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International Accounting Standards Board

INFORMATION FOR OBSERVERS

IASB Meeting: **February 2006, London**

Project: **Short-term convergence: income taxes – transitional arrangements (Agenda Paper 2B)**

Introduction

1. The staff has considered what transitional arrangements would be appropriate for the proposed amendments to IAS 12.

2. The staff recommends that:

   (a) existing users be required to apply the amendments to the assets and liabilities in the opening balance sheet for the first period starting after the publication of the standard and to all events and transactions thereafter. In applying the amendments to the assets and liabilities in that first opening balance sheet:

      i. a re-analysis of the cumulative amounts recognised through profit or loss or directly in equity should not be allowed and

      ii. assets and liabilities that currently fall under the initial recognition exemption should be treated as if they had been acquired for their carrying amount at the balance sheet date. In other words they would be grossed up to create (i) a new carrying amount and (ii) a deferred tax balance calculated in accordance with IAS 12 with the sum of (i) and (ii) equalling the previous carrying amount.

(b) first-time adopters whose date of transition to IFRSs is later than a specified date shortly after the publication of the final standard should apply the amendments retrospectively except that:

i. the requirements for the allocation of tax across components of profit or loss and equity should be applied prospectively to events and transactions after the date of transition to IFRS. The cumulative amount of tax that would have been recognised directly in equity at the date of transition should be assumed to be nil, ie there is no tax amount that needs to be recycled into profit and loss in a later period and

ii. the carrying amount of assets and liabilities that would currently fall under the initial recognition exception is determined as if they had been acquired for their carrying amount at the balance sheet date. In other words they would be grossed up to create (i) a new carrying amount and (ii) a deferred tax balance calculated in accordance with IAS 12 with the sum of (i) and (ii) equalling the previous carrying amount.

(c) first-time adopters whose date of transition to IFRSs is before date specified in (b) should apply the amendments retrospectively except:

i. the same exceptions noted in (b)(i) and (ii) and

ii. in relation to the proposals relating to (1) uncertainty over the amount and rate underlying the tax amounts and (2) the need to assess a valuation allowance for any deferred tax assets that would be recognised under the proposed amendments but are not recognised under the existing IAS 12.

For these proposals, first-time adopters in (c) will have to determine amounts for at least three balance sheets before a contemporaneous assessment can be made.[1] The judgments needed for such balance sheets should be required to be the same as those resulting from the first contemporaneous judgment, unless there unless there is objective evidence of a change in circumstances between the date of the balance sheet in question and the date of the first contemporaneous judgment. In that case, disclosure of the amount of the change and the reason would be disclosed. If the item in question is no longer recognised in the balance sheet at the date when the first contemporaneous judgement is made, the amount recognised in previous balance sheets should reflect the known final outcome of the uncertainty unless there is objective evidence of a change in circumstances.[2] If so, again the amount of the change and the reason should be disclosed

3. Agenda Paper 2C sets out the Board's proposed changes to IAS 12 and any new information needed to comply. It also sets out the detailed staff analysis of the resulting impact on the transitional arrangements for each change.

Transitional arrangements for existing users

4. If a standard does not include specific transitional arrangements, IAS 8 requires changes in accounting policy to be applied retrospectively unless it is impracticable to do so. [Not reproduced in Observer Notes.]

5. The staff notes that retrospective application of the proposed amendments requires information at the date of the opening balance sheet of the earliest period presented and subsequently. Mostly, no information is required for earlier dates because the deferred tax assets and liabilities depend solely on the carrying amount and tax base of asset and liabilities at the balance sheet date, assessments of the rates at that date

[1] For example, suppose the date of transition to IFRS is 31 December 2005, the entity presents two annual periods in the financial statements, and the date specified in (b) is 31 January 2008. The entity will have to determine amounts for balance sheets dated 31 December 2005, 31 December 2006 and 31 December 2007.
[2] An example illustrating this proposal is given in paragraph 26(b).

and assessments of recoverability at that date. However, information is required for earlier dates in relation to two proposed amendments as follows:

(a) the proposed amendments include changes in whether tax is recognised in profit or loss or equity. Retrospective application of those amendments could require information from earlier dates in order to determine the amount of tax that would have been directly recognised in equity. This amount needs to be known for disclosure and recycling purposes.

