STAFF PAPER

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Project	**Primary Financial Statements**
Paper topic	Management performance measures—disclosure of tax and NCI

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Objective

1. This paper sets out staff analysis and recommendations relating to the proposed requirement in the Exposure Draft *General Presentation and Disclosure* for an entity to disclose the tax effect and the effect on non-controlling interests for each item disclosed in the reconciliation between a management performance measure and the most directly comparable subtotal specified by IFRS Accounting Standards. This paper continues from the IASB discussion of Agenda Paper 21B at its January 2022 meeting.

2. In future papers, we plan to discuss:

   (a) presentation restrictions, for example, the restriction on the use of columns in the statement of financial performance;

   (b) whether specific guidance is needed with regards to the timing of public communications (following up on related discussion in Agenda Paper 21A of the September 2021 IASB meeting);

   (c) requirements relating to changes to management performance measures, including whether a change represents a change in accounting policy; and

   (d) how management performance measures interact with other requirements including:

(i) unusual income and expenses;

(ii) segment reporting;

(iii) subtotals in the statement(s) of financial performance; and

(iv) earnings per share measures.

Summary of staff recommendations in this paper

3. The staff recommend the IASB:

(a) confirm the proposed requirements in the Exposure Draft to disclose the income tax effect and the effect on non-controlling interests for each item disclosed in the reconciliation between a management performance measure and the most directly comparable subtotal or total specified by IFRS Accounting Standards;

(b) revise the requirement specifying how to calculate the income tax effect to allow an entity to either:

(i) calculate the tax effects of the underlying transaction(s) at the statutory tax rate(s) applicable to the transaction(s) in the relevant jurisdictions(s); or

(ii) calculate the tax effects described in 3(b)(i) and allocate any other income tax effects related to the underlying transaction(s) based on a reasonable pro rata allocation of the current and deferred tax of the entity in the jurisdictions concerned, or other method that achieves a more appropriate allocation;

(c) remove the proposed requirement in the Exposure Draft to disclose how the entity determined the income tax required by 3(a); and

(d) add a requirement for an entity to disclose that it has chosen to calculate the tax effect as described in 3(b)(i) when that is the case.

Structure of the paper

4. This paper is structured as follows:

    (a) background (paragraphs 5–42):

        (i) proposals in the Exposure Draft (paragraphs 5–9);

        (ii) feedback on the Exposure Draft (paragraphs 10–18);

        (iii) fieldwork findings (paragraphs 19–20);

        (iv) staff recommendations in January 2022 (paragraphs 21–24);

        (v) summary of IASB discussion in January 2022 (paragraphs 25–35);

        (vi) summary of additional outreach (paragraphs 36–42); and

    (b) staff analysis and recommendations (paragraphs 43–78);

        (i) clarifying the proposals in the Exposure Draft (paragraphs 47–65);

        (ii) simplified approach (paragraphs 66–70);

        (iii) choice between the clarified approach and the simplified approach (paragraphs 71–74); and

        (iv) staff recommendation (paragraphs 75–78); and

    (c) Appendix A—Example demonstrating the approaches.

Background

Proposals in the Exposure Draft

5. The Exposure Draft proposed that an entity would be required to disclose specific information about management performance measures, including (see paragraph 106 of the Exposure Draft):

    (a) a description of why the management performance measure communicates management's view of performance;

(b) a reconciliation to the most directly comparable total or subtotal specified by IFRS Accounting Standards;

(c) the income tax effect and the effect on non-controlling interests for each item disclosed in the reconciliation; and

(d) how the entity determined the income tax effect for each item disclosed in the reconciliation.

6. The Exposure Draft proposed that an entity shall determine the income tax effect stated in paragraph 5(c) on the basis of a reasonable pro rata allocation of the current and deferred tax of the entity in the tax jurisdiction(s) concerned or by another method that achieves a more appropriate allocation in the circumstances (see paragraph 107 of the Exposure Draft).

7. Paragraph BC176 explains the IASB considered whether an adjusted earnings per share that is based on the entity's management performance measures should be required. It rejected this approach because it would introduce complexity when entities have more than one management performance measure, if these measures are not calculated consistently.

