STAFF PAPER

12 January 2016

IFRS Interpretations Committee Meeting

Project	**Finalisation of agenda decision**
Paper topic	IAS 12 *Income Taxes*—Recognition of deferred taxes for the effect of exchange rate changes

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Introduction

1. In July 2015, the IFRS Interpretations Committee ('the Interpretations Committee') discussed a request regarding the requirement in paragraph 41 of IAS 12 relating to the recognition of deferred tax when the tax base of an entity's non-monetary assets and liabilities is determined in a currency that is different from its functional currency. Paragraph 41 of IAS 12 notes that:

> "The non-monetary assets and liabilities of an entity are measured in its functional currency (see IAS 21 *The Effects of Changes in Foreign Exchange Rates*). If the entity's taxable profit or tax loss (and, hence, the tax base of its non-monetary assets and liabilities) is determined in a different currency, changes in the exchange rate give rise to temporary differences that result in a recognised deferred tax liability or (subject to paragraph 24) asset. The resulting deferred tax is charged or credited to profit or loss (see paragraph 58)."

2. The Interpretations Committee tentatively decided not to add this issue to its agenda.

3. The objective of this Agenda Paper is to provide an analysis of the comment letters received on the tentative agenda decision and to ask whether the Interpretations Committee agrees with the staff recommendation that it should finalise the agenda decision.

Structure of the paper

4. This Agenda Paper is structured as follows:
   (a) discussions at the July 2015 Interpretations Committee meeting;
   (b) comment letter analysis;
   (c) additional work performed;
   (d) staff summary and recommendation;
   (e) questions for the Interpretations Committee;
   (f) Appendix A—proposed wording for the final agenda decision;
   (g) Appendix B—GLASS research report;
   (h) Appendix C—comment letters.
   (i) Appendix D—example

Discussions at the July 2015 Interpretations Committee meeting

5. The submitter raised the question of whether it is appropriate to recognise through profit or loss deferred tax expense or credit that arises because of the effect of exchange rate changes on the tax base of a non-monetary asset.

6. In July 2015, the Interpretations Committee tentatively decided not to add this issue to the agenda. The Interpretations Committee noted that:
   (a) paragraphs 58 and 61A provide guidance on the limited circumstances wherein changes in deferred tax are required to be recognised outside

the profit or loss and that these limited circumstances do not apply to the fact pattern analysed; and

(b) responses to the outreach request did not provide evidence that the issue is widespread or that diversity in the application of paragraph 41 of IAS 12 exists.

Comment letter analysis

7. The comment period for the tentative agenda decision ended on 28 September 2015. We received three responses from:

   (a) Deloitte Touche Tohmatsu Limited;

   (b) Consejo Mexicano de Normas de Información Financiera (CINIF); and

   (c) Embraer S.A.

8. The comment letters received are included in **Appendix C** of this paper.

Deloitte

9. Deloitte Touche Tohmatsu Limited agreed with the IFRS Interpretations Committee's decision not to add this item onto its agenda, for the reasons set out in the tentative agenda decision.

Consejo Mexicano de Normas de Información Financiera (CINIF)

10. In its response, CINIF informed us that in Mexico the majority of the entities that pay their taxes in a currency that is not their functional currency and publish financial information under IFRS determine their deferred taxes in compliance with paragraph 41 of IAS 12; however, there are some entities that issue financial information under local standards and follow an alternative treatment that is prescribed in US GAAP.

11. CINIF has explained that the economic environment is sometimes unstable, which affects the peso-US dollar exchange rates. CINIF notes that:

> "The Mexican economic environment occasionally is unstable and, consequently, so is its currency, the Mexican peso (the "peso"). In Mexico, many entities have a U.S. dollar (the "dollar") functional currency and the peso-dollar exchange rate continually fluctuates: in some periods significant exchange losses are generated, and in subsequent periods there often can be a recovery of the exchange rate that generates exchange gains; in other words, there is no clear trend in the exchange rate."

12. CINIF explains that because the peso is the currency in which taxes are paid in Mexico, entities that operate with a functional currency other than the peso need to determine exchange rate fluctuations that create temporary differences related to non-monetary assets and, consequently, result in deferred taxes. CINIF is of the view that these effects are very inconsistent and, therefore, create significant volatility in the effective tax rate.

