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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.

These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**November 2008, London**
Project:	**IFRS for Private Entities (formerly IFRS for SMEs)**
Subject:	**Redeliberation of Approach for Income Taxes (Agenda Paper 14A)**

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1. For the November 2008 Board meeting, the private entity agenda papers are organised as follows:
   - **Agenda Paper 14** – Overview
   - **Agenda Paper 14A** – Redeliberation of approach for income taxes (Section 28)
     - **Attachment 1** – Temporary difference approach with simplifications
     - **Attachment 2** – Taxes-payable-plus approach
   - **Agenda Paper 14B** – Redeliberation of outstanding issues for other sections
2. Agenda Paper 14A sets out a number of issues regarding the appropriate approach for accounting for income taxes. The main issue, Issue 28.1, was deferred at a previous Board meeting where the Board asked the staff to prepare two drafts based on two specified approaches to accounting for income taxes (see Attachments 1 and 2 to this agenda paper). During development of those two drafts, staff identified a number of issues that are worth highlighting separately to the Board and these are shown as new issues 28.2 to 28.7 below. All of these new issues are relevant to both of the staff drafts so will need to be considered if the Board wishes to pursue either of the approaches in Attachments 1 and 2.

Issue 28.1: Income Taxes – which method?

3. **Reason for revisiting issue.** At the September 2008 meeting, the Board considered but rejected a taxes payable with disclosure approach for deferred tax. At that meeting the Board discussed possible ways to simplify deferred tax recognition and measurement that take into account the needs of users of private entity financial statements and cost-benefit considerations. The Board asked the staff to develop the following two approaches for discussion at a future meeting:

    a. Starting from the temporary difference approach as set out in the latest version (second pre-ballot draft) of a forthcoming exposure draft of revisions to IAS 12 *Income Taxes*, but making simplifications in areas considered particularly complex.

    b. Recognising deferred taxes only for those differences between accounting and tax treatment of items of income or expense that arise because the cash basis is used to measure taxable profit while the accrual basis is used to measure profit or loss for financial reporting purposes.

    Staff have therefore prepared two drafts of Section 28 based on those two approaches (see Attachment 1 and 2 to this agenda paper). The two drafts also propose the appropriate disclosure requirements to include in Section 28 *Income Taxes*, as a decision on the disclosure issues was deferred in September 2008, pending a decision on which approach to follow for income taxes.

4. **Comment letters.** Many comment letters recommended simplifying the recognition and measurement requirements for income taxes, but there was no clear consensus of the best way to do that. Suggestions included:

    a. Taxes payable method (no deferred tax recognised), with some disclosure about 'deferrals'.

    b. Taxes payable method plus accrual of those deferred taxes that are expected to reverse in a short period (say two or three years).

    c. Timing difference method.

    d. Timing difference method plus accrual of deferred taxes relating to book/tax basis differences that were recognised directly in other comprehensive income.

    e. Do not recognise deferred tax assets, or limit the time period for assessing whether there will be sufficient future taxable profit for recovery, to avoid ongoing calculations.

    f. Do not require tax consequences of transactions to be attributed to discontinued operations or equity as this is complex.

5. **Field tests.** Several field test entities feel that deferred tax is too complex for them. However, a few other field test entities support deferred tax requirements as deferred tax is useful information for assessing cash flows. Several entities had problems with areas of Section 28. Some of the more significant issues identified include:

    a. Explanation of the underlying concept should be improved. It would be easier if the IASB used only one concept, either the timing or the temporary difference concept.

b. Problems measuring temporary differences. Measurements in the field test entity's restated financial statements are 'rough' or are not finalised.

c. The concept of recognising a deferred tax asset is not practical for private entities since private entities do not prepare the necessary budgets/forecasts. A few field test entities noted particular problems with tax loss carry forwards as the entities only prepared limited forecasts

d. Problems determining tax rates where, depending on the level of profits of the year, the entity may use a 'reduced rate' on part of or all its profits.

e. Difficulties understanding certain paragraphs, for example ED paragraph 28.17 on initial recognition and ED paragraph 28.25 on measuring deferred tax at the rates applicable to undistributed profits.

f. 28.18 should note that if an entity considers the timing differences to be insignificant then there is no need to recognise deferred tax.

g. 28.18(b) should provide the same exemption for unremitted earnings of local subsidiaries as it does for foreign subsidiaries.

