EFRAG
European Financial Reporting Advisory Group

EFRAG's ~~Draft~~ Letter to the European Commission Regarding Endorsement of Deferred Tax related to Assets and Liabilities arising from a Single Transaction *(Amendments to IAS 12)*

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Dear Mr John Berrigan

Endorsement of Deferred Tax related to Assets and Liabilities arising from a Single Transaction *(Amendments to IAS 12)*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG is pleased to provide its opinion on the Deferred Tax related to Assets and Liabilities arising from a Single Transaction *(Amendments to IAS 12* Income taxes*)* ('the Amendments') which were issued by the IASB on 7 May 2021. An Exposure Draft of Amendments was issued on 17 July 2019. EFRAG provided its comment letter on that Exposure Draft on 14 November 2019.

The objective of the Amendments is to reduce the diversity that exists in practice on whether the recognition exemption in paragraphs 15 and 24 of IAS 12 apply to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences.

The Amendments shall be applied for annual periods beginning on or after 1 January 2023, with earlier application permitted. If entities apply the Amendments earlier, they shall disclose that fact.

The Amendments will be applied prospectively to transactions that occur on or after the beginning of the earliest comparative period presented except for transactions related to right of use assets and lease liabilities and decommissioning, restoration and similar liabilities and the corresponding amounts recognised as part of the cost of the related asset. For these transactions, entities will recognise at the beginning of the earliest comparative period a deferred tax asset and a deferred tax liability for all deductible and taxable differences and recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings at that date.

A description is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments would meet the technical criteria for endorsement, in other words whether the Amendments would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, lead to prudent accounting and is not contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good. We provide our conclusions below.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued its initial assessment for public comment and, when finalising its advice and the content of this letter, took the comments received in response into account. EFRAG's evaluation is based on input from standard setters, market participants and other interested parties, and its discussions of technical matters are open to the public.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

Based on the above reasoning, EFRAG has concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, and do not raise issues on prudent accounting. EFRAG has also assessed that the Amendments do not create any distortion in their interaction with other IFRS Standards and that all necessary disclosures are required. Therefore, EFRAG has concluded that the Amendments are not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that endorsing the Amendments is conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter.

In EFRAG's assessment of whether the Amendments would be conducive to the European public good, EFRAG has assessed whether the Amendments would improve financial reporting, would reach an acceptable cost-benefit trade-off, and whether the Amendments could affect economic growth.

Our advice to the European Commission

As explained above, we have concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, do not raise issues on prudent accounting, and that they are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good. Therefore, we recommend the Amendments for endorsement.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Appendix 1: Understanding the changes brought about by the Amendments

Background of the Amendments

1 IAS 12 establishes in paragraphs 15 and 24 that a deferred tax asset and a deferred tax liability shall be recognised for all taxable and deductible differences, except for some specific cases that arise at initial recognition and that prevent entities from recognising them ("the initial recognition exemption"). Research conducted by the IFRS Interpretations Committee indicated that views differed on whether the initial recognition exemption applied to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences.

The issue and how it has been addressed

2 Differing views resulted in entities accounting for deferred tax on such transactions in different ways, reducing comparability between their financial statements. The approaches could lead to no deferred tax recognised, or the recognition of deferred tax on a net or gross basis.

3 The amendments narrowed the scope of the initial recognition exemption in paragraphs 15 and 24 of IAS 12 so that it no longer applies to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences.

4 The final amendments were issued on 7 May 2021.

What has changed?

5 The amendments add in paragraphs 15, 22 and 24 of IAS 12 that the initial recognition exemption does not apply to transactions that on initial recognition give rise to equal taxable and deductible temporary differences.

