International Financial Reporting Standards

Accounting for income taxes- Is there a need for change?

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CMAC meeting, 27 February 2015
Agenda paper 3

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

Agenda

- Purpose of the session
- Background information
- CMAC tax survey results
  – questions for the CMAC members

Purpose of the session

- To understand how you use tax information today
  - what information about income taxes do you need?
  - how do you build that information into your models, if at all?
- To understand your views on today's approach to accounting for income taxes.
  - does the accounting provide you with the information that you need? Why or why not?
  - would you prefer different or additional disclosure?
- To understand to what extent you think the Standard for income taxes should be amended?
  - Narrow-scope amendments to improve disclosures requirements?
  - Fundamental rethink of the principle to account for income taxes?

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Background

The overall objective of income tax accounting today

- The objective of the IFRS for income taxes* is to provide information about:
  - current tax — tax payable or refundable for the current period
  - deferred tax — future tax consequences of book-tax differences on balance sheet

- ‘Temporary difference’ approach
  – deferred tax arises from
    – all timing differences; and
    – other differences such as (1) undistributed profits in subsidiaries, (2) revaluation gain on assets and (3) intangible assets acquired in business combination at fair value

* IAS 12 *Income Taxes*

Why are we doing this project?

- There are questions about the usefulness of the information provided by the current accounting requirements and their complexity.
  - Income Tax remains one of the most time-consuming topics at the IFRS Interpretation Committee
  - EFRAG's 2011 discussion paper[1] recognised deficiencies on both a conceptual and application level.
  - A number of professionals and recent academic research question the value / relevance of deferred tax information.

1. http://www.efrag.org/files/ProjectDocuments/Proactive%20-%20Income%20Taxes/120127_Income_tax_DP_final.pdf

CMAC Tax Survey Results

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The way you use tax information

- The survey results indicated that DCF and Multiples are the most popular valuation techniques
- According to the survey, the top three ways tax information is used in these valuations are:
  - adjusting profit or loss
  - estimating cash flows related to income taxes
  - computing the cost of capital

Question 1 for CMAC members:
Following on from the survey results, please expand on:
- how you use tax information today;
- what information about income taxes you need; and
- how you build that information into your models, if at all?

The tax information you use

- The survey results indicated the following as the most relevant tax information used today:
  - deferred tax assets and liabilities
  - total income tax expense
  - effective tax rate
  - company-provided normalised and expected tax rates
- Although all respondents use tax information to a certain extent, there were mixed views about that information:
  - some think it is clear and understandable but insufficient
  - some think that the information is unclear, difficult to understand and insufficient

Deferred tax information you use

- The results also indicated that while many of you do use deferred tax information, there are different views on what deferred tax information represents:
  - deferred tax liabilities and deferred tax assets are future income taxes due to past transactions or past events **(current IAS 12)**
  - deferred tax liabilities and deferred tax assets are past income taxes but have been deferred to the future periods for some reason
  - deferred tax assets (liabilities) are theoretical (artificial) numbers with no economic meaning for my analysis

Question 2 for CMAC members:
Does today's accounting, especially the recording of deferred taxes, provide you with the information that you need?
- Why or why not?
- Would you prefer different or additional disclosure?

Other areas to improve

- From the survey we learnt that you seek <u>disclosure</u> improvements in the following areas:
  - Introduction of ‘valuation allowance’ and clear picture of unused tax losses
  - Explanation of how the effective rate is calculated (further disclose tax rate by segment/jurisdiction etc)
  - Additional information to help forecast future tax rate/future tax expense/future cash tax
  - More detailed disclosure of the breakdown of deferred tax liability/deferred tax asset (recurring/non-recurring)
  - Disclosures about the tax consequences of remitting cash from subsidiaries; as well as other items that affect availability of resources
  - Current tax expense in interim statements

Other areas to improve (Cont'd)

- You are also seeking improvements in following areas where the staff think that there is a need for a fundamental change in principle (please refer to Appendix I for more information):
  - Time scale and pattern of reversal of temporary difference / **Discounting** of deferred tax balances
  - Separate disclosures of DTL into 2 groups: (1) arising from recurring activities and (2) arising from **revaluation**

Question 3 for CMAC members

- Are these points a fair reflection of other areas to improve?
- Are we missing any other important information?
- To what extent do you think the Standard should be amended? Enhanced disclosure or a fundamental change of principle?

