

STAFF PAPER

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IASB® Meeting

Project	Primary Financial Statements		
Paper topic	Determining the income tax effect of management performance measure adjustments		
CONTACT(S)	Zhen Xu Aida Vatreňjak	z xu@ifrs.org avatreňjak@ifrs.org	+44 (0)20 7246 6477 +44 (0)20 7246 6456

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Purpose of this paper

1. This Agenda Paper considers whether to:
 - (a) provide guidance on how to determine the income tax effect of the differences between management performance measures (MPMs) and the most directly comparable IFRS subtotal or total. In this paper, we refer to these differences as MPM adjustments.
 - (b) require disclosure of the method used to determine the income tax effect.

Staff recommendations in this paper

2. The staff recommend that the Board:
 - (a) specify that the income tax effect of MPM adjustments should be determined based on a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction concerned, or other method that achieves a more appropriate allocation in the circumstances; and
 - (b) require entities to disclose how, in their particular circumstances, the income tax effect of MPM adjustments has been determined.

Structure of the paper

3. This paper is structured as follows:
 - (a) what are the Board's tentative decisions on the income tax effect of MPM adjustments and the feedback received? (paragraphs 4–8)
 - (b) do entities allocate taxes to alternative performance measures today and how do they make the allocation? (paragraphs 9–11)
 - (c) could IAS 12 *Income Taxes* be applied to determine the income tax effect of MPM adjustments? (paragraphs 12–21)
 - (d) what guidance should the Board provide? (paragraphs 22–31)
 - (e) should the Board require entities to disclose how the income tax effect of MPM adjustments has been determined? (paragraphs 32–34)
 - (f) appendix A—extracts from IAS 12
 - (g) appendix B—examples of disclosures explaining how the tax effect of alternative performance measures was determined

What are the Board's tentative decisions on the income tax effect of MPM adjustments and the feedback received?

4. At its May 2018 meeting, the Board tentatively decided to require disclosure of the tax effects and effect on non-controlling interests (NCI) of each of the adjustments between any MPMs disclosed in the financial statements and the most directly comparable IFRS subtotal or total.
5. The purpose of the disclosure of the income tax (and NCI) effects of MPM adjustments is to enable users of financial statements to adjust their analysis for those MPM adjustments they do not accept. For example, it would allow them to calculate adjusted EPS in their preferred manner. This is supported by findings from a CFA

Institute investor survey¹ which showed that a majority of respondents (66%) supported the disaggregation of tax effects of alternative measures of performance. They said such disaggregation is helpful for analysing different line item components.

6. Since the Board discussion in May 2018, the staff discussed the Board’s proposals for MPMs in 12 project outreach meetings. Meetings with users, preparers, standard-setters and regulators included the following meetings:
 - (a) Global Preparers Forum (GPF) in November 2018;
 - (b) Capital Markets Advisory Committee (CMAC) in November 2018; and
 - (c) Accounting Standards Advisory Forum (ASAF) in December 2018.

7. Some stakeholders, including users, were supportive of the proposed disclosure of the income tax effect of MPM adjustments because they considered this information useful in enabling users to consider the effects of MPM adjustments individually.

8. However, some members of ASAF and GPF expressed concerns about the practicality of the proposed disclosure of the income tax effect of MPM adjustments. The key concerns raised were:
 - (a) how the income tax effect should be determined in particular situations, for example:
 - (i) when entities have multiple subsidiaries in different jurisdictions; and
 - (ii) when the MPM adjustment is a credit and the entity is loss-making; and
 - (b) the cost and complexity of determining the income tax effect of each of the MPM adjustments.

¹ CFA Institute, [‘Bridging the Gap: Ensuring Effective Non-GAAP and Performance Reporting’](#), November 2016

Do entities allocate taxes to alternative performance measures today and how do they make the allocation?

9. The staff performed research based on 85 annual reports for entities from different jurisdictions and industries to observe whether and how entities disclosed the income tax effect of differences between alternative performance measures and subtotals defined by IFRS Standards.
10. Twelve out of 71 entities that disclosed alternative performance measures disclosed the income tax effect of differences between the alternative performance measures and IFRS defined subtotals. However, the income tax effect was usually disclosed on an aggregate basis (ie a single amount representing the effect for all differences rather than the disaggregated effect for each item of difference). Only three of those twelve entities disclosed how the income tax effect was determined. Another two entities adjusted their alternative performance measure for tax and disclosed how they determined the income tax effect. However, they did not disclose the amount of tax included in the alternative performance measure.
11. Appendix B includes examples of disclosures explaining how the tax effect of alternative performance measure adjustments has been calculated.

Could IAS 12 *Income Taxes* be applied to determine the income tax effect of MPM adjustments?

