rise to the following overall accounting entries for the year ended 31 December 2012.

	€m	€m
2012		
Depreciation (€7.5m ÷ 5)	1.50	
PP&E		1.50

Finance cost (€7.5m × 6%)	0.45	
Provision for clean-up costs		0.45
Deferred tax (balance sheet)	0.18	
Deferred tax (profit or loss) (40% × €0.45m)		0.18

If equivalent entries are made for the following periods, the following amounts will be included in subsequent income statements (all figures in € millions):

	2012	2013	2014	2015	2016	Total
Depreciation	1.50	1.50	1.50	1.50	1.50	7.50
Finance costs	0.45	0.47	0.50	0.53	0.55	2.50
Cost before tax	1.95	1.97	2.00	2.03	2.05	10.00
Current tax (income)					(4.00)	(4.00)
Deferred tax (income)/charge[1]	(0.18)	(0.19)	(0.20)	(0.21)	0.78	–
Cost after tax	1.77	1.78	1.80	1.82	(1.17)	6.00
Effective tax rate	9.2%	9.6%	10.0%	10.3%	157.1%	40.0%

1 In years 2012-2015 40% × finance cost for period. In 2016, reversal of cumulative deferred tax asset recognised in previous periods.

Absent the initial recognition exception, the entity would, on initial recognition of the provision and the addition to PP&E, establish a deferred tax asset of €3 million in respect of the provision (€7.5m @ 40%) and an equal liability in respect of the asset. This would result in the following amounts being included in subsequent income statements (all figures in € millions):

	2012	2013	2014	2015	2016	Total
Depreciation	1.50	1.50	1.50	1.50	1.50	7.50
Finance costs	0.45	0.47	0.50	0.53	0.55	2.50
Cost before tax	1.95	1.97	2.00	2.03	2.05	10.00
Current tax (income)					(4.00)	(4.00)
Deferred tax (income)/charge[1]	(0.78)	(0.79)	(0.80)	(0.81)	3.18	–
Cost after tax	1.17	1.18	1.20	1.22	1.23	6.00
Effective tax rate	40.0%	40.0%	40.0%	40.0%	40.0%	40.0%

1 In 2012 reduction in deferred tax liability in respect of PP&E €0.6m (€1.5m @ 40%) and increase in asset in respect of provision €0.18m (€0.45m @ 40%) – similarly for 2013-2015. The charge in 2016 represents the release of the remaining net deferred tax asset (equal to cumulative income statement credits in 2012-2015).

It is not clear that the accounting treatment strictly required by IAS 12, with its widely fluctuating effective tax rates – resulting in a post-tax profit in 2016 for what is in reality a post-tax loss-making transaction – appropriately reflects the economic reality that all expenditure is ultimately eligible for tax deductions at the standard rate of 40%. Indeed, it could be argued that the more realistic alternative treatment set out above is consistent with the underlying intention of the initial recognition exception (that the reporting entity should provide for deferred tax on initial recognition unless to do so would create an immediate net tax expense or credit in the statement of comprehensive income). That implied intention of the exception would not be breached by providing for deferred tax on initial recognition in such cases.

7.2.7.B Finance leases taxed as operating leases

In a number of jurisdictions, tax deductions are given for finance leases as if they were operating leases (i.e. on the basis of lease payments made). The total cost for both accounting and tax purposes is obviously the same over the period of the lease, but for accounting purposes the cost comprises depreciation of the asset together with finance costs on the lease liability, rather than the cash paid, which is treated as a balance sheet movement. Strict application of the initial recognition exception will therefore lead to a result similar to that in set out the first table in Example 31.18 above.

That leads some to argue that, given that the asset and liability recognised at the inception of a finance lease (or on establishment of a decommissioning provision) are a single transaction, they should be regarded as effectively giving rise to a single (net) temporary difference of zero. This means that, as and when (net) temporary differences emerge after initial recognition, deferred tax may be recognised on those temporary differences, with the effect that the effective tax rate in the income statement reflects the statutory rate actually applicable to the transaction as a whole (as illustrated in the second table in Example 31.18 above).

Those who take this view might also argue that it is consistent with the implied, if not explicit, intention of the initial recognition exception that deferred tax should always be recognised unless it creates a 'day one' tax charge or credit in the statement of comprehensive income.

Others argue that this approach is not acceptable. The financial statements present a clearly separate asset and liability which do not meet any offset criteria. The initial recognition exception should therefore be applied to the asset and liability separately and not as if the two comprised some form of single net asset or liability.

The Interpretations Committee considered this issue on two occasions in 2005. *IFRIC Update* for April 2005 appeared to support the latter view:

'The [Interpretations Committee] noted that initial recognition exemption applies to each separate recognised element in the balance sheet, and no deferred tax asset or liability should be recognised on the temporary difference existing on the initial recognition of assets and liabilities arising from finance leases or subsequently.'[i]

However, only two months later, the Committee added:

'The [Interpretations Committee] considered the treatment of deferred tax relating to assets and liabilities arising from finance leases.

While noting that there is diversity in practice in applying the requirements of IAS 12 to assets and liabilities arising from finance leases, the [Interpretations Committee] agreed not to develop any guidance because the issue falls directly within the scope of the Board's short-term convergence project on income taxes with the FASB.'[ii]

This appears to indicate that, whilst the Interpretations Committee regards the analysis that the asset and lease liability must be considered separately as consistent with the letter of IAS 12 as drafted, it accepts the alternative approach.

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i *IFRIC Update*, April 2005.
ii *IFRIC Update*, June 2005.