Areas that may require fundamental change – Appendix I

Appendix I - Areas that may require fundamental change

- The case study in Agenda Paper 3A delves into more detail by illustrating the current and potential accounting for two areas where a fundamental change in principle may be required:
  - **Deferred tax and time value of money**
  - **Deferred tax and fair value**
- The above problems may distort the profit after tax and also shareholders' equity; this could then affect commonly used metrics such as Return on Equity or Return on Capital.
- Staff have provided an explanation of alternative approaches in the following slides. Staff have also discussed the effect of applying those approaches to the same fact pattern in the case study in Agenda Paper 3A.

Other possible approaches

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Possible approaches to income tax accounting[1]

- Temporary difference approach (approach under IAS 12 today)
  - Deferred tax is recognised for a difference between accounting balance sheet and tax balance sheet.
- Accrual approach (timing difference approach)
  - Deferred tax is recognised for a difference between income statement and tax return
- Flow-through approach
  - Only current tax is recognised (no deferred tax)
- Partial tax allocation approach
  - Deferred tax is recognised for some but not all timing differences
- Valuation adjustment approach
  - Deferred tax is recognised as an adjustment to the value of underlying asset/liability

1. http://www.efrag.org/files/ProjectDocuments/Proactive%20-%20Income%20Taxes/120127_Income_tax_DP_final.pdf

Summary of possible approaches to income tax accounting

	Information provided in:			
Approach:	Balance sheet	P&L	Cash flows	Main disclosures
Temporary difference (today)	1. Current tax asset/liability 2. DTA/DTL[1] arising from temporary differences[2]	1. Current tax expense 2. Deferred tax expense	1. Tax paid	1. Movement of DTA/DTL 2. Reconciliation of tax rate 3. Tax effect of OCI 4. Unrecognised DTA

Approach:	Balance sheet	P&L	Cash flows	Possible disclosures[4]
Accrual	1. Current tax asset/liability 2. DTA/DTL arising from timing differences[3]	1. Current tax expense 2. Deferred tax expense	1. Tax paid	1. Movement of DTA/DTL 2. Reconciliation of tax rate 3. Unrecognised DTA
Flow through	1. Current tax asset/liability	1. Current tax expense	1. Tax paid	1. Reconciliation of tax rate (all timing & permanent differences) 2. Additional information determined to be useful

[1] DTA/DTL refers to deferred tax assets/deferred tax liabilities
[2] Temporary difference is a book-tax difference in balance sheet
[3] Timing difference is a book-tax difference in income statement
[4] Subject to further deliberation by the IASB.

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Summary of possible approaches to income tax accounting (continued)