6. **WG recommendation.** WG members did not express a clear consensus on how private entities should account for income taxes; however the majority felt that the requirements as proposed in the SME Exposure Draft (ED) are too complex for private entities. More WG members leaned toward the taxes payable method than any other method, supported by some note disclosures about tax deferrals. More WG members favoured a timing difference approach than the proposed temporary difference approach as a simplification because comparing the income statement and the tax return is relatively straightforward. There was also support for either not recognising deferred tax assets at all or restricting deferred tax assets to those that are deemed to be realisable in the very short term such as one or two years, because private entities often do not have accurate cash flow budgets.

7. **Staff comment.** The Board expects to publish an exposure draft on income taxes later in 2008. One aim of that exposure draft is to enhance understandability by substantially rewriting IAS 12, without changing greatly the overall approach in IAS 12. The staff have taken the latest version of this forthcoming exposure draft (the second pre-ballot draft) into account in drafting both Attachment 1 and Attachment 2.

8. The drafts in Attachments 1 and 2 reflect the Board's decision in May 2008 that the final standard should incorporate the requirements of IAS 1 *Presentation of Financial Statements* (as revised in 2007).

9. Staff note that the following terms are used in one or both of the drafts and hence will need to be added to the glossary of the IFRS for Private Entities:

(a) Comprehensive income

(b) Continuing operations

(c) Recoverable amount (will be added anyway as a result of Board decisions regarding Section 26 *Impairment of Non-financial Assets)*

10. **Staff recommendation.** At the September 2008 meeting the Board asked the staff to develop the following two approaches for consideration at this meeting. These are set out in Attachment 1 and 2 to this agenda paper.

- Attachment 1 – Temporary difference approach with simplifications
- Attachment 2 – Taxes-payable-plus approach

11. The starting point for developing Attachment 1 was the latest version of a forthcoming exposure draft of revisions to IAS 12 *Income Taxes*. The principal simplifications from the latest version of the income taxes exposure draft that are proposed in Attachment 1 are:

    - Deferred tax assets arising from tax loss and tax credit carryforwards are not recognised (see Issue 28.2).
    - Retention of the current IAS 12 requirement for measuring the deferred tax liability when income is taxable at two rates depending on whether it is distributed or not (see Issue 28.4).
    - All deferred tax assets and liabilities are classified as non-current (see Issue 28.5).
    - Current tax assets and liabilities are not discounted (see Issue 28.7).
    - The initial measurement of assets and liabilities that have a tax basis different from their initial carrying amount is not disaggregated into (i) an asset or liability excluding entity-specific tax effects and (ii) any entity-specific tax advantage or disadvantage (note, this is not highlighted as a separate issue in this paper).

12. The starting point for developing Attachment 2 was the taxes payable approach but with recognition of some future tax consequences of transactions and other events. The principle for when to recognise such future tax consequences is deferred tax should be recognised only for differences between the accounting and tax treatment of those items of income and expense that are recognised on a cash basis in measuring taxable profit but recognised on an accrual basis in measuring profit or loss for financial reporting purposes. The wording and requirements in Attachment 2 are consistent with Attachment 1 (based on the latest version of the forthcoming income taxes exposure draft) where applicable.