8. Paragraph BC177 explains the IASB considered feedback that earnings per share information was important to users of financial statements and that one of the benefits of management performance measures to users is the detailed information that can be used to calculate a related earnings per share figure. To calculate such an earnings per share figure, users need information about the earnings adjustments attributable to the parent and the tax effects of those adjustments. Therefore, the IASB proposed an entity should disclose separately the effect of income tax and the amount attributable to non-controlling interest for each reconciling item between a management performance measure and the most directly comparable total or subtotal specified by IFRS Accounting Standards. The IASB decided to propose this disclosure at the level of individual adjustments made in calculating a management performance measure rather than at the level of the total adjustment because it gives users information needed to select which adjustments they want to consider in arriving at an adjusted earnings per share measure used in their analysis.

9. Paragraph BC178 explains the IASB noted that some preparers of financial statements have said the disclosure of the tax and non-controlling interest effects for individual adjustments may be complex and costly. To alleviate the costs of preparing disclosures about the tax effect for management performance measure adjustments, the IASB proposed a simplified approach for calculating the income tax effect for the reconciling items. The IASB concluded that this simplified approach would provide users of financial statements with a reasonable estimate of the income tax effect for adjustments, making it clear when the tax effect for an adjustment is materially different to the effect calculated applying the entity's effective tax rate. The IASB noted that this approach is similar to the approach for determining the income tax effect on items of other comprehensive income set out in IAS 12 *Income Taxes*.

Feedback on the Exposure Draft

10. Respondents provided mixed feedback on the proposed requirement to disclose the income tax effect and the effect of the non-controlling interests for each item disclosed in the reconciliation between a management performance measure and the most directly comparable total or subtotal specified in IFRS Accounting Standards. While some respondents, including many users, agreed with the proposed disclosure requirements, some—mostly preparers—did not agree.

11. Respondents that agreed with the requirement said that it would provide useful information. In particular:

    (a) some users explicitly stated that the tax and non-controlling interest information would be useful. For example, one user said that the tax effects of the reconciling items can be materially different from the amount calculated using the effective tax rate and therefore information about those different effects is important. Another user said that information about the income tax effect and the effect of the non-controlling interests is needed to calculate adjusted earnings per share excluding some of the reconciling items. However, some of these users also said they were interested in a high-level understanding of the tax effects, for example, when the tax rate on reconciling items was significantly different than the effective tax rate, and not the detailed calculations.

(b) one securities regulator said that in their jurisdiction a defined adjusted earnings per share measure is required and entities have been required to disclose the income tax effect and effect on non-controlling interests on reconciling items for a decade. For this reason, the regulator said they failed to see the concerns raised by preparers over providing the proposed disclosures.

12. In contrast, two users said they were not particularly concerned whether that information was given. One user said this was because as a credit analyst they would not usually use this information. The other said it was because in their view users were able to make reasonable estimates without specific disclosure and therefore the benefits may not justify the costs to preparers.

13. Most of the respondents that disagreed with providing the tax and non-controlling interest information said it was because it would be too costly to provide. A few of these respondents also said that the proposed simplified approach to determining the tax effect did not sufficiently reduce these costs, for example because they would still need to determine effective tax rates in different tax jurisdictions.

14. Some of the respondents that disagreed also said that the tax and non-controlling interest information may require arbitrary allocations that could be misleading.

15. A few respondents disagreed with the requirements because they would result in disclosure that was beyond the equivalent requirements for the line items included in the totals or subtotals specified by IFRS Accounting Standards.

16. A few respondents said that providing information on tax and non-controlling interest was inconsistent with management performance measures communicating a management view because this information was not always used by management.

17. Some respondents suggested that the requirements for tax and non-controlling interest should be restricted to management performance measures that are disclosed on a post-tax basis because, in their opinion, the information was not relevant for pre-tax measures such as EBITDA.

18. Some respondents suggested the requirement should be restricted to the reconciling items in total instead of individual adjustments saying this would be consistent with how tax and non-controlling interest effects are often disclosed today.

Fieldwork findings

19. Many participants that reported management performance measures disclosed the income tax effect for items disclosed in the reconciliation. However, a few of these entities presented a net tax impact for all adjusting items and did not disclose the tax impact for each adjusting item. A few of the participants that disclosed the tax impact did not disclose the effect on non-controlling interests for each item disclosed in the reconciliation. One of these participants said they were unable to calculate the amount using current systems and others said the amounts were immaterial.

20. Some participants said that the calculation of tax and non-controlling interests for each item disclosed in the required reconciliation was challenging due to system limitations. For example, one participant said that an adjustment to remove restructuring costs would be made at the group level but could involve expenses arising in numerous different tax jurisdictions and the existing systems were not designed to calculate the tax effects of these individual expenses in the subsidiary entities. One participant said that although the requirement for tax and non-controlling interest was similar to that for items of other comprehensive income, it was more difficult to apply to management performance measures. This is because there are more types of reconciling items and they change more frequently than items included in other comprehensive income.