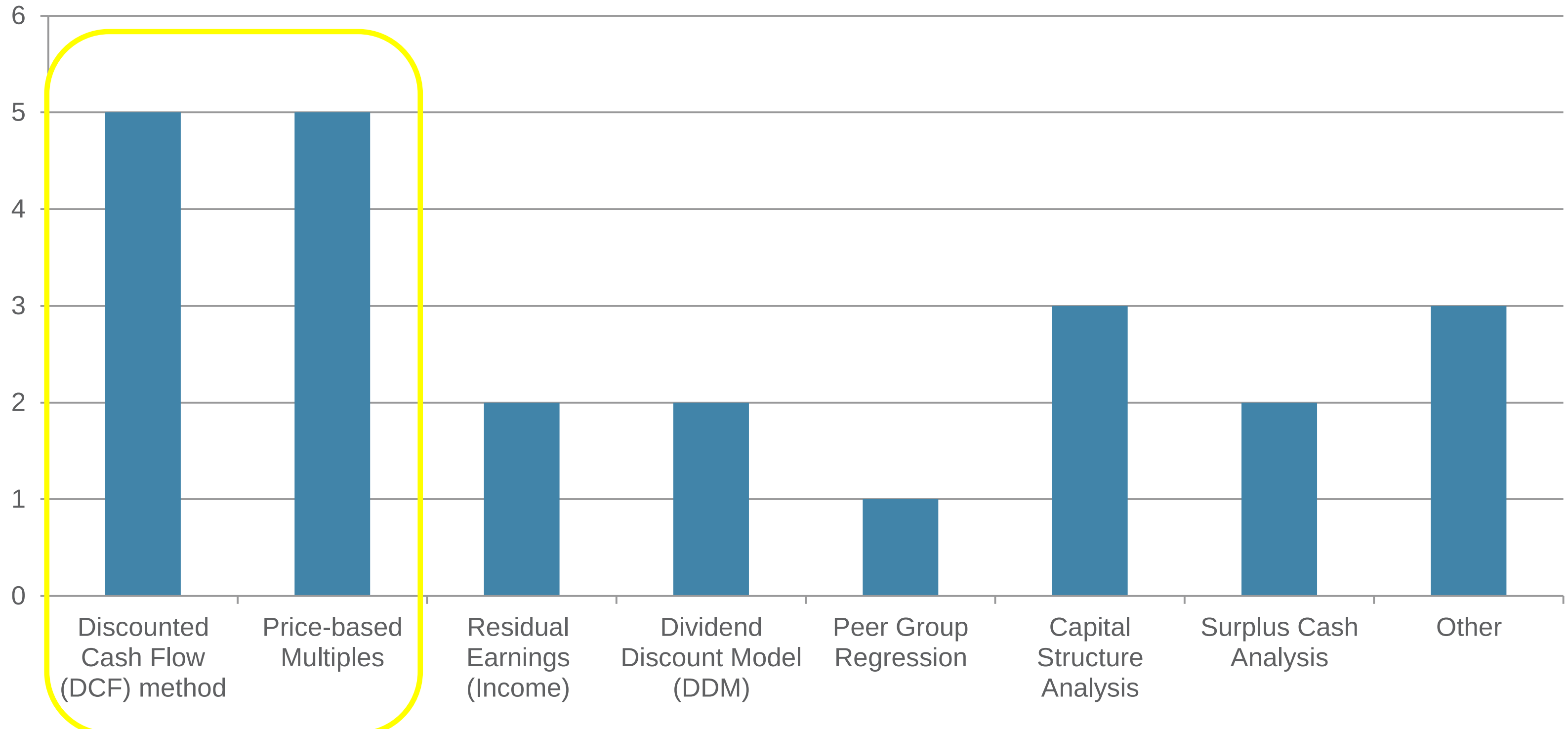
	Information provided in:			
Approach:	Balance sheet	P&L	Cash flows	Possible disclosures[4]
Partial Allocation	1. Current tax asset/liability 2. DTA/DTL only to the extent that they are expected to become payable/ refundable	1. Current tax expense 2. Deferred tax expense	1. Tax paid	1. Movement of DTA/DTL 2. Reconciliation of tax rate 3. Unrecognised DTA/DTL
Valuation adjustment	1. No deferred tax 2. Assets/liabilities net of tax	1. Current tax expense 2. Depreciation net of tax	1. Tax paid	1. Disclosures of underlying assets/liabilities will be divided into (1) net of tax amount and (2) tax cost/benefit

[1] DTA/DTL refers to deferred tax assets/deferred tax liabilities
[2] Temporary difference is a book-tax difference in balance sheet
[3] Timing difference is a book-tax difference in income statement
[4] Subject to further deliberation by the IASB.