13. The respondent informed us that in the opinion of some preparers, this volatility of the effective tax rate distorts their financial statements. Some preparers believe that the effective tax rate determined in a particular period is not representative of the income taxes that will ultimately be incurred. This is because in their experience the effects of exchange rate fluctuations subsequently reverse.

14. Accordingly, CINIF suggests that the IASB should explore the possibility of including, in IAS 12, the same exception that is provided in US GAAP in order to solve this significant problem for Latin-American companies that operate in unstable economic environments.

15. CINIF has conducted research within the Group of Latin American Accounting Standard Setters (GLASS) on this issue and on its impact. CINIF requested all GLASS countries to share their experiences with regard to this issue. CINIF had

shared its views with the GLASS countries. The results of their research are provided in **Appendix B**. We provide a summary of their comments below:

(a) CINIF received responses from Colombia, Uruguay and Argentina;

(b) Colombia and Uruguay agreed with Mexico, ie IASB should explore the possibility of including, in IAS 12, the same exception that is provided in US GAAP; and

(c) Argentina provided two opinions:

  (i) Opinion 1 agreed with Mexico; and

  (ii) Opinion 2 disagreed with Mexico. The proponents of this opinion argue that if an exception were to be introduced to paragraph 41, it could be used by anyone applying IAS 12, regardless of the level of stability of the economic environment in which the entity operates. As a result, they consider the proposed exception to be very risky. However, they suggested that the IASB should explore the possibility of allowing management judgement to evaluate whether or not to recognise the deferred taxes derived from such a situation, taking into consideration the probability of payment of the deferred taxes caused by exchange rate volatility.

Staff analysis on the comments

16. The primary concern raised by the respondent is significant volatility in effective tax rates, which they think distorts the financial statements.

17. We have developed an example to illustrate the effect of exchange rate fluctuations on the effective tax rates and also to highlight what information recognition of such deferred taxes in the financial statements provides to users. The example also demonstrates the interaction between deferred tax and current tax.

18. The example is presented in **Appendix D**. A summary of our conclusions is presented in paragraph 48.

19. In the GLASS research report we note that only three countries have raised concerns about this issue.

20. The probability aspect highlighted by Argentina in Opinion 2 is similar to that raised by Embraer S.A. as described in paragraphs 24-25. We have considered this aspect in paragraphs 31-33.

Embraer S.A.

21. Embraer has raised several issues in their letter. We have segregated the issues and analysed each of them separately.

Issue 1: question raised in the submission

22. Embraer is of the view that the question raised in the submission was not about whether non-monetary deferred taxes should be recognised in profit or loss. They think that the submitter was questioning the appropriateness of the accounting treatment that IAS 12 lends to this event, instead of asking what that accounting treatment is. For this reason, they think the Interpretations Committee should discuss the issue again.

23. However, they also agree with the submitter's question about the appropriateness of the accounting treatment to recognise the non-monetary deferred taxes in profit or loss.

Issue 2: requirements in paragraph 41 not aligned with the objective of IAS 12

24. Embraer explains that the requirement in paragraph 41 of IAS 12 is not consistent with the objective of IAS 12. They believe that this inconsistency is the cause of the issue. Embraer notes:

> "Paragraph 41 of IAS 12 simply requires the recognition of non-monetary deferred taxes on profit or loss. However, we do not think that paragraph 41 is consistent with the objective of IAS 12 because the differences created by foreign exchange fluctuations are erratic and it is not possible to affirm that it is probable that the recovery of an asset will result in larger or smaller amounts of tax payments because of the foreign exchange effect-we think that is an uncertain assumption."

25. We reproduce the objective of IAS 12 below:

> "It is inherent in the recognition of an asset or liability that the reporting entity expects to recover or settle the carrying amount of that asset or liability. If it is probable that recovery or settlement of that carrying amount will make future tax payments larger (smaller) than they would be if such recovery or settlement were to have no tax consequences, this Standard requires an entity to recognise a deferred tax liability (deferred tax asset), with certain limited exceptions."