6 The amendments clarify in paragraph 22A that, depending on the applicable tax law, a lease could be an example where equal taxable and deductible temporary differences may arise on initial recognition of the right-of-use asset and the lease liability. This would be the case when tax deductions are attributable to the lease liability. Applying the Amendments, the initial recognition exemption would not apply in such a transaction. Conversely, the initial recognition exemption does not apply where the tax deductions are attributable to the leased asset as in those cases deferred tax does not arise on initial recognition and subsequently is recognised applying the existing requirements in IAS 12 as currently endorsed.

7 The amendments also provide an illustrative example explaining the deferred tax accounting for advance lease payments and initial direct costs.

When do the amendments become effective?

8 An entity shall apply the amendments to IAS 12 for annual periods beginning on or after 1 January 2023. Early application is permitted. If an entity applies the Amendments for an earlier period, it shall disclose that fact.

What are the transition requirements?

9 The Amendments will be applied prospectively to transactions that occur on or after the beginning of the earliest comparative period presented except for leases and decommissioning, restoration and similar liabilities. For these transactions, entities will recognise at the beginning of the earliest comparative period a deferred tax asset and a deferred tax liability for all deductible and taxable differences and recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings at that date.

Appendix 2: EFRAG's technical assessment on the Amendments against the endorsement criteria

Notes to Constituents:

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on the Amendments. In it, EFRAG assesses how the Amendments satisfy the technical criteria set out in the Regulation (EC) No 1606 2002 for the adoption of international accounting standards. It provides a detailed evaluation for the criteria of relevance, reliability, comparability and understandability, so that financial information is appropriate for economic decisions and the assessment of stewardship. It evaluates separately whether the Amendments leads to prudent accounting and finally considers whether the Amendments would not be contrary to the true and fair view principle.

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity of contributing to the IASB's due process. They do not necessarily indicate the conclusions that would be reached by EFRAG in its capacity of advising the European Commission on endorsement of the definitive IFRS Standards in the European Union and European Economic Area.

In the latter capacity, EFRAG's role is to make a recommendation about endorsement based on its assessment of the final IFRS Standard or Interpretation against the technical criteria for European endorsement, as currently defined. These are explicit criteria which have been designed specifically for application in the endorsement process, and therefore the conclusions reached on endorsement may be different from those arrived at by EFRAG in developing its comments on proposed IFRS Standards or Interpretations. Another reason for a difference is that EFRAG's thinking may evolve.

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

10 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002 (The IAS Regulation), in other words that the Amendments:

(a) are not contrary to the principle set out in Article 4 (3) of Council Directive 2013/34/EU (The Accounting Directive); and

(b) meet the criteria of understandability, relevance, reliability, and comparability required of the financial information needed for making economic decisions and assessing the stewardship of management.

11 Article 4(3) of the Accounting Directive provides that:

The annual financial statements shall give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss. Where the application of this Directive would not be sufficient to give a true and fair view of the undertaking's assets, liabilities, financial position and profit or loss, such additional information as is necessary to comply with that requirement shall be given in the notes to the financial statements.

12 The IAS Regulation further clarifies that *'to adopt an international accounting standard for application in the Community, it is necessary firstly that it meets the basic requirement of the aforementioned Council Directives, that is to say that its application results in a true and fair view of the financial position and performance of an enterprise - this principle being considered in the light of the said Council*

Directives without implying a strict conformity with each and every provision of this Directive' (Recital 9 of the IAS Regulation).

13 EFRAG's assessment as to whether the Amendments would not be contrary to the true and fair view principle has been performed against the European legal background summarised above.

14 In its assessment, EFRAG has considered the Amendments from the perspectives of both usefulness for decision-making and assessing the stewardship of management. EFRAG has concluded that the information resulting from the application of the Amendments is appropriate both for making decisions and assessing the stewardship of management.

