STAFF PAPER

14 July 2015

IFRS Interpretations Committee Meeting

Project	New items for initial consideration		
Paper topic	IAS 12 *Income Taxes* — Recognition of deferred taxes for the effect of exchange rate changes		
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This paper has been prepared for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in IFRIC *Update*. The approval of a final Interpretation by the Board is reported in IASB *Update*.

Introduction

1. The IFRS Interpretations Committee ('the Interpretations Committee') received a submission regarding the recognition of 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. The question is whether it is appropriate to recognise deferred taxes, arising due to the effect of exchange rate changes on the tax base of a non-current asset, through profit or loss.

2. The objective of this Agenda Paper is to provide the Interpretations Committee with a summary of the issue and the staff's research, analysis and recommendation.

Structure of the paper

3. This paper is organised as follows:
   (a) submission received;
   (b) extracts from the Standards;
   (c) summary of outreach conducted;
   (d) staff analysis;
   (e) assessment against the Interpretations Committee's agenda criteria;

(f) staff recommendation;

(g) questions for the Interpretations Committee;

(h) Appendix A—Proposed wording for tentative agenda decision; and

(i) Appendix B—Submission.

Submission received

4. According to paragraph 41 of IAS 12, temporary differences arise consequent to changes in exchange rate 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. The resulting deferred taxes on such temporary differences are charged or credited to profit or loss.

5. The submitter explains that they conceptually agree that in 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.

6. However, the submitter is of the view that the temporary difference does not arise from gains and losses that affect profit or loss and therefore, it could be argued that the recognition of the change in the deferred tax asset or liability through profit or loss creates an inconsistency. The submitter has noted, for instance, that revaluation of non-current assets or recognition of the effects of inflation on non-monetary assets is accounted for through equity.

7. Based on the research carried out by the submitter, they have noted other companies throughout their region with similar material impacts in their financial statements due to exchange rate fluctuations on tax basis of assets in a local currency that is different from their functional currency.

8. Further, the submitter provides explanations as to why recognising such deferred tax outside profit or loss is more appropriate. The submitter notes that:

   (a) the effects of recognising such temporary differences can have significant impact in profit or loss, especially for entities with high

capital requirements wherein the temporary difference might reverse over a very long period (eg the life of the asset or even upon its sale); and

(b) such impacts will either reverse through changes in the exchange rate in the future (therefore not materialising in an actual taxable or deductible item) or over the assets life (in their case, up to 45 years), while having significant impacts on their profit or loss every quarter.

9. The submitter also draws reference to Accounting Standards Codification (ASC) sub topic 740-10-25-3(f) issued by the US Standard setter, the Financial Accounting Standard Board (FASB), that prohibits recognition of deferred tax asset or liability in such cases.

Extracts from the Standards

10. Paragraph 41 of IAS 12 notes that **(emphasis added)**:

> 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, <u>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).</u>

11. Paragraph 58 of IAS 12 notes that:

> Current and deferred tax shall be recognised as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:
>
> (a) a transaction or event which is recognised, in the same or a different period, outside profit or loss, either in other

> comprehensive income or directly in equity (see paragraphs 61A–65); or
>
> (b) a business combination (other than the acquisition by an investment entity, as defined in IFRS 10 Consolidated Financial Statements, of a subsidiary that is required to be measured at fair value through profit or loss) (see paragraphs 66–68).

12. Paragraph 61A of IAS 12 describes situations when deferred taxes are recognised outside the profit or loss as reproduced below:

> Current tax and deferred tax shall be recognised outside profit or loss if the tax relates to items that are recognised, in the same or a different period, outside profit or loss. Therefore, current tax and deferred tax that relates to items that are recognised, in the same or a different period:
>
> (a) in other comprehensive income, shall be recognised in other comprehensive income (see paragraph 62).
>
> (b) directly in equity, shall be recognised directly in equity (see paragraph 62A).

13. Paragraph 23 of IAS 21 *The Effects of Changes in Foreign Exchange Rates* notes that:

> At the end of each reporting period:
>
> (a) foreign currency monetary items shall be translated using the closing rate;
>
> (b) non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and
>
> (c) non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was measured.