13. In Agenda Paper 6A for the September 2008 Board meeting, the staff recommended that the taxes payable method, supplemented by appropriate disclosures, should be required for private entities on the grounds of cost-benefits. Staff noted that this is one of the most common areas of the ED that was highlighted by respondents as complex and burdensome. Paragraph 205 of that agenda paper listed the staff's four principal reasons for recommending the taxes payable method. For the same reasons, regarding the two approaches in Attachments 1 and 2, staff recommends that the Board pursue the taxes-payable-plus approach (Attachment 2) as the basis of Section 28 *Income Taxes* of the IFRS for Private Entities. The two matters on which staff asks for views of the Board are whether the attachments capture the two approaches envisioned by the Board in September 2008 and which approach the Board would like to pursue in the final IFRS for Private Entities.

Question 28.1

Does the Board think that the description of the temporary difference approach with simplifications in Attachment 1 and the description of the taxes-payable-plus approach in Attachment 2 appropriately reflect the two approaches that the Board decided to consider at the September 2008 meeting? If not, what modifications should be made?

Question 28.2

Does the Board agree with the staff recommendation that Section 28* Income Taxes *of the IFRS for Private Entities be based on the taxes-payable-plus approach in Attachment 2?

Issue 28.2: Deferred tax assets – carryforward of unused tax losses and credits?

14. **Comment letters.** Do not recognise deferred tax assets, or limit the time period for assessing whether there will be sufficient future taxable profit for recovery, to avoid ongoing calculations.

15. **Field tests/WG recommendations.** See paragraph 5 - 6 of this agenda paper for comments**.**

16. **Staff comment.** Currently, under both of the drafts in the attachments to this paper, deferred tax assets would be not recognised for the carryforward of currently unused tax losses and tax credits. This differs from the latest version of the forthcoming exposure draft of revisions to IAS 12, which would require that such deferred tax assets be recognised, subject to a valuation allowance.

17. **Staff recommendation.** Staff propose that private entities should not be permitted to recognise deferred tax assets for these carryforwards, for the following reasons:

    (a) Small private entities do not normally have the ability to make accurate forecasts of future taxable profits, especially over long periods.

    (b) Small private entities that are start-up companies, in particular relatively new companies, have no basis for making forecasts of future taxable profits.

    (c) Bank lenders to small private entities have consistently told us they do not consider these assets in making lending decisions.

Question 28.2
Does the Board agree with the staff recommendation that private entities should not be permitted to recognise deferred tax assets for unused tax loss and tax credit carryforwards?

Issue 28.3: Probable versus more likely than not

18. **Additional staff issue.** As noted in paragraph 7, the staff have generally tried to use the wording in the latest version of the forthcoming income taxes exposure draft in their two drafts. The latest version of the income taxes exposure draft currently proposes to use ‘more likely than not’ instead of ‘probable’. ‘Probable’ is currently used in the SME ED, and probable is defined in the glossary of the

SME ED as ‘more likely than not’. Staff believe using ‘probable’ is more appropriate for private entities.

19. **Staff comment.** Both the drafts in the attachments to this paper reflect the staff’s proposal below. In paragraphs 28.3(e) and 28.19 in Attachment 1 and paragraphs 28.4(d) and 28.19 in Attachment 2 staff have chosen to use ‘probable’ rather than ‘more likely than not’. Below is a comparison of the wording in the latest version of the income tax ED and in Attachment 1, the temporary difference draft of Section 28 (note, the same wording is used in Attachment 2):

Second pre-ballot draft of the income tax ED	**Section 28 temporary difference draft**
Recognise any valuation allowance necessary to reduce the carrying amount of deferred tax assets less the valuation allowance to the amount for which it is more likely than not that there will be taxable profit against which it can be realised [paragraph 5(f)]	Recognise any valuation allowance necessary to reduce the carrying amount of deferred tax assets less the valuation allowance to the estimated recoverable amount based on **probable** future taxable profit [paragraph 28.3(e)]
An entity shall recognise a valuation allowance to reduce the carrying amount of deferred tax assets less the valuation allowance to the amount for which it is more likely than not that there will be taxable profit against which the carrying amount can be realised [paragraph 19]	An entity shall recognise a valuation allowance to reduce the carrying amount of deferred tax assets less the valuation allowance to the estimated recoverable amount based on probable future taxable profit [paragraph 28.19]

20. **Staff recommendation.** Staff propose retaining the word probable in the IFRS for Private Entities (defined as ‘more likely than not’ in the glossary), rather than following the revised wording in the forthcoming income taxes exposure draft. The staff’s reason for retaining probable is that ‘more likely than not’ is difficult to understand in a private entity context. The Board has instructed staff to use simplified language in the IFRS for Private Entities for clarity. Staff believe that the wording proposed in the attachments is appropriately simplified without a substantive difference from the forthcoming income taxes exposure draft.

