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Is the information in IAS 12 useful?

I. The objective of financial reporting in the Conceptual Framework

“The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity [CF.OB2].”

In this sense, the Conceptual Framework states, related to the usefulness of financial reporting for its main users (the underscore was added):
"Investors’, lenders’ and other creditors’ expectations about returns depend on their assessment of the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity. Consequently, existing and potential investors, lenders and other creditors need information to help them assess the prospects for future net cash inflows to an entity [CF.OB3].”

II. The objective of IAS 12

“The objective of this Standard 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.

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.”

As it is clearly stated in the standard, the rationale to recognize a deferred tax liability or asset is the existence of a future recovery of the recognized assets or the future settlement of the recognized liabilities, but accepting the existence of certain limited exceptions based on the rationale implicit in the following paragraphs of the standard:

15 “A deferred tax liability shall be recognised for all taxable temporary differences, except to the extent that the deferred tax liability arises from:

(a) the initial recognition of goodwill; or
(b) the initial recognition of an asset or liability in a transaction which:
(i) is not a business combination; and
(ii) at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

However, for taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, a deferred tax liability shall be recognised in accordance with paragraph 39."

39 An entity shall recognise a deferred tax liability for all taxable temporary differences associated with investments in subsidiaries, branches and associates, and interests in joint arrangements, except to the extent that both of the following conditions are satisfied:

(a) the parent, investor, joint venturer or joint operator is able to control the timing of the reversal of the temporary difference; and
(b) it is probable that the temporary difference will not reverse in the foreseeable future.

Our main interest is to identify the underlying rationale in the exceptions to recognize deferred tax assets and liabilities in paragraph 39.

The required conditions are that the entity controlling an asset has the capacity to determine the form and timing of its recovery, and that at the measurement date the future payment of the income tax on the difference between the carrying amount in the statement of financial position and its tax base is unlikely to take place in the foreseeable future.

III. The situation of non-depreciable assets

Applying the principles of IAS 12, depreciable assets are recovered and therefore both their carrying amounts and their tax bases are reduced over time as a consequence of depreciation.

As a result of the reduction of both bases, usually the difference between them is also reduced, and the related deferred tax is also reduced over their useful life and finally, if they have a residual value, through its sale.

When an entity accounts for certain fixed assets using the revaluation model in IAS 16, if the assets are non-depreciable, their expected use is indefinite (for example land in agricultural activity) and their sale is not expected to occur in the foreseeable future, the recognition of a liability does not meet the following criteria for recognition of liabilities in the Conceptual Framework:

"Recognition of liabilities

4.46 A liability is recognised in the balance sheet <u>when it is probable</u> that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. …"

In most of the significant cases related to agricultural activity of which we are aware in our region, it is not probable that an outflow of resources embodying economic benefits will result from the sale of the agricultural land, because the entities have the following alternative courses of action:

a) not to sell their agricultural land because normally this means the liquidation of the entity and the non-existence of a “going concern” basis for the preparation of financial statements;
b) to sell a portion of the agricultural land through the creation of a different legal entity whose only asset is the agricultural land and subsequently sell shares of the newly created entity with no tax effect for the entity or for their shareholders.

In our country, because of the non-recognition by the tax authorities of certain restatements (pursuant to local accounting standards) for income tax purposes, the carrying amount of some non-depreciable assets is more than double (sometimes reaching a 1000% difference) their tax bases and, therefore, applying IFRS the entities have to recognize a deferred tax liability of 35% of the difference (the sole income tax rate).

The amounts are significant and in most cases it is unlikely that an outflow of economic resources will take place in the foreseeable future. The recognition of material improbable liabilities reduces the usefulness of financial information for its users, because such information reflects higher than actual leverage. The ROE ratio is also affected, since the entity presents equity that is much smaller than in reality.

The aforementioned situation is very common in countries with medium or high inflation where the tax authority does not recognize certain restatement of assets for tax purposes, resulting in a significant temporary difference for non-depreciable items in entities applying the Revaluation Model in IAS 16, the Fair Value option in IAS 40 or the Fair Value option in IFRS 1 as deemed cost.