12. IAS 12 applies to the income tax consequences of transactions and events of the current period that are recognised in the entity's financial statements. Appendix A includes extracts from IAS 12.
13. In many cases, an MPM is determined by excluding income or expenses that arise from transactions of the current period that are recognised in the financial statements. For example, in our analysis of financial statements of 85 entities, over 85% of entities determined alternative performance measures by excluding items of income and expense (eg restructuring expenses).
14. In such cases, we think that a requirement to disclose the income tax effects of these MPM adjustments is essentially a requirement to disclose separately a component of the current period's current and deferred income tax recognised in accordance with

- IAS 12. This is similar to the requirement in IAS 12 to separately identify current and deferred tax relating to items recognised in other comprehensive income or directly in equity (paragraph 61A of IAS 12).
15. Determining the income tax effects of an MPM adjustment that is an exclusion of income or expenses recognised in the current period may be straightforward. For example, say an MPM excludes restructuring expense incurred in a subsidiary and the tax legislation applies on an individual transaction basis:
- (a) if this expense is tax deductible when recognised, an entity could multiply the restructuring expense by the tax rate in the jurisdiction in which the expense was incurred to arrive at the tax effect of the adjustment;
 - (b) if this expense is tax deductible when paid, and thus creates deductible temporary differences, then the tax effect would include the reversal of any related deferred tax; or
 - (c) if this expense is not tax deductible then the adjustment would have no tax effect.
16. It may be more complicated to determine the tax effect of individual income and expenses recognised in the financial statements when there are aspects of tax legislation that apply on an aggregated basis (such as the ability to offset prior year's losses carried forward against the current year's taxable profit, or graduated rates of income tax). In these circumstances, some entities may:
- (a) determine the amount of current and deferred tax that would be recognised if the income or expense was not recognised; and
 - (b) determine the tax effect of MPM adjustment as the difference between the total amount of current and deferred tax and the amount determined in (a) above.
17. However, there are other approaches possible—entities would need to select an approach to apply and make assumptions in applying it, and then explain how the approach and assumptions made are consistent with IAS 12. This is likely to be a complex and costly process.

18. Similar complications arise if MPM adjustments are based on tailor-made accounting policies. In applying IAS 12 to such adjustments, entities could go through a similar process to the process described in paragraph 16 to determine the income tax effect. For example, some entities may:
- (a) determine the amount of any current and deferred tax relating to IFRS-recognised income and expense included in the financial statements;
 - (b) determine the amount of any current and deferred tax that would be recognised if the adjusted income or expense was recognised in the financial statements (to calculate deferred tax, the entity would have to calculate adjusted carrying amounts of assets or liabilities related to the MPM adjustment); and
 - (c) determine the tax effect of the adjustment as the difference between the two.
19. As noted in paragraph 17, this is likely to be complex and costly.
20. In exceptional circumstances, paragraph 63 of IAS 12 provides a practical expedient for determining the amount of current and deferred tax relating to items recognised in OCI or directly in equity, stating that:
- the current and deferred tax related to items that are recognised outside profit or loss are based on a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction concerned, or other method that achieves a more appropriate allocation in the circumstances
21. This practical expedient could be extended to the calculation of the income tax effect of MPMs.

What guidance should the Board provide?

22. Users have told us that what they need is an indication of the likely income tax effect of any adjustments rather than a precise calculation of the effect. They could estimate the tax effects of MPM adjustment by multiplying the adjustment by the effective tax rate. However, there may be material differences between the tax effect of the

adjustment and the estimate made in such a way. What users need from this disclosure is to understand whether there are material differences. We therefore think that user information needs can be met using different methods provided these methods are reasonable in the entity's circumstances.

23. We have considered two ways in which the Board could provide guidance on how to determine the tax effect of MPM adjustments:
- (a) Approach A—state that IAS 12, including the practical expedient in paragraph 63, applies to all MPM adjustments; and
 - (b) Approach B—provide specific guidance along the lines of the practical expedient in paragraph 63 of IAS 12 to require allocation of current and deferred tax on a reasonable basis.

Approach A—apply IAS 12, including paragraph 63

24. Approach A would state that entities should apply IAS 12 when determining the tax effect of MPM adjustments, including, in exceptional circumstances, the practical expedient in paragraph 63.
25. As discussed in paragraphs 12–21, whilst this approach could work for most MPMs, it can be complex to apply in situations when tax is determined on an aggregated basis or in the case of tailor-made accounting policies. In order to apply the practical expedient in paragraph 63, entities would have to be able to demonstrate that it is difficult to determine the amount of current and deferred tax. IAS 12 states that this should only be in exceptional circumstances. Consequently, this approach could be costly and complex for preparers to apply.
26. We could consider providing additional guidance on how to apply IAS 12. For example, we could clarify the application of IAS 12 when determining the effect of MPM adjustments in complex situations, including when adjustments are made using tailor-made accounting policies (for example using the approach in paragraph 18).
27. Such additional guidance would add complexity in itself, and it might also require the Board to identify what constitutes a tailor-made accounting policy. This is not a defined term and there are different views on what constitutes a tailor-made

accounting policy. Consequently, defining what constitutes a tailor-made accounting policy may be difficult.²