<u>Question 28.3</u>
Does the Board agree with the staff recommendation to use probable as set out above?

Issue 28.4: Different tax rates on distributed and undistributed income

21. **Additional staff issue.** The proposed revisions to IAS 12 in the forthcoming income taxes exposure draft regarding measurement of deferred tax when income is taxable at two rates depending on whether it is distributed or not rely heavily on

management expectations. Staff question whether this requirement is appropriate for private entities.

22. **Staff comments.** Here is the proposal in paragraphs AG32 and AG33 of the latest version of the forthcoming income taxes exposure draft:

Tax effects of distributions

AG32 In some jurisdictions, tax is payable at a higher or lower rate if part or all of the profit or retained earnings is paid out as a distribution to shareholders. In these circumstances, an entity shall measure current and deferred tax assets and liabilities using the rate expected to apply, including the effect of the entity's expectations of future distributions. In other jurisdictions, tax may be refundable or payable if part or all of the profit or retained earnings is paid out as a dividend to shareholders. In these circumstances, the measurement of current and deferred tax assets and liabilities shall include assumptions about future deductions including the effect of the entity's expectations of future distributions.

AG33 When determining the effect of the entity's expectations of future distributions, an entity shall consider past experience and whether it expects to have the intention and ability to make distributions for the period in which the deferred tax asset or liability is expected to be realised or settled. If the entity does not expect to make distributions, then the entity shall use the rate applicable to undistributed amounts and shall not anticipate deductions for distributions

23. Both the drafts in the attachments to this agenda paper reflect the staff's proposal and hence continue to follow the approach used in the SME ED and in existing IAS 12 regarding measurement of deferred tax when income is taxable at two rates depending on whether it is distributed or not.

24. **Staff recommendation.** Staff believe that private entities cannot make the kind of judgements that the latest draft of the proposed revisions to IAS 12 would require since the proposed revisions to IAS 12 rely heavily on management expectations. Therefore, staff have proposed simplified requirements in their drafts. Here is the proposal in paragraph 28.23 of Attachment 1 (which is identical to paragraph 28.23 in Attachment 2):

28.23 In some jurisdictions, income taxes are payable at a higher or lower rate if part or all of the profit or retained earnings is paid out as a dividend to shareholders of the entity. In other jurisdictions, income taxes may be refundable or payable if part or all of the profit or retained earnings is paid out as a dividend to shareholders of the entity. In those circumstances, an entity shall measure current and deferred taxes at the tax rate applicable to undistributed profits until the entity recognises a liability to pay a dividend. When the entity recognises a liability to pay a dividend, it shall recognise the resulting current or deferred tax liability (asset), and the related tax expense (income).

<u>Question 28.4</u>
Does the Board agree with the staff recommendation to retain the accounting proposed in the SME ED (and existing IAS 12) when a jurisdiction imposes different tax rates on distributed and undistributed income?

Issue 28.5: Classifying deferred income tax assets and liabilities as current or non-current

25. **Additional staff issue.** The latest version of the forthcoming income taxes exposure draft requires that an entity must disaggregate deferred tax liabilities and assets into a current amount and a non-current amount on the basis of classification of any related asset or liability. If a deferred tax liability or asset does not relate to a recognised asset or liability, an entity is required to classify it as current or non-current based on the date the entity expects the temporary difference to reverse. Also, an entity must allocate any valuation allowance for a particular tax jurisdiction between current and non-current deferred tax assets for that tax jurisdiction on a pro rata basis. Staff questions whether this requirement is appropriate for private entities.