The most relevant example in our region of the aforementioned difference is related to agricultural land used by their owners to produce agricultural products (IAS 16) or agricultural land leased to third parties (IAS 40).

The problem is more significant because of the recognition of “nominal differences” as determined by IAS 12, because of the application of the following paragraphs:

53 “Deferred tax assets and liabilities shall not be discounted.”

In our view, it is unacceptable that the amounts are not discounted because, even in the case of depreciable assets, the effect of non-recognition of the fair value of liabilities at initial measurement creates a significant and unjustified difference with financial instruments that are measured at present value.

The justification for not discounting is included in the following paragraphs of IAS 12:

54 “The reliable determination of deferred tax assets and liabilities on a discounted basis requires detailed scheduling of the timing of the reversal of each temporary difference. In many cases such scheduling is impracticable or highly complex.

Therefore, it is inappropriate to require discounting of deferred tax assets and liabilities. To permit, but not to require, discounting would result in deferred tax assets and liabilities, which would not be comparable between entities. Therefore, this Standard does not require or permit the discounting of deferred tax assets and liabilities."

The calculation of the probable future timing of the reversal of the amounts of assets and liabilities is significantly less complex than many of the required calculations for financial instruments in IFRS 9 and IFRS 17, and therefore the argument seems unacceptable.

In countries with medium or high inflation, for long-term depreciable assets the difference between the carrying amounts and their tax bases is very significant. Relevant examples of this situation are bearer plants with a productive life of 20 years or more.

The following paragraphs are part of the basis for conclusions in IFRS 17, sustaining our arguments about the relationship between the needed costs or efforts for discounting for estimated future amounts with uncertain times, and the relevance of the resulting measurement of the entity's assets or obligations.

IFRS 17 Basis for Conclusions

BC189 "… The Board also concluded that discount rates and the amount and timing of future cash flows can generally be estimated without excessive measurement uncertainty at a reasonable cost. Absolute precision is unattainable, but it is also unnecessary. The Board is of the view that the measurement uncertainty caused by discounting does not outweigh the additional relevance of the resulting measurement of the entity's obligations. Furthermore, many entities have experience in discounting, both to support investment decisions and to measure items for which other IFRS Standards require discounting, such as financial instruments, employee benefit obligations and long-term non-financial liabilities. …"

Also, in our view the second exception in paragraph 15 creates an unacceptable situation as a result of not recognizing a liability when a transaction creates a probable future outflow of resources, as a future increase in the income tax payment.

For example, when the tax deductibility of an item of property, plant & equipment) is limited by the tax law, the future limitation (total or partial) of the deductibility of the cost of the asset for tax purposes creates the obligation to pay future income tax when the consumption of the asset occurs.

In our view, the proper treatment is to recognize a deferred tax liability as part of the cost of the asset. The calculation of the amount to be accounted for as additional cost and a deferred tax obligation is basic. It can be argued that the increase in the carrying amount does not create a new liability for the additional difference between the book and tax bases of the asset. On the other hand,

pursuant to US GAAP (ASC 740-10-25-51), an additional deferred tax liability is required.

We understand that some time ago the IASB had reached a tentative conclusion to eliminate this exception, but we are not aware of any action having been taken.

IV. Conclusions

Based on the reasoning presented above, our proposal is to modify paragraph 15 by adding the following text at the end:

“However, for taxable temporary differences associated with non-depreciable items of property, plant and equipment and investment property, a deferred tax liability shall be recognised in accordance with paragraph 39A.”

We therefore propose the inclusion of paragraph 39A as follows:

39A “An entity shall recognise a deferred tax liability for all taxable temporary differences associated with non-depreciable items of property, plant and equipment and investment property, except to the extent that it is highly probable that the temporary difference will not reverse in the foreseeable future.“

We also propose deleting the exception in 15(b).

Finally, our proposal is to replace paragraph 53 with the following text:

53 “Deferred tax assets and liabilities shall be measured at the present value of the amounts estimated to reverse discounted from the estimated dates of reversal of the taxable temporary differences.

53A “The discount rate (or rates) shall be a pre-tax rate (or rates) that reflect(s) current market assessments of the time value of money and the risks specific to the deferred tax asset or the deferred tax liability.”