Survey results – Appendix II

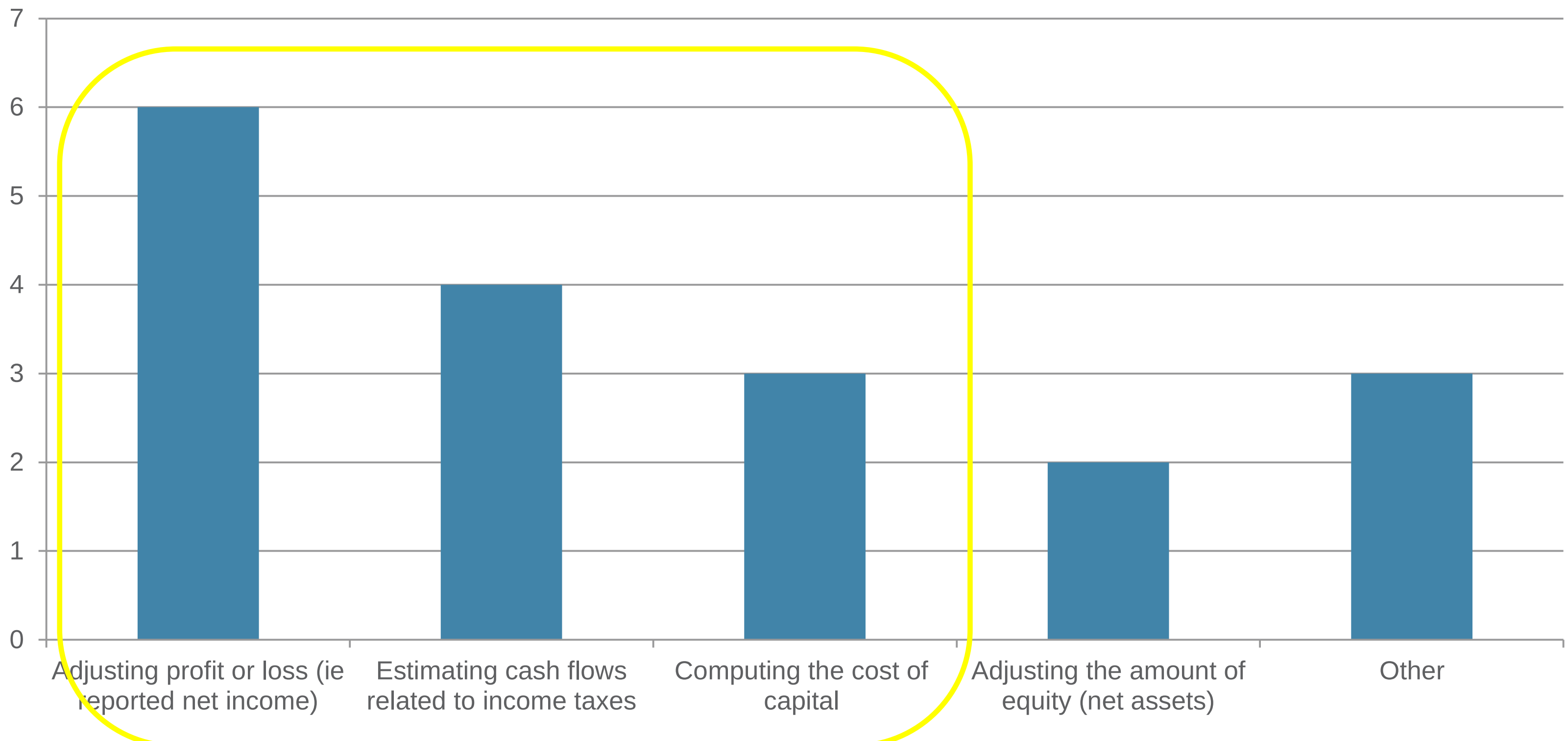
The way you use tax information

- From survey received, we learnt that DCF and Multiples are the most popular valuation techniques