Approach B reasonable allocation of income tax

28. Approach B is based on the practical expedient in paragraph 63 of IAS 12 for determining the tax effect of items recognised outside profit or loss. This approach would specify that the income tax effect of MPM adjustments should be based on a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction concerned, or other method that achieves a more appropriate allocation in the circumstances.
29. The advantage of this approach is that it makes it clear that entities should apply a simple approach and are not required to prepare complex calculations of the income tax effects of these adjustments. This approach is therefore simpler and less costly than Approach A.
30. Also, although simple, we think this approach is likely to result in more appropriate allocation of taxes to MPM adjustments than prepared by some entities today. For example, because Approach B requires allocation of current and deferred tax of the entity in the tax jurisdiction concerned, entities could not determine the tax effect by applying the entity's effective tax rate to an adjustment, unless the entity operates in a single tax jurisdiction. We also think that the consequence of this approach is that entities would, in assessing what allocation method is appropriate, consider the tax treatment of individual items so that, for example, allocation of the tax effect of non-deductible expenses would be zero.
31. Whilst this approach may result in entities selecting different methods of allocation, we still think it would meet user needs described in paragraph 22. We therefore recommend Approach B.

² In April 2019, the Board discussed the difficulties of defining tailor-made accounting policies in the context of prohibiting their use in MPMs—see [AP21A](#) paragraph 65.

Question 1

Does the Board agree with the staff recommendation to specify that the income tax effect of MPM adjustments should be determined based on a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction concerned, or other method that achieves a more appropriate allocation in the circumstances?

Should the Board require entities to disclose how the income tax effect of MPM adjustments has been determined?

32. The staff think that requiring entities to disclose how the income tax effect of MPM adjustments has been determined in their particular circumstances would provide useful information to users of financial statements. If users understand the basis on which the income tax effect has been calculated, they can assess whether they agree with the calculation and if necessary make adjustments in their analysis.
33. We think that requiring entities to disclose this information would require little extra cost for preparers of financial statements because entities would have this information readily available. Indeed, evidence suggests that some entities provide this disclosure today, see analysis in paragraph 10 and the Appendix B.
34. We therefore recommend requiring this disclosure.

Question 2

Does the Board agree with the staff recommendation to require entities to disclose how, in their particular circumstances, the income tax effect of MPM adjustments has been determined?

Appendix A– extracts from IAS 12

Objective

The objective of IAS 12 is to prescribe the accounting treatment for income taxes. The principal issue in accounting for income taxes is how to account for the current and future tax consequences of:

- (a) the future recovery (settlement) of the carrying amount of assets (liabilities) that are recognised in an entity's statement of financial position; and
- (b) transactions and other events of the current period that are recognised in an entity's financial statements.

1 This Standard shall be applied in accounting for income taxes.

61A Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:

- (a) **in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).**
- (b) **directly in equity, shall be recognised directly in equity (see paragraph 62A).**

63 In exceptional circumstances it may be difficult to determine the amount of current and deferred tax that relates to items recognised outside profit or loss (either in other comprehensive income or directly in equity). This may be the case, for example, when:

- (a) there are graduated rates of income tax and it is impossible to determine the rate at which a specific component of taxable profit (tax loss) has been taxed;
- (b) a change in the tax rate or other tax rules affects a deferred tax asset or liability relating (in whole or in part) to an item that was previously recognised outside profit or loss; or

- (c) an entity determines that a deferred tax asset should be recognised, or should no longer be recognised in full, and the deferred tax asset relates (in whole or in part) to an item that was previously recognised outside profit or loss.

In such cases, the current and deferred tax related to items that are recognised outside profit or loss are based on a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction concerned, or other method that achieves a more appropriate allocation in the circumstances.

Appendix B– examples of disclosures explaining how the tax effect of alternative performance measures was determined

B1. We have found the following examples of disclosure explaining how the tax effect of adjustments used to calculate alternative performance measures has been determined:

- (a) the tax impact of the adjustments is calculated based on the US or foreign statutory tax rate as they relate to each adjustment. Certain adjustments are either not taxable or not tax-deductible.
- (b) the tax impact is the sum of the tax on each non-underlying item, based on the applicable country tax rates and tax treatment.
- (c) taxes on the adjustments between IFRS and core results take into account, for each individual item included in the adjustment, the tax rate that will finally be applicable to the item based on the jurisdiction where the adjustment will finally have a tax impact