Staff recommendations in January 2022

21. In Agenda Paper 21B of the January 2022 IASB meeting, the staff recommended the IASB retain the disclosure requirements proposed in the Exposure Draft (see paragraph 5). This recommendation responded to user feedback that the disclosures provide useful information. The staff also recommended revising the wording of the simplified approach to determining the tax effects proposed in the Exposure Draft and adding application guidance to clarify the cost mitigation intended by the approach.

This recommendation responded to preparer feedback on the costs of providing the disclosures.

22. The staff proposed the following revisions to the simplified approach:

> An entity shall determine the income tax effect required by paragraph 106(c) [of the Exposure Draft] on the basis of a reasonable ~~pro rata~~ allocation of the current and deferred tax of the entity ~~in the tax jurisdiction(s) concerned or by another method that achieves a more appropriate allocation in the circumstances~~.

23. The staff proposed the following guidance on applying the term 'reasonable allocation' in the revised simplified approach:

    (a) in assessing what is a reasonable allocation, an entity shall consider the tax jurisdiction(s) and the individual treatment of the reconciling item in those jurisdictions; but

    (b) a reasonable allocation need not involve complex calculation relating to tax effects that arise at an aggregated level.

24. The staff analysis included an alternative approach to reducing costs of the proposed requirements—requiring an entity to disclose the income tax effects and the effects of non-controlling interest for each reconciling item only for those management performance measures calculated on a post-tax basis or used in a per share measure. This alternative approach would not have required the disclosure for any measure that does not include income tax, for example an adjusted operating profit or an EBITDA measure not used in a per share measure.

Summary of IASB discussion in January 2022

25. At its January 2022 meeting the IASB discussed the staff's recommendations regarding the disclosure of the tax effect for each item disclosed in the reconciliation ('management performance measure reconciling items') between a management performance measure and the most directly comparable subtotal specified by IFRS Accounting Standards but did not make any decisions. Most IASB members agreed that providing users with information needed to select which reconciling items they

want to consider in their analyses in arriving at an adjusted earnings per share measure was an important aim of the proposal. These IASB members agreed the disclosure requirement should be retained to the extent possible. However, most IASB members also agreed that the calculation of tax for individual items of income or expense can be complex and that adequate cost relief for such complexity would be necessary. The IASB asked for further information about how entities that already disclose the tax effects for each reconciling item in their non-GAAP disclosures calculate these tax effects.

26. Some IASB members supported retaining the proposal in the Exposure Draft because it provides users with the information necessary to understand the impacts of individual reconciling items on an earnings per share basis. These members said that the tax effects can have a significant impact on the amount of reconciling items and that it was important to allow users to select which reconciling items they want to consider in their analyses.

27. A few IASB members did not think the costs of developing systems and processes would be prohibitively costly. One member said that this was because entities have a limited number of management performance measures, and those measures are consistent from period to period. Another member referred to examples of entities that currently include information about the effects of tax and non-controlling interest on each line item reconciling their non-GAAP measures to measures specified in IFRS Accounting Standards in their management commentary. Many entities also calculate a tax adjustment to provide a post-tax measure or an adjusted earnings per share measure. This member suggested this as evidence that the challenges to calculating tax on reconciling items can be overcome in practice.

28. A few IASB members disagreed with the proposal in the Exposure Draft because they thought calculating tax on the basis of an individual item of income or expense was inconsistent with the definition of taxes in IAS 12, which is based on a net amount of income and expenses. These members suggested revising the proposal in the Exposure Draft to require information on the tax effects for the management performance measure as a whole rather than on the individual reconciling items.

29. Some IASB members said that for management performance measures that are calculated on a pre-tax basis, entities may need to develop systems and processes to capture the information required to calculate the tax effects for individual reconciling items. These members preferred the alternative approach in the staff paper (see paragraph 24) or the alternative approach further revised to require disclosure of the tax effects only for the management performance measure as whole. One IASB member said obtaining tax information may be particularly challenging when the legal entities which are taxable are not the same as the reporting entities for consolidation. Another member was concerned that additional costs for systems and processes may cause entities to stop providing some management performance measures resulting in a loss of useful information.

30. Some IASB members said they understood the concerns of some preparers about the potential complexity of calculating an effective tax rate for an individual reconciling item, particularly when expenses that are tax deductible at an entity level are not tax deductible at the taxable entity level.