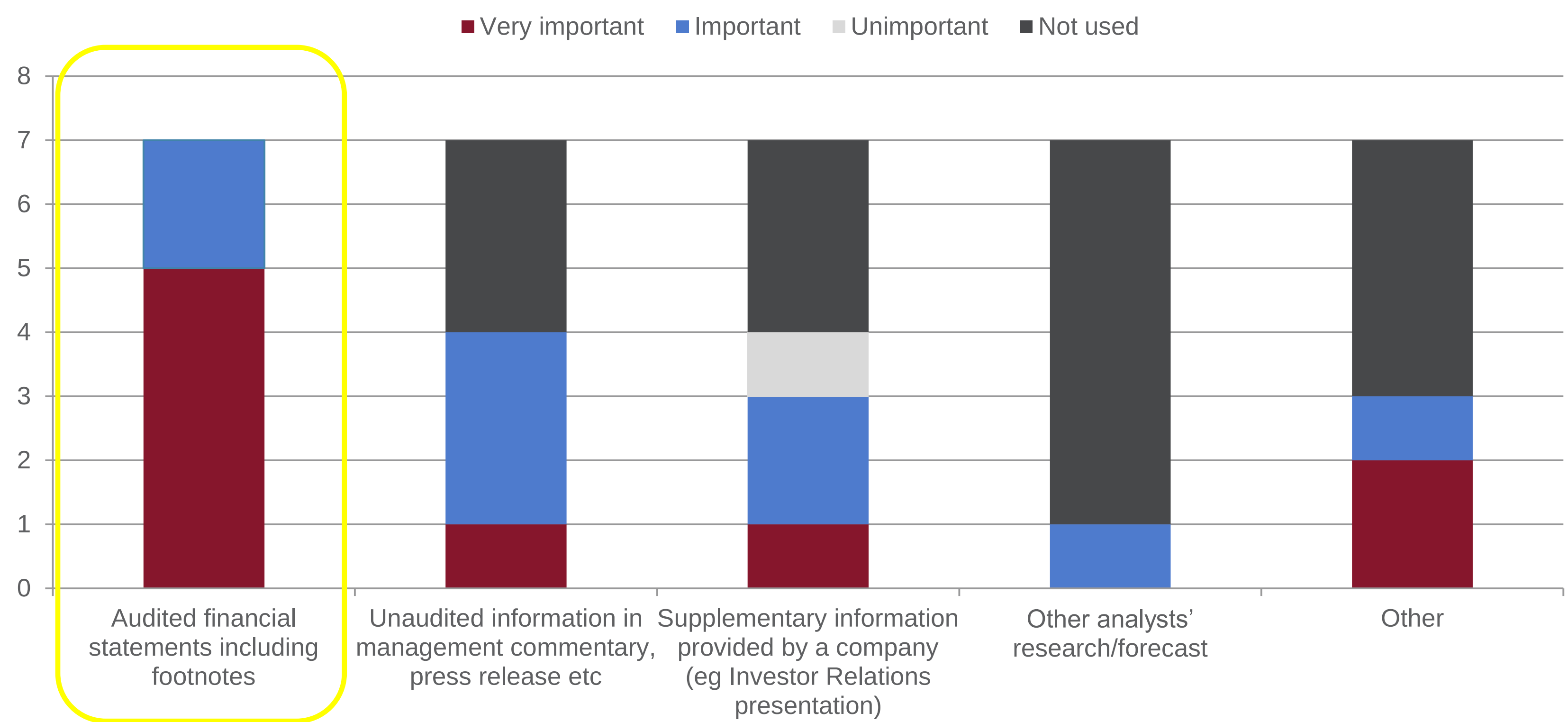
The way you use tax information

- All respondents indicated that tax information is used when performing the previously mentioned valuations, in the following ways