Summary of outreach conducted

14. In order to gather information about the issue described in the submission, we sent requests to securities regulators, members of the International Forum of Accounting Standard-Setters (IFASS) and the global IFRS technical teams of the international networks of the large accounting firms. Specifically, we asked:

> *Q1. In your jurisdiction, how common is the issue described in the submission of a tax base being denominated in a currency that is different from the functional currency?*
>
> *Q2. If the issue described in Question 1 is common, what is the predominant accounting treatment for the accounting for deferred taxes? In addition:*
>
> *(i) could you please describe the rationale for that accounting treatment?; and*
>
> *(ii) if possible, please provide examples of the predominant approach you observe. Ideally, this should be examples from publicly available financial statements, but those on a confidential basis would also be helpful.*
>
> *(iii) to what extent do you observe diversity in the application of the requirements of paragraph 41 of IAS 12?*
>
> *We also asked respondents to explain the basis on which they had prepared their response. For example, if they conducted their own outreach we requested them to tell us the type of stakeholders that responded (e.g. preparers under IFRS in their jurisdictions).*

15. The views received represent informal opinions and do not reflect the formal views of those organisations.

Responses received

16. We received 18 responses from the following respondents:

    (a) 2 regulators;

    (b) 10 national standard-setters; and

(c) 6 global IFRS technical teams of the international networks of the large accounting firms.

17. The views received represent informal opinions and do not reflect the formal views of those organisations.

18. The geographical breakdown for the responses received from national standard-setters is as follows:

Geographical region	**Number of respondents**
Asia	4
Europe	4
Americas	..
Oceania	2
Africa	..
Total respondents	10

19. We summarise the results of the outreach in the following paragraphs.

Summary of outreach responses

20. The majority of the respondents observed that this issue is not common or widespread.

21. Most of the respondents have noted that the requirements in paragraph 41 of IAS 12 are clear in respect of recognising such deferred tax charge or credit in profit or loss.

22. The respondents who observed that this issue is common noted the following:

(a) the issue is prevalent in some countries especially those with recent devaluation of currencies;

(b) the issue is observed in certain industries such as oil, gas, metals, mining and shipping;

(c) the predominant accounting treatment is recognising such deferred tax charge or credit in profit or loss; and

(d) they have not noted any diversity in the accounting of such deferred taxes. However, two respondents have informed us that they have noticed some diversity in presentation of such tax effects in the statement of profit or loss. They have informed us that most entities present such tax effect in income tax expense line whereas some entities have presented such tax effects with foreign exchange gain/loss. The respondents have referred to publicly available financial statements wherein the entity has presented such tax effects with foreign exchange gain/loss rather than within the income tax expense line.

(e) one respondent has referred to publicly-available financial statements wherein the entity has explained, in notes disclosure, that the tax bases are denominated in foreign currency that is different from its functional currency and therefore the income tax expense line is highly sensitive to the effects of changes in exchange rates particularly from changes in non-monetary assets. That entity has provided a sensitivity analysis of deferred tax to changes in foreign exchange rates.

23. One IFASS member has observed that some of their board members are of the opinion that there is conceptual justification to the recognition of the resulting deferred tax income or expense arising from these temporary differences in equity based on the reasons set out in the submission. However, they acknowledge that such a change would require an amendment to IAS 12.

24. One IFASS member has suggested transferring the question to the IASB to consider or discuss a potential amendment to IAS 12.

25. In addition to the above, we also reached out to two users of financial statements to obtain their views on the submission and particularly 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.

Staff analysis

Requirements in IAS 21

26. The objective of IAS 21 is to prescribe how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

27. Paragraph 23 of IAS 21 requires that non-monetary items measured at historical cost are translated using the exchange rates at the date of the transaction and non-monetary items measured at fair value are measured using the exchange rates as at the date when the fair value was measured. Accordingly, non-monetary items are not retranslated at the end of the reporting period at the closing rates at that date.