Issue 3: impracticable to determine the amount of income tax

26. Embraer is of the view that the concept of 'impracticability' as described in paragraph 40 of IAS 12 is also applicable to paragraph 41. The respondent notes:

> "We think that the concept of foreign exchange fluctuations is more aligned with the concept in paragraph 40 of IAS 12 in regards to the idea that it is impracticable to determine the amount of income taxes that would be payable when the temporary difference reverses. This means that the non-monetary deferred taxes recognised through profit or loss gave no information value to users because it represented an artificial deferred tax value, disconnected to the tax payments throughout the next years."

27. Paragraph 40 of IAS 12 notes:

> "As a parent controls the dividend policy of its subsidiary, it is able to control the timing of the reversal of temporary differences associated with that investment (including the temporary differences arising not only from undistributed profits but also from any foreign exchange translation differences). Furthermore, it would often be impracticable to determine the amount of income taxes that would be payable when the temporary difference reverses. Therefore, when the parent has determined that those profits will not be distributed in the foreseeable future the parent does not recognise a deferred tax liability. The same considerations apply to investments in branches."

Issue 4: volatility in the financial statements

28. Embraer has provided statistics from their financial statements to demonstrate the volatility in deferred taxes due to foreign exchange rate fluctuations.

Staff analysis on the comments

Issue 1: question raised in the submission

29. We think the question in the submission was whether it is appropriate to recognise through profit or loss deferred tax that arises because of the effect of exchange rate fluctuations on the tax base of a non-current asset or liability. We think that the submission was not about the appropriateness of the accounting treatment that IAS 12 lends to this event, as indicated by the respondent.

30. The change in foreign exchange rates leads to a change in the tax base of a non-monetary asset or liability. The change in the tax base of a non-monetary asset or a liability is the event that gives rise to temporary differences that result in a deferred tax asset or liability. The submitter conceptually agreed that in the situations described in paragraph 41 of IAS 12, changes in the exchange rate (or

inflation adjustments) give rise to temporary differences that result in a recognised deferred tax liability or asset. However, the submitter thought that '…the temporary difference does not arise from gain and losses that affect profit or loss and therefore, it could be argued that the recognition of the change in the deferred tax asset of liability through profit or loss creates an inconsistency'. Consequently, the staff paper presented in July 2015 IC meeting focussed on where non-monetary deferred taxes should be recognised rather than on whether or not such deferred taxes should be recognised in the financial statements.

Issue 2: requirements in paragraph 41 not aligned with the objective of IAS 12

31. We think the guidance in paragraph 16 of IAS 12, as reproduced below (**emphasis added**), explains when a future tax payment is regarded as probable:

> "It is inherent in the recognition of an asset that its carrying amount will be recovered in the form of economic benefits that flow to the entity in future periods. When the carrying amount of the asset exceeds its tax base, the amount of taxable economic benefits will exceed the amount that will be allowed as a deduction for tax purposes. This difference is a taxable temporary difference and the obligation to pay the resulting income taxes in future periods is a deferred tax liability. As the entity recovers the carrying amount of the asset, the taxable temporary difference will reverse and the entity will have taxable profit. **This makes it probable that economic benefits will flow from the entity in the form of tax payments.** Therefore, this Standard requires the recognition of all deferred tax liabilities, except in certain circumstances described in paragraphs 15 and 39."

32. We think the guidance in paragraph 16 of IAS 12 applies even when temporary differences arise due to volatile foreign exchange rate fluctuations. We think that if the carrying amount of the asset is recovered, the temporary differences will

reverse and the entity will have taxable profit; hence IAS 12 regards the future tax payment as probable.

33. We agree that future fluctuations in exchange rates cannot be predicted. In our view, IAS 12 does not require an entity to make such an estimate. Instead, recognition of deferred taxes on exchange rate changes captures the effects of exchange rate movements that have already occurred.

Issue 3: impracticable to determine the amount of income tax

34. The respondent has drawn an analogy from paragraph 40 of IAS 12 to state that it is impracticable to determine the amount of income taxes that would be payable when the temporary difference reverses.

35. The requirements in paragraph 40 are specifically related to situations in which a parent controls the dividend policy of its subsidiary. In such situations the parent is able to control the timing of the reversal of temporary differences associated with that investment. Such temporary differences include those arising not only from undistributed profits but also from any foreign exchange translation differences. Consequently, we think that paragraph 40 of IAS 12 should not be analogised to the issue under discussion here. With respect to the requirement in paragraph 41 of IAS 12, an entity does not control the timing of foreign exchange fluctuations or the reversal of temporary differences associated with the non-monetary asset or liability.