31. However, based on the feedback, IASB members did not think the simplified approach in the Exposure Draft (see paragraph 6) or the staff's proposed revisions and application guidance (see paragraphs 22–23) were clear enough to be operational. Some IASB members suggested that any guidance needs to clarify when an entity is required to do a more detailed calculation and, when it is not required to do a detailed calculation, which details can be omitted.

32. As an alternative, a few IASB members suggested that qualitative disclosure could be required when quantitative disclosure was too complex or onerous. The qualitative disclosure was suggested to include an explanation of the reasons why the calculation was too complex and an indication of how the effective tax rate for the item differed from the effective tax rate of the entity.

33. Some IASB members questioned the level of precision needed by users on the tax effects for reconciling items and asked whether cost relief could be provided by allowing for approximations.

34. One IASB member thought entities could not approximate the tax effects of reconciling items. This is because directors would have a legal responsibility for the disclosures which would require a precise calculation of any material tax effects for each reconciling item. Another IASB member was concerned about the auditability of approximations.

35. Some IASB members asked whether there was more information on the extent of entities for which the calculation of tax effects for reconciling items would be prohibitively complex and the extent to which the proposed solutions would be effective in providing relief. Some IASB members suggested the staff talk to a sample of entities that currently disclose information similar to that proposed in the Exposure Draft in their non-GAAP reporting to gain a better understanding of their circumstances and how they overcome the challenges discussed.

Summary of additional outreach

Targeted outreach

36. The staff conducted targeted outreach with entities that currently disclose the tax effects and the effects on non-controlling interests for individual reconciling items, as proposed in the Exposure Draft. Based on the results of this outreach the staff identified two drivers of costs and complexity in calculating the tax effect for individual reconciling items:

    (a) systems and processes required to capture and consolidate item specific tax effects; and

    (b) tax effects that impact multiple transactions and require allocations to individual items.

37. The staff did not identify any common entity level factors that make the calculation of tax effects for reconciling items more or less difficult than for other entities. All of the entities in the outreach operate multiple business lines across multiple jurisdictions with differing tax rates. However, no entities with whom we conducted outreach operate in a jurisdiction that has graduated tax rates—a common example cited as involving complexity.

38. All of the entities have systems and processes in place to identify the tax effects of reconciling items at the taxable entity level and to consolidate those effects. Those processes identify the applicable effective tax rate in the relevant jurisdiction and any tax impacts relevant to the individual reconciling item. None of the entities encountered challenges in identifying the tax effects for individual items at this level. The entities are aware of the jurisdictional tax rates that apply and said the tax effects relevant to individual items are usually known or knowable in consultation with the entity's tax department. For example, goodwill is almost never tax deductible, and the deferred tax impact of intangible assets is already calculated for the group tax calculation.

39. One entity suggested that once the system was created it was not complex or costly because internal rules were established for the different types of reconciling items used in their adjusted measures and these rules were consistently applied from period to period.

40. One entity said their calculations considered overarching group level tax effects. This entity said that when there was a transaction giving rise to a reconciling item that would have group wide tax effects a discussion was usually had with its tax department to determine how tax would impact the group. For example, if a reconciling item were identified for an ongoing litigation expense across multiple jurisdictions with a cost sharing agreement, the entity would agree an allocation of the costs across the affected entities and this would form the basis for calculating the tax effects of the reconciling item. The agreed allocation and related tax effects would continue for the life of the litigation.

41. One entity includes the tax effects on individual reconciling items in its audited financial statements and said that this information was subject to audit. They said the focus of the audit (and management's approach) is to identify material differences in the effective tax rate applicable to reconciling items. In this entity, the subsidiaries are the same as the taxable entities and these subsidiaries are also audited individually. The entity does not operate in jurisdictions that give rise to group level tax effects and therefore it does not experience the need to make any tax allocations across entities for its reconciling items. However, due to the nature of the entity's business there are

complex tax consequences of individual transactions within the different entities which give rise to large swings in the effective tax rate between periods at an entity level.

Preparer letters

42. In addition to the targeted outreach, the staff received written feedback from a few preparers following the IASB's redeliberations of the requirement to disclose the tax effect and effect on non-controlling interest of the items reconciling a management performance measure to the most directly comparable subtotal or total specified by IFRS Accounting Standards. These preparers raised the following concerns about calculating tax on individual reconciling items:

    (a) it may be difficult or arbitrary to allocate tax losses applicable at a group level on consolidation to individual items.