(b) the elimination of the initial recognition exception will change the carrying amount of the assets and liabilities that fell under the exception. They will now be recognised initially at the fair value that they would have if their tax base equalled fair value. For assets and liabilities that are not remeasured at fair value, entities will need to determine what the initial fair value and any subsequent depreciation would have been.

6. [Not reproduced in Observer Notes.]

7. The staff identified two issues that could require judgments that could be affected by hindsight:

(a) the proposals relating to uncertainty over the amounts and rates underlying the tax amounts and

(b) the need to assess a valuation allowance for any deferred tax assets that would be recognised under the proposed amendments but are not recognised under the existing IAS 12.

8. Full retrospective application would require an entity to determine the probability weighted average of the possible outcomes (the expected outcome) at the date of the beginning balance sheet for the earliest period presented. If that date is before the publication of the final standard, an entity may not be able to make that judgment without being affected by hindsight. The same is true for valuation allowances for deferred tax assets that were not previously recognised.

9. [Not reproduced in Observer Notes.]

10. [Not reproduced in Observer Notes.]

11. [Not reproduced in Observer Notes.]

12. Given this, and the potential costs for the items discussed in paragraphs 5 and 6, the staff does not recommend full retrospective application. The staff recommends that the amendments should be applied to the assets and liabilities in the opening balance sheet for the first period starting after the publication of the standard and to all events and transactions thereafter. In applying the amendments to the assets and liabilities in first opening balance sheet:

    (a) a re-analysis of the cumulative amounts recognised through profit or loss or directly in equity should not be allowed and

    (b) assets and liabilities that currently fall under the initial recognition exemption should be treated as if they had been acquired for their carrying amount at the balance sheet date. In other words they would be grossed up to create (i) a new carrying amount and (ii) a deferred tax balance calculated in accordance with IAS 12 with the sum of (i) and (ii) equalling the previous carrying amount.

13. [Not reproduced in Observer Notes.]

Transitional arrangements for first-time adopters

14. The Basis for Conclusions on IFRS 1 gives the following explanations for the Board's general conclusions on transition:

    (a) it is more important to achieve comparability over time within a first-time adopter's first IFRS financial statements and between different entities adopting IFRSs for the first time at a given date; achieving comparability between first-time adopters and entities that already apply IFRSs is a secondary objective. (BC10)

    (b) In general, the transitional provisions in other IFRSs do not apply to a first-time adopter (paragraph 9 of IFR 1). Some of these transitional provisions require or permit an entity already reporting under IFRSs to apply a new requirement prospectively. These provisions generally reflect a conclusion that one or both of the following factors are present in a particular case:

i. Retrospective application may be difficult or involve costs exceeding the likely benefits. IFRS 1 permits prospective application in specific cases where this could occur.

ii. There is a danger of abuse if retrospective application would require judgments by management about past conditions after the outcome of a particular transaction is already known. IFRS 1 prohibits retrospective application in some areas where this could occur. (BC12)

(c) The Board rejected three further arguments sometimes given for permitting or requiring prospective application in some cases:

i. to alleviate unforeseen consequences of a new IFRS if another party uses financial statements to monitor compliance with a contract or agreement. However, in the Board's view, it is up to the parties to an agreement to determine whether to insulate the agreement from the effects of a future IFRS (paragraph 21 of the Preface to International Financial Reporting Standards).

ii. to give a first-time adopter the same accounting options as an entity that already applies IFRSs. However, permitting prospective application by a first-time adopter would conflict with the Board's primary objective of comparability within an entity's first IFRS financial statements. Therefore, the Board did not adopt a general policy of giving first-time adopters the same accounting options of prospective application that existing IFRSs give to entities that already apply IFRSs.

iii. to avoid difficult distinctions between changes in estimates and changes in the basis for making estimates. However, a first-time adopter need not make this distinction in preparing its opening IFRS balance sheet, so IFRS 1 does not include exemptions on these grounds. If an entity becomes aware of errors made under previous GAAP, IFRS 1 requires it to disclose the correction of the errors. (BC13)