28. Tax bases of assets and liabilities are not recorded in the financial statements. Consequently, retranslation of a foreign currency tax base into an entity's functional currency is not reported as a transaction under IFRS (i.e. it does not directly affect profit or loss, other comprehensive income or the balance sheet). However, the tax base of an asset or liability is an input to the determination of any temporary difference, which in turn is recognised as a deferred tax liability or asset. For the purpose of complying with the requirements of paragraph 41 of IAS 12 (see paragraph 29 below), tax bases of non-monetary assets and liabilities are translated at the exchange rate as at the end of the reporting period.

Requirements in IAS 12

29. Paragraph 41 of IAS 12 is applicable when the tax base of non-monetary assets and liabilities are determined in a currency (ie foreign currency) that is different from the functional currency of the entity. In such cases, temporary differences arise when the exchange rate of the foreign currency (in which tax base is determined) changes in relation to the functional currency of the entity. Such temporary difference gives rise to deferred tax asset or liability. The resulting deferred tax charge or credit is recognised in profit or loss in accordance with paragraph 41 of IAS 12.

30. Paragraphs 58(a) and 61A of IAS 12 provides guidance as to when deferred tax is charged or credited outside the profit or loss. Accordingly deferred taxes, arising

from a transaction or event that is recognised, in the same or a different period, outside profit or loss and included in other comprehensive income or directly in equity, are also recognised outside profit or loss and included in other comprehensive income or directly in equity. Paragraph 58(b) applies to recognition of current and deferred tax in a business combination that is not applicable to the facts and circumstances analysed in the submission.

31. Based on our analysis of IAS 12, we note that it is only in specific situations mentioned in paragraphs 58 and 61A to 68 of IAS 12 that the deferred tax charge or credit could be recognised outside the profit or loss. We also think that drawing an analogy to accounting for revaluation of non-current assets or recognition of the effects of inflation on non-monetary assets through equity is not appropriate because revaluation surplus is recognised in other comprehensive income in accordance with IAS 16 *Property. Plant and Equipment*. The tax effects when an asset is revalued for tax purposes are specifically addressed in paragraph 65 of IAS 12. These are not applicable to the facts and circumstances in the submission.

32. As explained in paragraph 28 above, in the given facts and circumstances the exchange differences on retranslation of tax base of non-monetary assets and liabilities is not reported in the financial statements. And as explained in paragraph 27 above, the carrying value of non-monetary assets and liabilities are not translated at the end of the reporting period. Accordingly, we think that paragraphs 58 and 61A of IAS 12 do not apply to these facts and circumstances.

33. Therefore, we think that the deferred tax charge or credit arising on temporary differences consequent to a change in the exchange rate of foreign currency cannot be recognised outside of profit or loss.

34. We think that when the impact of such deferred tax on profit or loss for a period is significant, an entity could explain such amounts by making appropriate disclosures as set out in paragraph 79 of IAS 12. Paragraph 79 requires separate disclosure of major components of tax expense (income). Appropriate disclosures and explanations, in this regard, could help users of the financial statements understand the nature and impact of such recognised deferred taxes.

Presentation in the statement of profit or loss

35. As described in paragraph 22(d) above, two respondents have highlighted some limited diversity in the presentation of deferred tax recognised as per paragraph 41 of IAS 12. Those respondents noted that rather than present the change in deferred tax asset or liability for movements in foreign exchange rates within the income tax line, some entities have presented such change in deferred tax within foreign exchange gain/loss.

36. We think that the words 'the resulting deferred tax….' as stated in the last sentence of paragraph 41 of IAS 12 provides sufficient guidance to indicate that the tax effect arsing on the application of paragraph 41 of IAS 12 is a 'deferred tax' item. Accordingly, we think presenting such deferred tax charge or credit along with deferred taxes arising on other temporary differences is the appropriate approach and that would be useful in providing overall information on the income tax effects to the users of the financial statements. We do not think that change in deferred tax asset or liability for movements in foreign exchange rates should be presented within foreign exchange gains/losses.

Agenda criteria assessment

37. The staff's assessment of the Interpretations Committee's agenda criteria is as follows:[1]

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
that have widespread effect and have, or are expected to have, a material effect on those affected;	**No**. On the basis of our analysis of the outreach results received, we consider that this issue is widespread but that diversity in practice does not exist.