    (b) it would be challenging to obtain information about the tax on individual line items from each of the taxable entities in the group as the relevant entities may change from year to year depending on the reconciling items.

    (c) if estimates are required for determining the tax effects of individual reconciling items and there is no estimation method specified in IFRS Accounting Standards there could be a risk of tax authorities misinterpreting estimates with legal consequences for the entity and its management.

Staff analysis and recommendations

43. The staff continue to think that stakeholder concerns over complexity of calculating tax on the reconciling items can be addressed by clarifying the application of the approach proposed in the Exposure Draft, simplifying the calculation, or a combination of both. The staff analysis assesses each of these three possible approaches as follows:

    (a) clarifying the requirement based on the existing guidance in IAS 12 on how to separately identify the income tax effects related to profit and loss, other comprehensive income (OCI) and equity (paragraphs 47–65);

(b) providing a simplified approach allowing an entity to calculate the tax effects of reconciling items using only the income tax effects directly related to the relevant transaction(s) (paragraphs 66–70); and

(c) allowing an option between the clarified approach and the simplified approach (71–78).

44. Based on the staff's outreach, having systems and processes in place to bring together the relevant income tax information is necessary for the disclosure of information about the income tax effects of reconciling items (see paragraph 38). The staff think that to achieve the aim of providing users with information needed to select which reconciling items they want to consider in their analyses in arriving at an adjusted earnings per share some systems costs will be unavoidable in cases where this information is not currently provided. The staff have therefore focused on reducing complexity rather than systems and process costs.

45. This approach may not address all concerns about systems costs raised by some stakeholders (see paragraph 13) and some IASB members (see paragraph 29).

46. However, the staff do not expect the costs of implementing such systems and processes to be excessive because:

(a) the information required to calculate the income tax effect for a reconciling item is generally already used by entities for their accounting and tax compliance;

(b) systems and processes already exist for identifying and collecting information regarding the underlying transactions that give rise to reconciling items;

(c) management performance measures and the related reconciling items are generally consistent from period to period;

(d) the information required to calculate the income tax effect does not necessarily require changes to accounting systems to be gathered and consolidated (because it is possible to develop processes to capture the relevant information outside the accounting system); and

(e) the majority of costs are expected to relate to the initial implementation and not to be ongoing.

Clarifying the proposals in the Exposure Draft

47. The proposal in the Exposure Draft for the calculation of tax on management performance measure reconciling items (see paragraph 6) was based on IAS 12 which provides a practical approach to identifying the tax effects for different categories of income or expense. The approach in the Exposure Draft was intended to replicate this approach for calculating tax on the reconciling items.

48. This section:

(a) summarises the requirements of IAS 12 to recognise the related income tax in each of profit or loss, OCI and equity (see paragraphs 49–57); and

(b) explains how those requirements could be applied to the management performance measures requirements (see paragraphs 58–65).

Requirements of IAS 12

49. The recognition principle for current and deferred tax is that accounting for the current and deferred tax effects of a transaction or other event is consistent with the accounting for the transaction or event itself (paragraph 57 of IAS 12). In applying this principle an entity is required to separately recognise current and deferred tax arising from transactions or events in the statement of profit or loss, OCI, and equity (paragraph 58 of IAS 12).

50. The Standard states that most deferred tax assets and liabilities arise where income or expense is included in accounting profit in one period, but is included in taxable profit (tax loss) in a different period (paragraph 59 of IAS 12).

51. This implies that most tax effects are a direct result of the current and deferred tax of the individual transaction or event—the current tax for the type of income or expense in the relevant jurisdiction and the deferred tax effects of any difference between the timing of recognition for accounting and for tax.

52. However, IAS 12 recognises that there are income tax effects that can be difficult to attribute directly to an individual item. The Standard says this may be the case, for example, when (paragraph 63 of IAS 12):

(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 the item;

(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 the item.

53. The staff think it may also be difficult to directly attribute the amount of current and deferred tax related to an item of income and expenses when:

(a) there are recoverable net losses that contribute to an unused tax credit recognised as a deferred tax asset; and

(b) there is a reduction in taxable net profit because of the use of an unused tax credit for which a deferred tax asset was previously recognised.

54. The following example demonstrates how it may be difficult to attribute a loss carry-back to a related item in profit and loss or to a related item in OCI. The assumptions are as follows:

(a) Years 1 and 2 are the first years of operations.

(b) The entity has no temporary differences.

(c) Pre-tax operating results are breakeven for year 1 and CU800 loss for year 2.