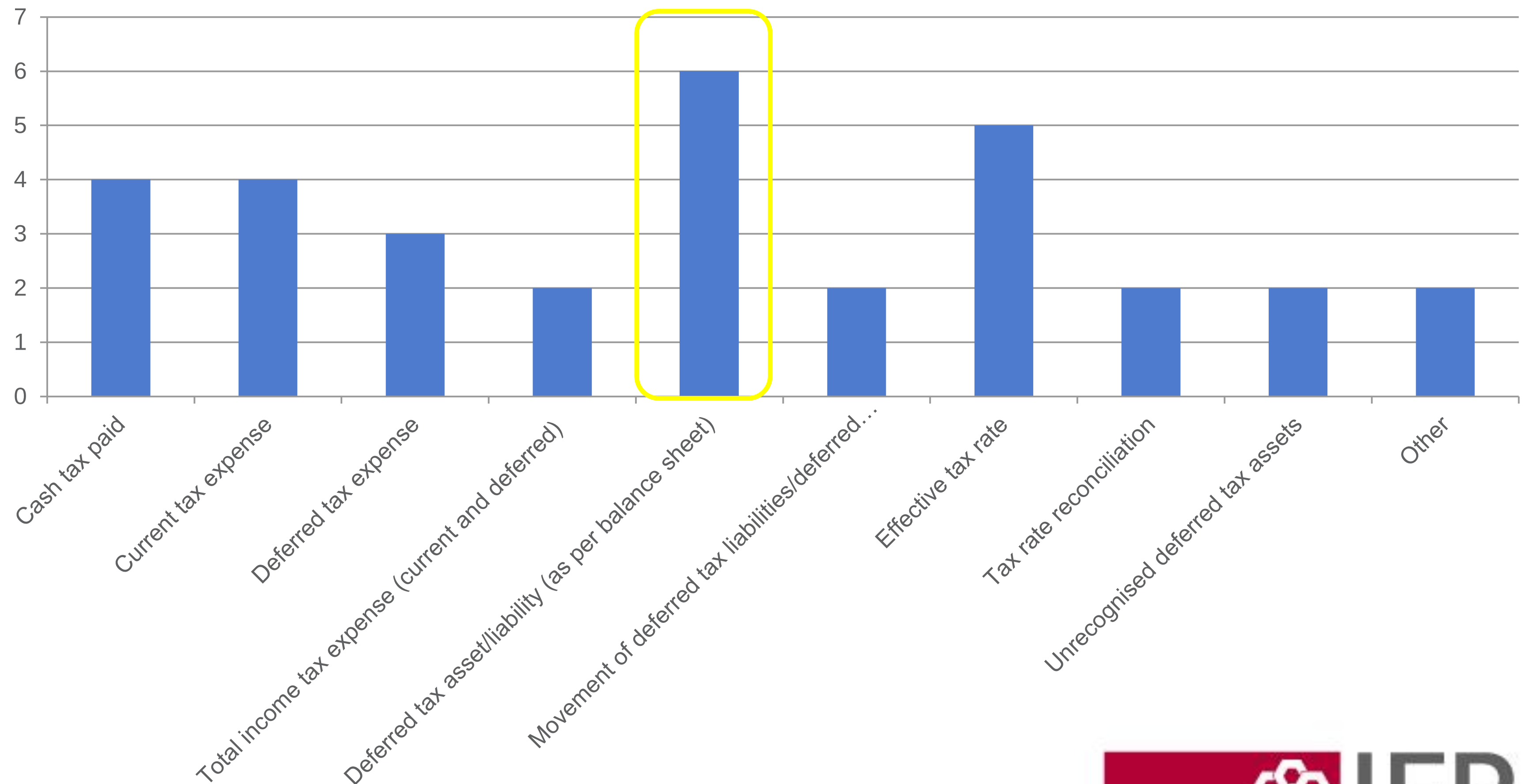
Tax information you use

- Questions 4 through 6 of the survey were used to understand the importance of tax information disclosed in audited annual report as well as which specific parts are of most importance.