15 EFRAG's assessment on whether the Amendments are not contrary to the true and fair view principle set out in Article 4(3) of Council Directive 2013/34/EU is based on the assessment of whether it meets all other technical criteria and whether they lead(s) to prudent accounting. EFRAG's assessment also includes assessing whether the Amendments do not interact negatively with other IFRS Standards and whether all necessary disclosures are required. Detailed assessments are included in this appendix in the following paragraphs:

(a) relevance: paragraphs 16 to 24;

(b) reliability: paragraphs 25 to 31;

(c) comparability: paragraphs 32 to 37;

(d) understandability: paragraphs 38 to 42;

(e) whether overall they lead to prudent accounting: paragraphs 43 to 44; and

(f) whether they would not be contrary to the true and fair view principle 45 to 47.

Relevance

16 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.

17 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

18 EFRAG observes that the Amendments are intended to narrow the scope of the initial recognition exemption so that it no longer applies to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences. Therefore, the accounting for deferred tax of these transactions would be aligned with the general principles of IAS 12, resulting in a company recognising the tax effects of the transaction as it uses the asset and settles the corresponding liability. EFRAG also acknowledges that the initial recognition exemption was not intended to apply to such transactions.

19 The gross approach (i.e., treating the deferred tax effects of the asset and the liability separately versus the net approach which would treat the transaction as a single unit of account) is consistent with the requirements in IAS 12. This approach is also consistent with IFRS 16 *Leases* which recognise assets and liabilities separately. Therefore, EFRAG considers that gross approach provides relevant information.

20 Entities may recognise a lower amount of deferred tax assets than deferred tax liabilities at initial recognition. As discussed in paragraphs 27 and 28 below, this would result in a day one loss that would reflect the entity's expectations that it will be unable to benefit fully from the tax deductions available when it settles the liability,

but that it is nonetheless required to make future tax payments as it recovers the asset.

21 As explained in paragraph 3, the Amendments address the initial recognition accounting of certain transactions. These transactions would be accounted for subsequently in accordance with IAS 12 general requirements. In this regard, entities might subsequently reduce the carrying amount of their deferred tax assets, by applying IAS 12 general requirements, if they consider that these will not be recoverable. If the IRE applied to the transactions in scope, deferred taxes would not be recognised neither on initial recognition nor subsequently. Therefore, the Amendments may indirectly reveal carrying amount reductions earlier than if the initial recognition exemption were applying to the transactions in the scope of the Amendments.

22 The Amendments would also result in entities recognising the tax effects of the transactions in scope not only when deduction becomes available for tax purposes and therefore, the transactions would be aligned with the overarching principles of IAS 12. This will provide relevant information to users about the tax position of the entity.

23 EFRAG considers that this might help users of financial statements to evaluate future prospects of the company. It might also increase users' ability to assess management stewardship.

24 EFRAG's overall assessment is that the Amendments would result in the provision of relevant information and therefore satisfy the relevance criterion.

Reliability

25 EFRAG also considered the reliability of the information that will be provided by applying the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

26 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

27 The Amendments might result in an entity recognising unequal amounts of deferred tax assets and liabilities on initial recognition of a transaction. In such cases, an entity would recognise any difference in profit or loss. This could be for example if, on initial recognition, the entity recognises a deferred tax liability but is unable to recognise an equal and offsetting deferred tax asset because of recoverability requirements or if different tax rates apply to the measurement of the deferred tax asset and liability.

28 An entity recognising unequal amounts of deferred tax assets and liabilities due to recoverability requirements in a transaction that give rise to equal taxable and deductible temporary differences would reflect the entity's expectations that it will be unable to benefit fully from the tax deductions available when it settles the liability, but that it is nonetheless required to make future tax payments as it recovers the asset.

29 While other solutions to avoid the recognition of a day one loss may exist, these may be inconsistent with how the IAS 12 initial recognition exemption is applied in other situations and would be complex to implement. Therefore, EFRAG considers that the day one loss that may arise, is offset by the disadvantages of other solutions.

30 Furthermore, EFRAG considers that unequal amounts of deferred tax assets and liabilities might arise on initial recognition only infrequently, because an entity might often meet the recoverability requirement through the future reversal of taxable temporary differences arising from the same transaction.