(d) A CU800 exchange gain is realized on a foreign currency transaction that is designated as hedge of the foreign net investment. That exchange gain is taxable for year 1.

	Year 1	Year 2
Income Statement		
Pretax operating income (loss)	0	-800
Tax expense (34 per cent)	0	?
	0	?
Cumulative Translation Adjustment (Equity)		
Beginning balance	0	0
Translation loss	-528	0
Hedging gain	800	0
Tax (expense) benefit (34 per cent)	-272	?
Ending balance	0	?

55. In year 1 the entity pays income tax of CU272 on the hedging gain recognised in OCI. If the entity is able to carry-back the operating loss in year 2 to recover the CU272 income tax, the question arises whether that income tax recovery should be included in:

(a) profit or loss—the location of loss generating the recovery; or

(b) OCI—the location of the item that generated that income tax paid that will now be recovered.

56. The question arises because the income tax recovery is the result of both events. In these cases, IAS 12 requires the income tax related to each of profit or loss, OCI and equity to be allocated on the basis of a reasonable pro rata allocation of the income tax in the tax jurisdiction concerned or other method that achieves a more appropriate allocation (paragraph 63 of IAS 12).

57. The requirement in IAS 12 to allocate income tax on a reasonable basis applies only to the specific circumstances when it is difficult to determine the amount of the current and deferred tax effects—such as in the examples provided (see paragraph 52). The income tax effects related to the transaction or other event continue to be identified. This implies the income tax effects included in profit or loss, OCI or equity are both of:

(a) the income tax effects of the transactions or other events; and

(b) a reasonable allocation of any income tax effects that are difficult to relate directly to the transaction or other event in the circumstances specified.

Applying the IAS 12 approach to the management performance measure requirements

58. In the staff's view the intention of the approach in the Exposure Draft to identify the income tax effects of management performance measure reconciling items was similar to the approach in IAS 12 to identifying the income tax effects related to profit or loss, OCI and equity as described in paragraph 57. In the Exposure Draft the wording was simplified making the drafting of the requirement appear to be a simple allocation of an entity's total tax to the reconciling items. The staff think that the intended approach could be clarified by revising the description of how an entity calculates the tax effect for individual reconciling items to explain that an entity:

    (a) calculates the tax effects directly related to the transaction(s) at the statutory tax rate(s) applicable to the transaction(s) in the relevant jurisdiction(s); and

    (b) then allocates any other tax effects that are indirectly related to the underlying transaction or other event 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.

59. The staff think this would also make the proposal more operational by clarifying:

    (a) the income tax effects entities are required to identify—the income tax effects directly related to the underlying transaction(s); and

    (b) when entities are able to make reasonable allocations—when there are other income tax effects that relate indirectly to the transaction or other event.

60. The staff think this clarification would help to reduce the perceived complexity of the Exposure Draft proposals because it:

    (a) requires entities to identify the direct income tax effects of reconciling items in the relevant jurisdictions, which should not be difficult to identify—for example whether the item is non-taxable, partially taxable, or taxable at a specific rate in the relevant jurisdiction; and

    (b) allows flexibility for the entity to make judgments over the best allocation of those items that are more difficult to attribute to a specific transaction—for example determining the amount of group tax relief applicable to the reconciling item compared to other items of income or expense.

61. The staff think this approach is aligned with the requirements in IAS 12 for profit and loss, OCI, and equity. However, it is not identical and may have its limitations. IAS 12 requires the identification of the income tax effects of transactions or events to the categories of profit or loss, OCI, and equity. It does not require an entity to calculate the tax effects of an individual item of income or expense.

62. It may be more complicated to allocate tax effects that are indirectly related to the specific items of income or expense, particularly when management performance measure reconciling items will be a subset of items that are also included in profit or loss. Management performance measure reconciling items will also vary more significantly from entity to entity than items that are included in OCI or equity.

63. The use of a reasonable allocation may not address some stakeholders concerns that such allocations maybe seen as estimates (see paragraph 42).

64. Although a reasonable allocation is intended to reduce complexity, it may not do so in all cases, for example when significant judgments are required.

65. The judgment required in making a reasonable allocation may result in tax effects for similar transactions not being comparable between entities (see example in Appendix A).

Simplified approach

66. The staff think the calculation of the tax effects of reconciling items could be simplified by including only the income tax effects that are directly related to the underlying transaction(s). This would simplify the calculation by removing the requirement for an entity to allocate the tax effects that are difficult to determine—the indirect tax effects relating to a reconciling item (see example in Appendix A).

