

## MEMORANDUM

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DATE: 27 OCTOBER 2010

TO: MEMBERS OF THE FINANCIAL REPORTING STANDARDS BOARD AND THE AUSTRALIAN ACCOUNTING STANDARDS BOARD

FROM: CLIVE BRODIE

SUBJECT: COMMENTS ON IASB'S EXPOSURE DRAFT TO AMEND IAS 12

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### Purpose

1. The FRSB and AASB (the Boards) are asked to:
  - a) consider the issues noted in this memo for inclusion in the Boards' comment letters on the IASB's Exposure Draft ED/2010/11 *Deferred Tax Liabilities: Recovery of Underlying Assets* (Proposed amendment to IAS 12) [agenda item B5.7];
  - b) provide any further comments for inclusion in the Boards' comment letters on the Exposure Draft;
  - c) consider the draft comment letter (agenda item B5.2); and
  - d) agree on a process for finalising commenting letters on the Exposure Draft (comments are due by 9 November 2010).
2. This memo provides background information and a summary of issues raised so far for inclusion in the Boards' comment letters on the IASB's Exposure Draft.

### Background

#### *IASB's July 2010 tentative decision*

3. In the July 2010 IASB meeting, the IASB decided to introduce an exception to the measurement principle in IAS 12 *Income Taxes* so that deferred tax liabilities relating to the remeasurement of investment properties, property, plant and equipment or intangible assets are measured based on the tax consequences that follow the recovery of the asset through sale or, if lower, through use.

#### *IASB Income Tax project team request for input*

4. The IASB Income Tax project team, through the National Standard Setters, sought input from the FRSB in relation to the proposed amendment to IAS 12. In particular the IASB staff were seeking understand the practical implication of the proposal and whether there was likely to be any negative impact in practice resulting from the proposed amendment to IAS 12 to enable them to address such concerns at the early stage rather than in a later stage of the due process.

#### *Teleconference of members of the FRSB and AASB staff and memos to IASB staff*

5. On Friday 13 August members of the FRSB held a teleconference to discuss the IASB's Exposure Draft and prepare a memo to the IASB staff commenting on the Exposure Draft. Refer to:
  - a) the memo to Mitsuhiro Takemura and Michael Kraehnke – agenda item B5.3;
  - b) the AASB staff comments on the Exposure Draft – agenda item B5.4; and

#### *IASB Exposure Draft and due date for comments to IASB*

6. The IASB issued the Exposure Draft in September 2010 (agenda item B5.7). Comments are due to the IASB by 9 November 2010.

## Previous issues to be considered for inclusion in the Boards' comment letters and further issues to be raised

7. Members of the FRSB attending the 13 August teleconference raised some issues which the members agreed would not be included in the memo to IASB staff but would be considered for inclusion in the FRSB's comment letter on the Exposure Draft. These issues related to:
  - a) The IASB's proposed consequential amendments to SIC-21 *Income Taxes-Recovery of Revalued Non-Depreciable Assets*; and
  - b) The IASB's proposed exception as it relates to assets acquired in a business combination.
8. Subsequently, the FRSB raised with IASB staff an issue in relation to entities with infrastructural assets with long lives (such as, water or electricity networks) and concluded that, depending on the wording of the proposed amendments to IAS 12, this issue may need to be raised in the FRSB's comment letter.
9. In addition, some AASB members have commented that the IASB's proposed disclosures would not add useful information.