(d) The Board will consider case by case when it issues a new IFRS whether a first-time adopter should apply that IFRS retrospectively or prospectively. The Board expects that retrospective application will be appropriate in most cases, given its primary objective of comparability over time within a first-time adopter's first IFRS financial statements. (BC 12)

(e) In balancing benefits and costs, the Board took as its benchmark an entity that plans the transition well in advance and can collect most information needed for its opening IFRS balance sheet at, or very soon after, the date of transition to IFRSs. (BC27)

First-time adopters whose date of transition to IFRS is later than the publication of the standard

15. There are no special transitional arrangements for IAS 12 in IFRS 1. Retrospective application is required. As noted above, information from before the date of opening balance sheet of the first period presented (ie the date of transition to IFRSs) is not needed, except in relation to

(a) the cumulative amounts of tax that would have been recognised directly in equity and

(b) the carrying amounts of assets and liabilities that are currently covered by the initial recognition exception.

[Not reproduced in Observer Notes.]

16. [Not reproduced in Observer Notes.]

17. [Not reproduced in Observer Notes.]

First-time adopters with a date of transition to IFRS before the publication of the standard

18. First-time adopters whose date of transition to IFRS is before the publication of the final standard will have the same issues relating to information needed from before the date of transition as set out in paragraph 15. They will also have the same problems relating to the proposals on uncertain tax positions and valuation allowances as set out in paragraph 7 for existing users.

19. [Not reproduced in Observer Notes.]The staff therefore argues that, for first-time adopters, any of the proposed amendments that can be applied retrospectively should be.

20. The staff has argued above that the following amendments cannot be applied retrospectively:

    (a) the determination of the cumulative amounts of tax recognised directly in equity

    (b) the carrying amounts of assets and liabilities that would currently fall under the initial recognition exemption

    (c) the proposals relating to uncertainty over the amount and rate underlying the tax amounts and

    (d) the need to assess a valuation allowance for any deferred tax assets that would be recognised under the proposed amendments but are not recognised under the existing IAS 12.

21. The staff therefore proposes that all other amendments should be applied retrospectively by first-time adopters with a date of transition to IFRS before publication of the standard.

22. [Not reproduced in Observer Notes.]

23. [Not reproduced in Observer Notes.]

24. [Not reproduced in Observer Notes.]

25. [Not reproduced in Observer Notes.]

26. So, in relation to uncertainty over tax amount and tax rate, the staff recommends that

(a) the same amounts and rates that are first assessed contemporaneously after the publication of the standard should be assumed to have been valid for previous balance sheets unless there is objective evidence of a change in circumstances between the date of the balance sheet in question and the date of the first contemporaneous judgment. In that case, the amount of the change and the reason should be disclosed.

(b) for tax balances that no longer exist at the date of the first contemporaneous assessment after publication of the standard, the amounts and rates that actually applied should be assumed to have been valid for previous balance sheets unless there is objective evidence of a change in circumstances between the date of the balance sheet in question and the date of recovery or settlement of the balance. In that case, the amount of the change and the reason should be disclosed. Consider for example a current tax liability that was recognised in a balance sheet dated before the publication of the standard and also was settled in full before the publication of the standard. The amount of the current tax balance recognised in the balance sheet dated before the publication of the standard would be the amount for which the liability was actually settled unless there is objective evidence of a change in circumstances between the date of the balance sheet in question and the date of settlement of the balance.

27. In relation to valuation allowances for deferred tax assets that were not previously required to be recognised under IAS 12, the staff recommends the same approach, ie that:

(a) the same valuation allowances that are first assessed contemporaneously after the publication of the standard should be assumed to have been valid for previous balance sheets unless there is objective evidence of a change in circumstances between the date of the balance sheet in question and the date of the first contemporaneous judgment. In that case, the amount of the change and the reason should be disclosed and

(b) for deferred tax assets that no longer exist at the date of the first contemporaneous assessment after publication of the standard, the valuation allowance based on the amount actually realised should be assumed to have been valid for previous balance sheets unless there is objective evidence of a change in circumstances between the date of the balance sheet in question and the date of recovery of the asset. In that case, the amount of the change and the reason should be disclosed.