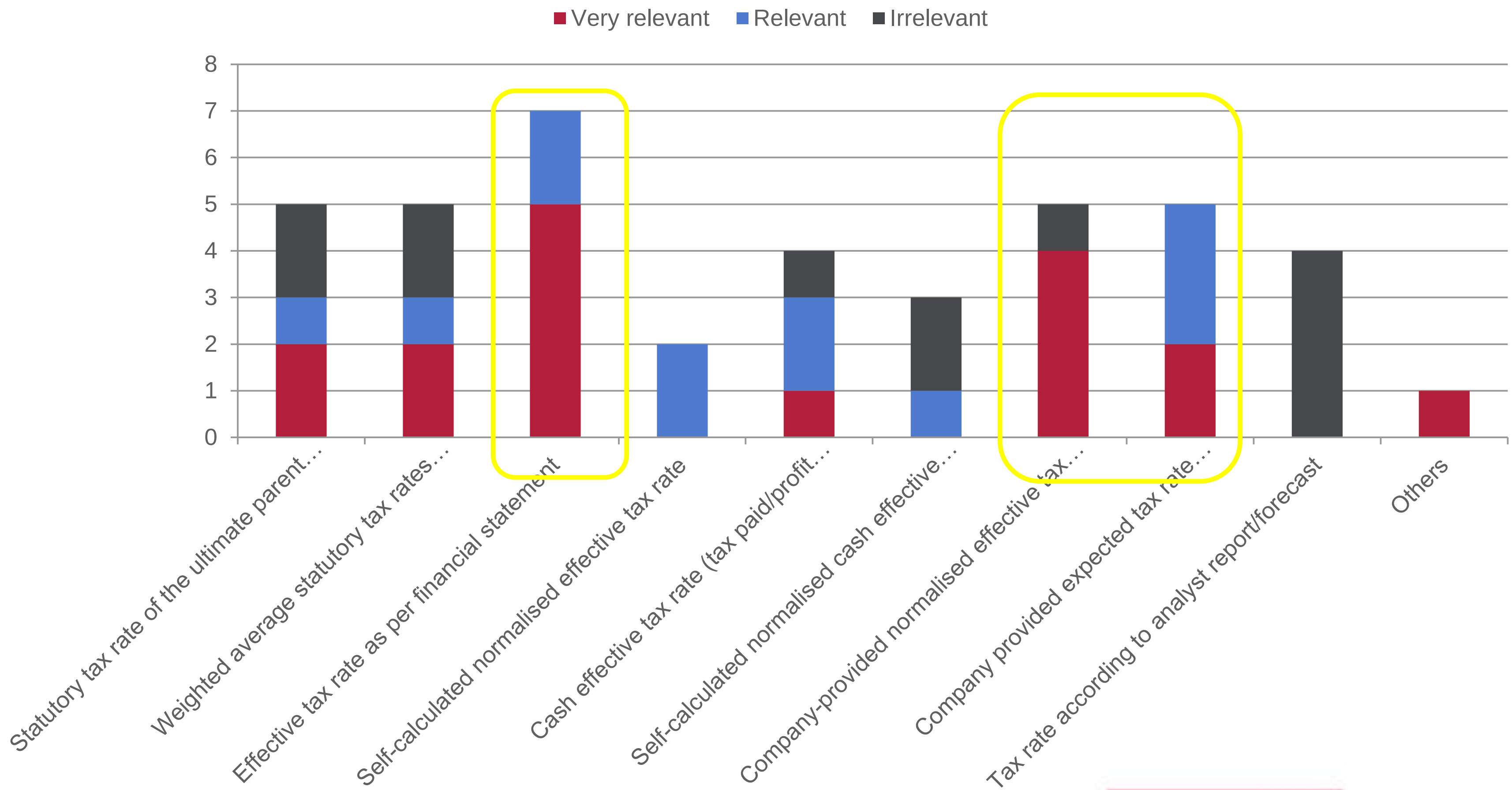


Tax information you use

- Four respondents considered deferred tax balances the most important information in FS