31 EFRAG's overall assessment is that the requirements in the Amendments will result in reliable information.

Comparability

32 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.

33 EFRAG has considered whether the Amendments result in transactions that are:

(a) economically similar being accounted for differently; or

(b) transactions that are economically different being accounted for as if they are similar.

34 Currently there are divergence on whether entities apply the initial recognition exemption for similar transactions that on initial recognition give rise to equal taxable and deductible temporary differences. This results in that for similar transactions some entities recognise deferred tax assets and liabilities while other entities do not. Consequently, the amounts recognised in the balance sheet and in the profit and loss account might be different.

35 There might also be entities that recognise deferred tax assets and liabilities for transactions such as decommissioning liabilities but do not recognise deferred tax assets and liabilities for other transactions such as leases while both give rise to equal taxable and deductible temporary differences. The Amendments set out the requirement that any transaction that on initial recognition give rise to equal taxable and deductible temporary differences should not apply the initial recognition exemption.

36 As explained in paragraph 9 above, the Amendments provide two different sets of requirements for transition, one applicable to leases and decommissioning liabilities and other applicable to other transactions. This may impair comparability as transactions that are economically similar will be recognized differently at transition date. However, as the Amendments are likely to mainly impact leases and decommissioning liabilities, EFRAG considers that this comparability issue is expected to have limited practical impact.

37 The Amendments address existing divergence in respect of the application of the initial recognition exemption in transactions that give rise to equal taxable and deductible temporary differences. This will bring consistency in accounting for deferred tax assets and deferred tax liabilities that arise from transactions that give rise to equal taxable and deductible temporary differences, and therefore will increase comparability between entities. Therefore, EFRAG's overall assessment is that the Amendments satisfy the comparability criterion.

Understandability

38 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.

39 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.

40 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.

41 The Amendments narrow the scope of transactions to which the initial recognition exemption in IAS 12 applies. Some entities are also already applying in practice the Amendments as they do not apply the recognition exemption to transactions that give rise to equal taxable and deductible temporary differences. The Amendments would also help users to understand the effective tax rate and tax position of the entity better.

42 In EFRAG's view, the Amendments do not introduce any complexity that may impair understandability. Therefore, EFRAG's overall assessment is that the Amendments satisfy the understandability criterion in all material respects.

Prudence

43 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.

44 EFRAG has not identified any particular impact on prudence. EFRAG has therefore concluded that the Amendments raise no issues in relation to prudence as defined above.

True and Fair View Principle

45 A Standard will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS Standards, it:

(a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss; and

(b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.

46 EFRAG assesses that the Amendments provide relevant, reliable, understandable and comparable information, lead to sufficiently prudent accounting, taking into account that it is intended to reduce diversity in practice. The Amendments will also align the accounting for deferred tax with the general principles in IAS 12. EFRAG assesses that the Amendments do not create any negative interactions with other IFRS Standards and are specifically designed to complement other standards by reflecting their tax consequences in a transparent way. Accordingly, EFRAG has assessed that the Amendments do not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.

47 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle.

Conclusion

48 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

1 EFRAG considered whether it would be conducive to the European public good to endorse the Amendments. In addition to its assessment included in Appendix 2, EFRAG has considered a number of issues in order to identify any potential negative effects for the European economy on the application of the Amendments. In doing this, EFRAG considered:

(a) Whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how they fit into IFRS Standards as a whole;

(b) The costs and benefits associated with the Amendments; and

(c) Whether the Amendments could have an adverse effect to the European economy, including financial stability and economic growth.

2 These assessments allow EFRAG to draw a conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation.

EFRAG's evaluation of whether the Amendments are likely to improve the quality of financial reporting

3 EFRAG notes that the Amendments are designed to reduce the diversity that exists in practice on whether the recognition exemption in paragraphs 15 and 24 of IAS 12 apply to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences.