26. **Staff comment.** Currently both drafts in the attachments to this paper retain the requirement adopted in the 2007 revision of IAS 1 *Presentation of Financial Statements* (see paragraph 28.26 of Attachment 1 and paragraph 28.26 of Attachment 2):

> When an entity presents current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position, it shall not classify deferred tax assets (liabilities) as current assets (liabilities).

27. **Staff recommendation.** Staff believe that, for private entities, requiring a current-non-current split of deferred taxes (as prescribed in the latest version of the forthcoming income taxes exposure draft) is onerous and in many cases for private entities will result in arbitrary classifications. This is not currently a requirement in full IFRSs and, at the earliest, would become a requirement in 2010 (when the forthcoming income taxes exposure draft is released as a final standard). This means that private entities will be asked to make this judgement without the benefit of gathering experience of larger entities with bigger and more trained accounting staff. Deferred tax assets and liabilities constantly churn over, and tax laws and strategies change. A key objective of financial statements of private entities is to provide information about short-term cash flows. Staff believe that information about which deferred taxes are expected to result in a net cash outflow in the next 12 months can better be provided in a note than by the wholesale rule proposed in the revisions in the forthcoming income taxes exposure draft. Therefore staff propose that all deferred tax assets and liabilities should be classified as non-current, with appropriate disclosure for significant items.

<u>Question 28.5</u>

Does the Board agree with the staff recommendation that all deferred tax assets and liabilities should be classified as non-current by private entities?

Issue 28.6: Enacted and substantively enacted

28. **Additional staff issue.** Regarding measurement of current and deferred tax assets and liabilities, the latest version of the forthcoming income taxes exposure draft requires entities to use "the tax rates and tax laws that have been substantively

enacted at the reporting date". 'Substantively enacted' in this case subsumes 'enacted'. Staff feel that 'enacted' should be added separately for clarity for private entities.

29. **Staff comment.** Both drafts in the attachments to this agenda paper currently reflect the staff's proposal and refer to 'enacted and substantively enacted'. Paragraph 28.16 of Attachment 1 (and paragraph 28.17 of Attachment 2) states "An entity shall measure a deferred tax liability (asset) at the amounts it expects to pay (recover) using the tax rates and laws that have been enacted or substantively enacted by the reporting date"

30. **Staff recommendation.** Staff believe that subsuming 'enacted' within 'substantively enacted' is too subtle for a private entity standard, and think that questions are likely to arise about an enacted tax law change that is not currently effective but will be effective in the period in which a temporary difference is expected to reverse. Staff propose to refer separately to 'enacted' for avoidance of confusion.

<u>Question 28.6</u>

Does the Board agree with the staff recommendation that the IFRS for Private Entities should refer to tax rates that have been 'enacted or substantively enacted'?

Issue 28.7: Discounting of current tax assets and liabilities

31. **Additional staff issue.** Regarding measurement of current and deferred tax assets and liabilities, the latest version of the forthcoming income taxes exposure draft requires entities to discount current tax assets and liabilities but prohibits them from discounting deferred tax assets and liabilities. Staff believe that discounting of the current items should not be required for private entities.

32. **Staff comment.** Paragraph 28.21 of Attachment 1 (and paragraph 28.21 of Attachment 2) state that 'an entity shall not discount current or deferred tax assets and liabilities'.

33. **Staff recommendation.** Staff believe that the benefit of discounting only the current deferred tax assets and liabilities while not discounting the non-current deferred tax assets and liabilities does not outweigh the cost involved in performing the calculations for private entities. Discounting involves not only an initial measurement but also accounting for the unwinding portion, an added complexity for small entities.

<u>Question 28.7</u>

Does the Board agree with the staff recommendation that the IFRS for Private Entities should require that current tax assets and liabilities be measured without discounting?