[1] These criteria can be found in the *IFRS Foundation Due Process Handbook* .

Paragraph 5.16 states that the Interpretations Committee should address issues:	Agenda criteria satisfied?
where financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**Not applicable.** We think that the existing paragraph 41 of IAS 12 provides sufficient guidance. We do not think diversity in practice exists.
that can be resolved efficiently within the confines of existing IFRSs and the *Conceptual Framework for Financial Reporting*.	**Not applicable.** We think that the existing paragraph 41 of IAS 12 provides sufficient guidance. We do not think diversity in practice exists
In addition:	
Can the Interpretations Committee address this issue in an efficient manner (paragraph 5.17)?	Not applicable
The solution developed should be effective for a reasonable time period. (paragraph 5.21)	Not applicable

Staff recommendation

38. We think that paragraph 41 of IAS 12 provides sufficient guidance in respect of recognising deferred tax charge or credit when the tax bases of an entity's non-monetary assets or liabilities are determined in a currency that is different from functional currency. We also think that there is no ambiguity in the requirements of paragraph 41.

39. We think appropriate disclosures explaining the nature and impact of such recognised deferred taxes could be useful to the users of the financial statements.

We also think presenting such deferred tax charge or credit along with other deferred taxes is the appropriate approach.

40. On the basis of the outreach results received and our assessment of the Interpretations Committee's agenda criteria, we recommend that the Interpretations Committee should not take this issue onto its agenda.

41. We have set out proposed wording for the tentative agenda decision in **Appendix A** of this paper.

Questions to the Interpretations Committee

Questions to the IFRS Interpretations Committee
1. Does the IFRS Interpretations Committee agree with the staff recommendation?
2. Does the IFRS Interpretations Committee have any comments on the drafting of the tentative agenda decision?

Appendix A—Tentative agenda decision

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

IAS 12 ***Income Taxes*****— Recognition of deferred taxes under IAS 12 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**

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 41of IAS 12 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 is charged or credited to profit or loss. The Interpretations Committee also noted that paragraphs 58 and 61A provide guidance on the limited circumstances wherein changes in deferred tax are required to be recognised outside profit or loss; the Interpretations Committee noted that these limited circumstances do not apply to the fact pattern analysed. This is because the tax bases, and consequently the change in their measurement, are not recognised in financial statements.

The Interpretations Committee also noted that paragraph 79 of IAS 12 requires 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 deferred tax, explanation of this in accordance with paragraph 79 of IAS 12 would help explain the tax expense (income) to the users of the financial statements. The Interpretations Committee also noted that presenting such deferred tax charge or credit along with other deferred taxes is the appropriate approach.

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.

Appendix B—Submission received

B1. We reproduce below the submission that we received. We have deleted details that would identify the submitter of this request.

10/02/2015

IFRS Interpretations Committee
First Floor
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IFRS INTERPRETATIONS COMMITTEE
POTENTIAL AGENDA ITEM REQUEST

The issue:

Recognition of deferred taxes for the effect of exchange rate changes on the tax basis of non-current assets through profit or loss

International Accounting Standard (IAS) 12, Income Taxes, is clear that when the tax base of a non- monetary asset is determined in a different currency from the functional currency of the entity, temporary differences will arise and deferred tax should be calculated. When exchange rates change, the amount of local currency needed to recover the cost of assets recorded in the functional currency also changes, but the local currency tax bases of those assets do not change. Therefore, foreign exchange gains and losses can affect the amount of temporary difference between the carrying amount basis in local currency and the underlying tax basis of an entity's assets and liabilities.

Further, when the tax law for a particular foreign jurisdiction permits or requires the taxpayer to adjust the tax base of an asset or a liability to take into account the effects of inflation, an entity is required to recognize the resulting deferred tax liability or asset as appropriate in its financial statements through profit or loss (except to the extent that the tax arises from a transaction or event which is recognized outside profit or loss).

Paragraph 41 of IAS 12 states 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*

recognized deferred tax liability or (subject to paragraph 24) asset. The resulting deferred tax is charged or credited to profit or loss (see paragraph 58).