4 The Amendments will also align the accounting for deferred tax with the general principles in IAS 12, resulting in a company recognising the tax effects of a transaction as it uses the asset and settles the corresponding liability.

5 EFRAG has therefore concluded that the Amendments are likely to improve the quality of financial reporting.

EFRAG's initial analysis of the costs and benefits of the Amendments

6 EFRAG first considered the extent of the work. For some Standards or Interpretations, it might be necessary to carry out some extensive work, in order to understand fully the cost and benefit implications of the Standard or Interpretation being assessed. However, in the case of the Amendments, EFRAG's view is that the cost and benefit implications can be assessed by carrying out a more modest amount of work.

7 Therefore, as explained more fully in the main sections of this Appendix, the approach that EFRAG has adopted has been to carry out detailed initial assessments of the likely costs and benefits of implementing the Amendments in the EU, to consult on the results of those initial assessments, and to finalise those assessments in light of the comments received.

Cost for preparers

8 EFRAG has carried out an assessment of the cost implications for preparers resulting from the Amendments.

9 EFRAG's assessment is that the Amendments may have an initial cost for preparers to familiarise with the application of the Amendments and to update the accounting policy documentation as well as internal information controls. Preparers may also have initial costs as they need to apply changes in their systems to record deferred tax asset and liabilities on transactions that give rise to the same amount of deductible and taxable temporary differences. However, we do not expect these costs to be significant as the Amendments:

(a) are not fully retrospective for leases and decommissioning liabilities and are applied prospectively for other transactions that give rise to equal amount of taxable and deductible temporary differences;

(b) do not imply an additional cost to entities that are in effect already applying the requirements in the Amendments;

(c) do not require entities to have significant ongoing costs.

(d) Some entities already record the assets in one system and the liabilities in separate systems. For those entities, the approach considered in the Amendments might be operationally simpler to solve the accounting divergence of these transactions (see paragraph 1 and 2 of Appendix 1) than the net approach (see paragraph 19 of Appendix 2).

10 EFRAG does acknowledge that the Amendments would result in costs to those preparers who are currently not recognising deferred tax or those who do it in a different way than the approach in the Amendments. However, these costs are unlikely to be significant in the context of the transition requirements and the strong process relating to deferred tax calculation that has been in place for many years.

11 Overall, EFRAG's assessment is that the Amendments are likely to result in insignificant costs for preparers related to implementation of the Amendments and/or ongoing costs of complying with the Amendments.

Costs for users

12 EFRAG has carried out an assessment of the cost implications for users resulting from the Amendments.

13 Except for updating the comparative year data, users are not expected to incur implementation cost insofar as the Amendments are not fully retrospective and users may not need to get familiar with the accounting implications of the Amendments as these are being applied in practice by some entities.

14 Overall, EFRAG's assessment is that the Amendments are likely to result in insignificant costs for users related to the update of users comparative information.

Benefits for preparers and users

15 EFRAG has carried out an assessment of the benefits for users and preparers resulting from the Amendments.

16 Users are likely to benefit from:

(a) reduced divergence in practice on whether entities apply the recognition exemption to transactions that, on initial recognition, give rise to equal taxable and deductible temporary differences.

(b) greater ability to evaluate future prospects of entities and to assess management stewardship

17 EFRAG's assessment is that while preparers are less likely to benefit from the Amendments, as for some preparers there will be costs relating to the Amendments, preparers will also benefit from the reduction in divergence.

Conclusion on the costs and benefits of the Amendments

18 EFRAG's overall assessment is that the overall benefits of implementing the Amendments are likely to outweigh their costs.

Conclusion

19 EFRAG believes that the Amendments will generally bring improved financial reporting when compared to current guidance. As such, their endorsement is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management stewardship.

20 EFRAG has not identified the Amendments could have any adverse effect to the European economy, including financial stability and economic growth.

21 Furthermore, EFRAG has not identified any other factors that would mean endorsement is not conducive to the public good.

22 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that endorsing the Amendments is conducive to the European public good.