Issue 4: volatility in the financial statements

36. As stated in paragraph 17, we have developed an example that explain the conceptual reasons for recognising such deferred taxes in the financial statements and the information value it has. We present a summary of our conclusions in paragraph 48.

Additional work performed

37. After taking into consideration the comment letters to the tentative agenda decision, we decided to perform additional work on this issue to obtain further understanding. We have:

 (a) looked into prior attempts to eliminate difference between US GAAP and IFRS (paragraphs 38-43);

 (b) conducted user outreach (paragraphs 44-47); and

 (c) created an example (we present a summary of our conclusions in paragraph 48).

Difference between US GAAP and IFRS

38. In contrast to the requirements in paragraph 41 of IAS 12, US GAAP prohibits recognition of deferred tax charge or credit arising due to the effect of exchange rate fluctuations on the tax base of a non-current asset or liability.[1]

39. In the following paragraphs we have looked into attempts made by the IASB and the Financial Accounting Standards Board (FASB) to eliminate the GAAP difference.

40. Statement of Financial Accounting Standards (SFAS) No. 109 *Accounting for Income Taxes* issued by the FASB included the exception that is carried forward to ASC sub-topic 740-10-25-3(f). Paragraph 119 of the Basis for Conclusions appended to SFAS 109 explained the reasons for including this exception:

> "119. Under Statement 96, that difference between the foreign currency equivalent of the U.S. dollar cost and the foreign tax basis of nonmonetary assets is accounted for as a temporary difference. Although that difference technically meets the definition of a temporary difference,

[1] Accounting Standard Codification (ASC), sub-topic 740-10-25-3(f).

> the Board concluded that the substance of accounting for it as such is to recognize deferred taxes on exchange gains and losses that are not recognized under Statement 52. The Board decided to resolve that conflict between the requirements of Statements 96 and 52 by prohibiting recognition of deferred taxes for those differences. The Board believes that decision will significantly reduce complexity by eliminating cross-currency (U.S. dollar cost versus foreign tax basis) computations of deferred taxes for those differences."

41. In June 2003, the IASB discussed whether to amend IAS 12 to provide for an exception similar to the one in US GAAP. The staff recommended that the IASB should not amend IAS 12 to converge with SFAS 109. The staff noted that although recognition of deferred taxes on exchange gains and losses in the income statement may seem counter-intuitive, it is fundamentally consistent with the balance sheet liability approach. Furthermore, the staff believed that the tax relief available has changed in value and that this should be reflected in the financial statements. On the basis of the staff recommendation, the IASB decided not to amend IAS 12.

42. In December 2004, the FASB discussed whether SFAS 109 should be amended to eliminate two exceptions to comprehensive recognition of deferred taxes. One of the exceptions was related to deferred taxes due to the impact of exchange differences, as discussed in this paper. The FASB had tentatively decided to eliminate the two exceptions of the exceptions to comprehensive recognition of deferred taxes contained in paragraph 9 of SFAS 109. However, the proposed amendments were not published.

43. In 2009 IASB published an Exposure Draft on *Income Tax*. One of the reasons for undertaking that project was to consider accounting for income tax as part of the FASB's and IASB's work to reduce differences between IFRS and US GAAP. The IASB noted the difference between US GAAP and IFRS in respect of

accounting for deferred taxes when the tax base of an entity's non-monetary assets and liabilities is determined in a currency that is different from its functional currency. However, for reasons mentioned in paragraph 41. the IASB proposed no exceptions for such differences. Hence, the difference between US GAAP and IFRS persisted.[2]

User outreach

44. In the July 2015 staff paper we stated that we had performed outreach with two users of financial statements to obtain their views on the submission and particularly on whether financial information is more useful if the tax effects are recognised outside of profit or loss. The users informed us that in their view this issue is not common and that they see no reason to recognise such tax effects outside of profit or loss.

45. In addition to that earlier outreach, we undertook additional outreach but we were able to contact only one investor who had come across this issue. We informally discussed this issue with a sell-side analyst of an investment firm that has investments in entities experiencing this issue.