On the other hand we understand that in determining how the deferred tax effects of a transaction or other event should be recognized, the underlying principle is that the accounting for such deferred tax effects should follow the accounting for the transaction or event itself. Paragraph 58 of IAS 12 states that:

Current and deferred tax shall be recognized as income or an expense and included in profit or loss for the period, except to the extent that the tax arises from:

a. a transaction or event which is recognized, in the same or a different period, outside profit or loss, either in other comprehensive income or directly in equity (see paragraphs 61A–65); or
b. a business combination (other than the acquisition by an investment entity, as defined in IFRS 10 Consolidated Financial Statements, of a subsidiary that is required to be measured at fair value through profit or loss) (see paragraphs 66–68).

We conceptually agree with the Board´s statement that in the situations described above, changes in the exchange rate (or inflation adjustments) give rise to temporary differences that result in a recognized deferred tax liability or asset. However, we note 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. Note, for instance, that revaluations of non-current assets or recognition of the effects of inflation on non-monetary assets are accounted for through equity.

As a practical matter, the effects of recognizing such temporary differences can have significant impact in the statement of profit or loss of entities with a functional currency different from the currency in which its tax basis are denominated. This is particularly true for entities in industries with a high capital requirements (i.e., with large amounts of non-current assets), where the temporary difference might reverse over very long term periods (e.g., the life of the asset or even upon its sale) and where exchange fluctuations might even reverse (with the corresponding reversal of the temporary difference) in short periods of time.

Current practice:

As stated above, IFRS requires the recognition of deferred taxes for the effect of exchange rate changes on the tax basis of non-current assets through profit or loss.

Under USGAAP, when the functional currency of an entity differs from the local currency (in our scenario, the tax currency), recording deferred taxes on temporary differences in nonmonetary assets and liabilities that result from either (1) exchange rate changes on remeasurement or (2) adjustments to the tax base from indexing, is prohibited. In particular, ASC 740-10-25-3(f) prohibits “recognition of a deferred tax

liability or asset for differences related to assets and liabilities that, under Subtopic 830-10 are remeasured from the local currency into the functional currency using historical exchange rates and that result from changes in exchange rates or indexing for tax purposes.”

We understand that some of the arguments provided by US GAAP to such an exception as similar to those presented by us above.

Reasons for the IFRS IC to address the issue:

We believe these types of situations are more frequent in countries where local currency is less stable and inflation rates are higher, such as ours and others in our region. It is in such countries where the impact of such approach to recognition of deferred taxes has more impact. We request you to particularly have such environments in mind in your consideration of our proposed agenda item.

By way of example, a 10% devaluation/revaluation of our local currency against our functional currency (a “reasonably possible change”, as determined in accordance with IFRS 7, Financial Instruments: Disclosures - Application guidance, paragraph B19) at a 30% income tax rate would yield a US$70 million impact on our profit or loss for the period (representing 36% of our Profit before tax) on our US$2.5 billion base of long term assets. We have researched and noted other companies throughout our region with similar material impacts in their financial statements due to exchange rate fluctuations on assets basis taxed in a local currency different from their functional currency.

We note that the above impacts will either reverse through changes in the exchange rate in the future (therefore not materializing in an actual taxable or deductible item) or over the assets life (in our case, up to 45 years), while having significant impacts on our profit or loss every quarter. Also, indexation of tax bases theoretically will recover the effects of exchange rate changes over such long periods of time, in which case, the profit or loss impact in one period will be offset by recognition of inflation on the assets´ tax basis over future periods (note that should we recognized the effects of inflation . Finally, the deferred tax gain or loss represents a non cash item.

Achieving hedge accounting for such a reporting exchange rate risk is overly complex or not viable. We understand that the IASB has identified the income tax topics where it does not plan to issue a discussion or research document within the next few years. Also, we acknowledge that the IASB and FASB did not succeed in developing a converged and simplified Standard on income taxes and that you consider that a fundamental review of income tax accounting would be a significant project. However, previously the IASB has made narrow scope amendments to IAS 12 to address issues that had been occurring in practice.