67. Simplifying the calculation to include only the direct tax effects of the reconciling item would base the calculation on verifiable information that is available to an entity. This would remove the need for an entity to make further judgments or assumptions. Such information would be easier to audit. Removing the judgmental aspects of the

calculation would respond to the concerns of a few preparers (see paragraph 42) and a few IASB members (see paragraph 34) about making estimates in the calculation of the tax effects.

68. The staff think this simplification would also provide sufficient information to meet user's needs. Although it would not capture all of the relevant tax effects in the entity it would provide information about the tax effects specific to the individual item such as whether it is non-taxable or taxable at a rate significantly different to the effective tax rate. This information would be consistent with the comments of some users that they were interested in a high-level understanding of the tax effects (see paragraph 11(a)).

69. However, the simplification does result in a loss of information. The indirect tax effects of a transaction are relevant to understanding the full tax effects of a reconciling item and in some cases may be material. The simplified approach would ignore these effects balancing the costs of the additional complexity with the level of precision needed by users.

70. Another drawback to providing a simplified approach in place of the clarified approach is that it may be interpreted as preventing entities from making reasonable allocations of the indirect tax effects of transactions resulting in a loss of information even in cases where entities are able provide the more complete calculation.

Choice between the clarified approach and the simplified approach

71. A third alternative would be to allow an entity to choose between the clarified approach and the simplified approach for all reconciling items. The benefit of allowing a choice is that it would clearly allow entities to provide more complete, but more complex, calculations, when they are able to do so while still reducing complexity when an entity judges it to be necessary. The disadvantage of the choice is that it reduces the comparability of information between entities. It may also result in a loss of information compared to a requirement to make the full calculation as some entities that are able to make the more complex calculations may choose not to.

72. The staff think that the choice should apply to reconciling items as a whole, and not on an item-by-item basis. The objective of the simplification is to reduce complexity by removing the need to make allocations of indirect tax effects. Making such allocations for some adjustments and not others would be inconsistent with this objective and could allow for opportunistic allocations.

73. The staff considered but rejected adding requirements to disclose information about the tax effects ignored by the simplified approach. The staff think that requiring the disclosure of such information would reduce the effectiveness of the simplification in reducing complexity. Information about many of the items giving rise to these effects (changes in tax rates affecting previously recognised deferred tax assets or liabilities, recognition of previously unrecognised deferred tax assets, etc) is also available in the entity's tax disclosures, for example, the tax reconciliation.

74. The staff also considered but rejected placing restrictions on the use of the simplified calculation. The staff think a condition such as undue cost or effort may be difficult to apply because it would be difficult to demonstrate undue cost or effort for reconciling items when the same reasonable method of allocation available does not result in undue cost or effort for items of OCI and equity applying IAS 12. Further, the basis for introducing the practical expedient is to reduce complexity by removing the requirement to make allocations that may be difficult or arbitrary. It would be impractical to draw a line between the types or amounts of allocations that are excessively difficult or excessively arbitrary and justify an exception versus those that are not. Such criteria would also add a layer of complexity.

Staff recommendation

75. The staff recommend the IASB:

    (a) confirm the proposal in the Exposure Draft to require an entity to disclose the income tax effect and the effect on non-controlling interests for each item disclosed in the reconciliation between a management performance measure and the most directly comparable subtotal or total specified by IFRS Accounting Standards;

(b) revise the proposed requirement specifying how to calculate the income tax effect to allow an entity to either:

(i) calculate the tax effects of the underlying transaction(s) at the statutory tax rate(s) applicable to the transaction(s) in the relevant jurisdiction(s); or

(ii) calculate the tax effects as described in (i) and allocate any other income tax effects related to the underlying transaction(s) based on a reasonable pro rata allocation of the current and deferred tax of the entity in the jurisdictions concerned, or other method that achieves a more appropriate allocation;

(c) remove the proposal in the Exposure Draft to disclose how the entity determined the tax effect of management performance measure reconciling items;

(d) add a requirement for an entity to disclose that it has chosen to calculate the tax effect as described in 75(b)(i) when this is the case.

76. In the staff's view allowing a choice between the clarified approach and the simplified approach will:

(a) clarify how to calculate the tax on reconciling items;

(b) allow entities that provide more complete calculations to continue to do so;

(c) reduce the complexity of calculating the tax effects of reconciling items; and

(d) provide users sufficiently detailed information on the tax effects of reconciling items for their analyses.