46. We asked the investor whether they consider information provided in the financial statements about recognising non-monetary deferred tax is useful to them in their analysis.

47. We heard from the investor that they generally focus on adjusted earnings and cash flows from operations. In determining this, they generally do not consider items related to foreign exchange volatility, which includes deferred taxes arising due to foreign exchange fluctuations. Consequently, we understand that such deferred taxes recognised in the financial statements are not considered particularly useful by the investor in determining adjusted earnings.

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[2] BC50 and BC51, Basis for Conclusions, Exposure Draft ED/2009/2, *Income Tax*.

Example

48. We have presented the example separately in **Appendix D** along with the conclusions. The summary of our conclusions is:

    (a) the value of tax depreciation benefit available to an entity in terms of functional currency changes due to exchange rate changes. This change is a real economic change that, we think, should be reflected in the financial statements; and

    (b) the recognition of such deferred tax in the financial statements has information value. It provides an indication of future consequences for current tax.

Staff summary and recommendation

49. The two respondents who did not agree with the tentative agenda decision have asked the IASB to explore the option to amend IAS 12 to include an exception similar to the one in US GAAP.

50. In response to the comment letters, we have performed additional work as discussed in paragraphs 37-48. On the basis of the additional work performed, we think that IAS 12 should not be amended to include an exception similar to the one in US GAAP for the following reasons:

    (a) Firstly, as summarised in paragraph 48, we think a change in foreign exchange rate affects an entity through a change in future tax depreciation available to the entity in terms of functional currency. This is a real economic gain or loss to the entity that, in our view, should be reflected in the financial statements.

    (b) We think convergence with US GAAP should not be a reason to provide an exception from recognising non-monetary deferred taxes, because this aspect has been considered by both the FASB and the

IASB in the past. The IASB has decided not add the exception, and the FASB has decided not to eliminate it.

(c) We were only able to conduct outreach with one additional investor. who was of the view that such deferred taxes are not particularly useful. We think that this limited outreach does not provide sufficient evidence about whether or not the information presented by way of recognising such deferred taxes is useful to investors.

51. Consequently, we think that the Interpretations Committee's conclusions are still valid and we recommend that it should finalise the tentative agenda decision as it was originally worded in the July 2015 IFRIC *Update*.

52. We present the proposed wording of the final agenda decision in **Appendix A** of this Agenda Paper.

Questions for the Interpretations Committee

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree with the staff's recommendation that the Interpretations Committee should finalise its decision not to add this issue to its agenda? 2. Does the Interpretations Committee agree with the wording for the final agenda decision shown in Appendix A?

Appendix A— Proposed wording for the final agenda decision

A1. We propose the following wording for the final agenda decision.

IAS 12 Income Taxes—Recognition through profit or loss of deferred taxes for temporary differences arising from the effect of exchange rate changes on the tax basis of non-current assets

The Interpretations Committee received a submission regarding the recognition of deferred taxes when the tax bases of an entity's non-monetary assets and liabilities are determined in a currency that is different from its functional currency. The question is whether deferred taxes arising due to the effect of exchange rate changes on the tax bases of non-current assets are recognised through profit or loss.

The Interpretations Committee noted that, in relation to the fact pattern analysed, paragraph 41 of IAS 12 *Income Taxes* states that when an entity's tax base of a non-monetary asset or liability is determined in a currency that is different from the functional currency, temporary differences arise resulting in a deferred tax asset or liability. Such deferred tax does not arise from a transaction or event that is recognised outside profit or loss and is therefore charged or credited to profit or loss in accordance with paragraph 58 of IAS 12. Such deferred tax charges or credits would be presented with other deferred taxes, instead of with foreign exchange gains or losses, in the statement of profit or loss.

The Interpretations Committee also noted that paragraph 79 of IAS 12 requires the disclosure of the major components of tax expense (income). The Interpretations Committee observed that when changes in the exchange rate are the cause of a major component of the deferred tax charge or credit, an explanation of this in accordance with paragraph 79 of IAS 12 would help to explain the tax expense (income) to the users of the financial statements.

In the light of the existing IFRS requirements the Interpretations Committee determined that neither an Interpretation nor an amendment to a Standard was necessary and therefore ~~[~~decided~~]~~ not to add this issue to its agenda.