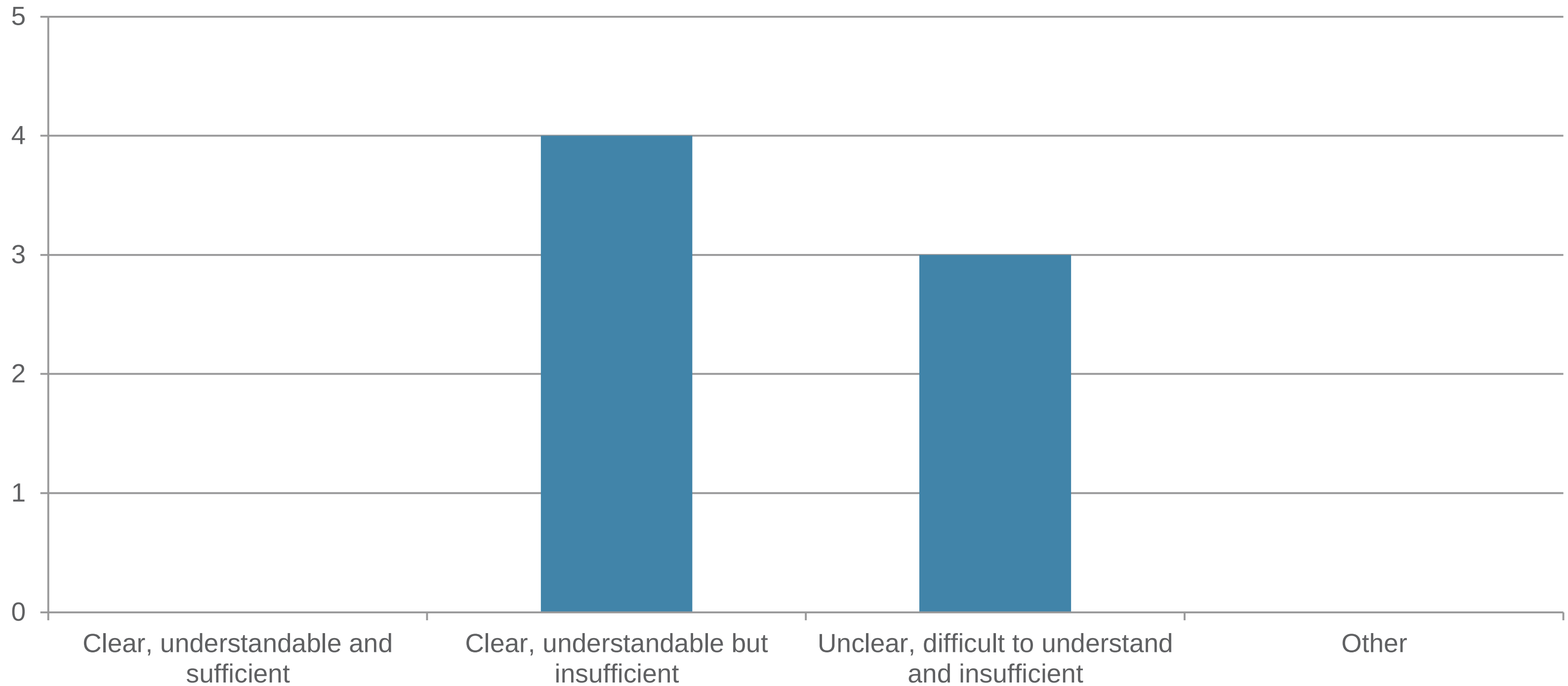


Tax information you use



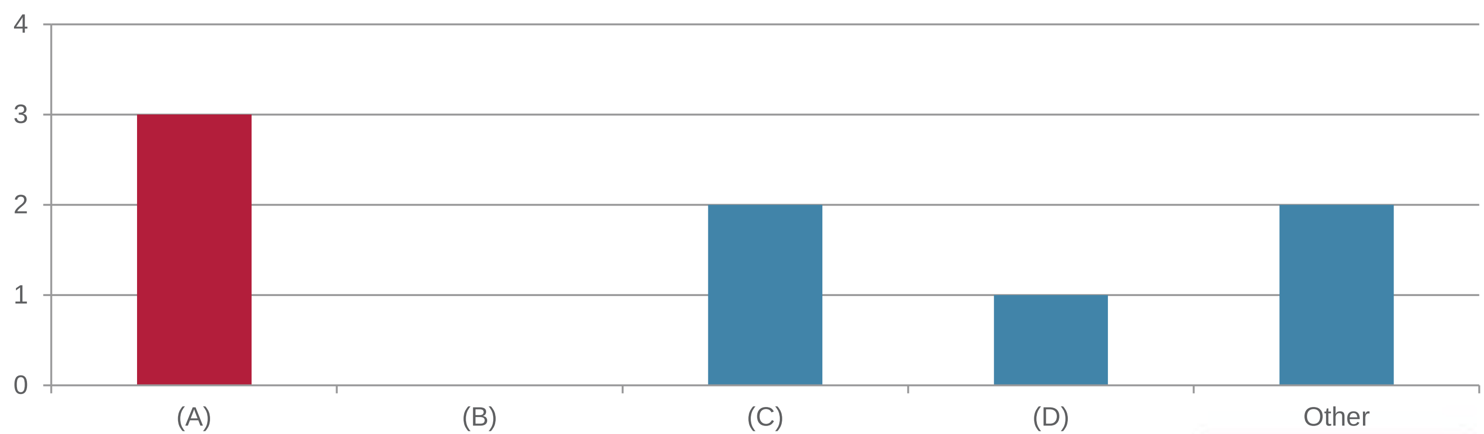
Today's approach to tax

- Despite all respondents using disclosed tax information to a certain extent, it is noted that the information available under the current Standard is rather unclear, difficult to understand and insufficient.



What does today's tax disclosure mean to you?

- (A) Deferred tax liabilities and deferred tax assets are future income taxes due to past transactions or past events. **(Current IAS 12)**
- (B) Deferred tax liabilities and deferred tax assets are future income taxes due to future transactions or future events.
- (C) Deferred tax liabilities and deferred tax assets are past income taxes but have been deferred to the future periods for some reason.
- (D) Deferred tax assets (liabilities) are theoretical (artificial) numbers with no economic meaning for my analysis



Thank you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