### *Consequential amendments to or withdrawal of SIC-21 Income Taxes – Recovery of Revalued Non-Depreciable Assets*

10. The proposed revision to SIC-21 *Income Taxes-Recovery of Revalued Non-Depreciable Assets* could have significant consequences, depending on how one interprets the amendment. The reason given for the amendment is that the guidance in SIC-21 is no longer necessary in respect of deferred tax liabilities once IAS 12 has been amended to include the exception. However, the rationale in SIC-21 is used in other analogous situations, not only when the asset is a revalued property, plant and equipment or investment property. For example, if non-deductible land is acquired in a transaction in which the initial recognition exemption in IAS 12 does not apply (e.g. in a business combination or in a transaction that affects taxable or accounting profit), currently a deferred tax liability is not recognised on the grounds that the asset is not depreciated and so its carrying amount will never be recovered through use, only through sale. This is based on the rationale in SIC-21. If SIC-21 is amended or withdrawn, it may mean that it is no longer appropriate to use the SIC-12 rationale for non-depreciable assets that are not revalued. If the land is subsequently measured at cost rather than fair value, the proposed exception will not apply.
11. In particular, it is unclear what impact the withdrawal of SIC-21 would have on accounting for deferred tax on revalued intangible assets with indefinite useful lives. Currently, some entities, in New Zealand and, we understand in other jurisdictions, by analogy apply SIC-21 to revalued intangible assets with indefinite useful lives thereby avoiding the recognition of a deferred tax liability. The withdrawal of SIC-21 could inadvertently result in such entities being required to recognise substantial deferred tax liabilities.
12. FRSB staff recommended to IASB staff that entities continue to be able to apply the rationale in SIC-21 to similar circumstances i.e. that the amendments made as a result of introducing the exception do not inadvertently preclude entities from applying the rationale in SIC-21 to circumstances that are similar in nature. IASB staff do not appear to have addressed this concern in ED/2010/11.

### *Exception as it relates to assets acquired in a business combination*

13. It seems that there are potential issues with the proposed exception as it relates to assets acquired in a business combination. For example, if the IASB proceeds with the exception as currently drafted, an entity will get a different value for goodwill depending solely on its choice of accounting policy for measurement of assets. Conversely, if the exception applied depending on whether the assets were subsequently measure at cost or fair value, the result will be a hybrid measurement or assets subsequently measured at cost – this would be similar to granting a new type of initial recognition exemption for assets acquired in a business combination. It is also concerning that the exemption is drafted for assets acquired in a "business combination". It is unclear whether this would mean all business combinations (for example, including common control transactions), or just business combinations within the scope of IFRS 3. If the exception were to apply to all business combinations, there is potential for abuse (at least at the subsidiary level, if not at group level).

*Application of the exception to entities with infrastructural assets*

14. The IASB is proposing that, in cases where it is difficult or subjective to determine the expected manner of recovery of an asset, there is a rebuttable presumption that the measurement of a deferred tax liability and a deferred tax asset shall reflect the tax consequences of recovering the carrying amount of an asset entirely by sale if that deferred tax asset or liability arises from remeasurement of investment property; property, plant and equipment and intangible assets. However, if an entity has clear evidence that it will consume the asset's economic benefits throughout its economic life, this presumption is rebutted and the entity must measure deferred tax assets and liabilities using the tax rate and the tax based that are consistent with the expected manner of recovery or settlement of the asset.
15. The FRSB was concerned that entities with infrastructural assets with long lives (for example, water or electricity networks) would not be able to apply the proposed exception because it would be difficult to argue that the assets are recovered other than through use. Given the purpose of the assets being to provide long-term essential services to the public and given the fact that such entities typically have a monopoly over the market; the infrastructural assets are rarely sold separately from the business. The FRSB was concerned that the presumption that recovery is through sale would be rebutted by the fact that it is unlikely that the assets would be sold in the near future and suggested to IASB staff that such entities should be able to apply the proposed exception.
16. FRSB staff raised this concern with IASB staff. IASB staff suggested the proposed exemption may be applied to infrastructural assets. IASB staff noted that that the requirement for there to be clear evidence that an asset would be recovered through use rather than sale before the presumption would be rebutted is considered [by some IASB members] to be a high hurdle. IASB staff suggested that, generally speaking, the longer the economic life of the asset the more difficult it is to rebut the presumption. The presumption can easily be rebutted, for example, when an asset's economic life is say three years because, with such a short life, it is more likely that the asset would be used for its entire useful life before being disposed of with an almost negligible residual value.
17. FRSB staff considers that, based on the wording in the Exposure Draft, the FRSB's concern remains and recommends that the FRSB raise this issue in its comment letter.

***Questions for the Boards***

18. *Do the Boards agree to raising the above issues in their comment letters on the IASB's Exposure Draft?*
19. *Do the Boards have any further comments for inclusion in their comment letters on the IASB's Exposure Draft?*

**Process for finalising a comment letters and next steps**

20. The FRSB and AASB are asked to agree on a process for finalising their comment letters to the IASB, the comment letters being due before the next FRSB/AASB meeting (comments are due by 9 November 2010).
21. FRSB and AASB staff will draft comment letters to be finalised in the manners agreed to by the Boards.