77. An important aspect of the approach in the Exposure Draft is that it is accompanied by a requirement for the entity to disclose how it determined the income tax effect. That requirement did not attract any feedback. However, the approach recommended in this paper clarifies how the tax effect is calculated and may reduce the need for more detailed information about how the entity has performed the calculation. The approach is also based on the guidance in IAS 12 on how to separately identify the tax

effects related to profit and loss, OCI and equity, which does not require specific disclosures about the use of reasonable pro rata allocations.

78. The staff think that an entity should be required to disclose when it has used the simplified approach. Without disclosure of the fact that some information has been excluded, the disclosed tax effects of reconciling items could be misleading. IAS 1 *Presentation of Financial Statements* requires an entity to disclose material accounting policy information. In some cases, use of the simplified approach may not result in a material difference from the clarified approach in the result of the calculation. However, the staff think whether or not the simplified approach has been used will be material information because it will help users to compare the bases for the calculations between different entities.

Questions for the IASB

Q1 Does the IASB agree to confirm the proposed requirement in the Exposure Draft to disclose the income tax effect and the effect on non-controlling interests for each item disclosed in the reconciliation between a management performance measure and the most directly comparable subtotal or total specified by IFRS Accounting Standards?

Q2 Does the IASB agree to revise the requirement specifying how to calculate the income tax effect to allow an entity to either:

(a) calculate the tax effects of the underlying transaction(s) at the statutory tax rate(s) applicable to the transaction(s) in the relevant jurisdictions(s); or

(b) calculate the tax effects described in (a) and allocate any other income tax effects related to the underlying transaction(s) based on a reasonable pro rata allocation of the current and deferred tax of the entity in the jurisdictions concerned, or other method that achieves a more appropriate allocation?

Q3 Does the IASB agree to remove the proposed requirement in the Exposure Draft to disclose how the entity determined the income tax effect for each management performance measure reconciling item?

Q4 Does the IASB agree to add a requirement for an entity to disclose that it has chosen to calculate the tax effect as described in Q2(a) when that is the case?

Appendix A—Example demonstrating the approaches

A1. The following example demonstrates how the clarified guidance and the simplified approaches could be applied to management performance measure reconciling items:

(a) An entity presents an operating profit of CU800.

(b) The entity undertakes a restructuring resulting in CU200 of expenses made of CU90 in tax jurisdiction A, CU70 in tax jurisdiction B and CU40 in tax jurisdiction C.

(c) The entity discloses adjusted operating profit of CU1000 comprised of operating profit CU800 and reconciling item of restructuring expenses of CU200.

(d) The entity has CU100 loss carry-forwards that it can use to offset tax in the current period. The entity operates in jurisdictions which permit the carry-forward to be applied to taxable income in any of the three jurisdictions.

(e) The tax rate applicable to the restructuring expenses in jurisdiction A is 18%, in jurisdiction B is 27% and in jurisdiction C is 34%.

A2. Applying the revised wording of how to calculate the tax effect for the reconciling item (see paragraph 75) the entity would first calculate the tax effect for the reconciling item for restructuring as the tax effects arising directly from the underlying transactions in the relevant jurisdictions—jurisdiction A CU16 (90 x18%), jurisdiction B CU19 (70 x 27%), and jurisdiction C CU14 (40 x 34%).

A3. The entity would then make a reasonable allocation of tax effects or the CU100 carry-forward that are indirectly related to the reconciling items. There are different methods of allocation that might be considered reasonable in this set of circumstances. For example, the entity could judge that:

(a) the loss carry-forward would be allocated first across each jurisdiction from highest tax rate to lowest tax rate and then pro rata between the reconciling and non-reconciling items in that jurisdiction because this would be the most beneficial use of the credit;

(b) the loss carry-forward would be applied on a pro rata basis across the reconciling items and non-reconciling items regardless of jurisdiction on the basis that the carry-forward could be equally applicable to all items; or

(c) the loss carry-forward would be applied entirely to the net income arising from non-reconciling items and none to the reconciling items because the reconciling items are all expenses that reduce taxable income and the loss carry-forward could only be applied to taxable income.

A4. Under this approach the amount of tax allocated to the reconciling item would be dependent on the allocation decision made and therefore could be different for different entities.

A5. Applying the simplified approach, the entity would make no allocation of the CU100 loss carry-forward attributable to the reconciling item for restructuring. Effectively the CU100 would be fully attributable to the unadjusted items comprising operating profit. The tax effect for the reconciling item for restructuring would be the total of the tax effects in each jurisdiction of CU49 ((A)16+(B)19+(C)14).