

9 November 2010

Sir David Tweedie
Chairman
The International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear David

EXPOSURE DRAFT ED/2010/11 *Deferred Tax: Recovery of Underlying Assets*

The Financial Reporting Standards Board (FRSB) of the New Zealand Institute of Chartered Accountants is pleased to submit its comments on the Exposure Draft ED/2010/11 *Deferred Tax: Recovery of Underlying Assets*.

Broadly speaking, the FRSB supports the proposals in the Exposure Draft. To resolve the issues with IAS 12 *Income Taxes*, the FRSB considers that a fundamental review of accounting for income taxes is required. In the interim, another exception to the principles in IAS 12 is necessary to address immediate practical issues.

The FRSB does however have a number of concerns that we believe must be addressed. We explain these concerns in our response to the questions for respondents to the Exposure Draft set out in the appendix to this letter.

If you have any queries or require clarification of any matters in this submission, please contact Clive Brodie (email: clive.brodie@nzica.com, ddi: +64 4 917 5624) in the first instance, or me.

Yours sincerely

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Appendix – FRSB’s responses to specific questions for respondents raised in the Exposure Draft

Question 1 – Exception to the measurement principle

The IASB proposes an exception to the principle in IAS 12 that the measurement of deferred tax liabilities and deferred tax assets should reflect the tax consequences that would follow from the manner in which the entity expects to recover or settle the carrying amount of its assets and liabilities. The proposed exception would apply when specified underlying assets are remeasured or revalued at fair value.

Do you agree that this exception should apply when the specified underlying assets are remeasured or revalued at fair value?

Why or why not?

1. The FRSB agrees that the exception should apply when the specified underlying assets are remeasured or revalued at fair value. The FRSB agrees that determining the expected manner of recovery of the underlying asset may be difficult and subjective when deferred tax liabilities or deferred tax assets arise from investment property that is measured using the fair value model or property, plant and equipment or intangible assets measured using the revaluation model.

Question 2 – Scope of the exception

The IASB identified that the expected manner of recovery of some underlying assets that are remeasured or revalued at fair value may be difficult and subjective to determine when deferred tax liabilities or deferred tax assets arise from:

- (a) investment property that is measured using the fair value model in IAS 40; (b) property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 or IAS 38;
- (c) investment property, property, plant and equipment or intangible assets initially measured at fair value in a business combination if the entity uses the fair value or revaluation model when subsequently measuring the underlying asset; and
- (d) other underlying assets or liabilities that are measured at fair value or on a revaluation basis.

The Board proposes that the scope of the exception should include the underlying assets described in (a), (b) and (c), but not those assets or liabilities described in (d).

Do you agree with the underlying assets included within the scope of the proposed exception?

Why or why not? If not, what changes to the scope do you propose and why?

2. The FRSB agrees that the proposed exception should apply to investment property that is measured using the fair value model in IAS 40 *Investment Property*; and property, plant and equipment or intangible assets measured using the revaluation model in IAS 16 *Property, Plant and Equipment* or IAS 38 *Intangible Assets*. This is because the most significant current issues in practice relate to investment property; property, plant and equipment and intangible assets.
3. However, the FRSB has some concerns regarding the proposed exception as it relates to assets acquired in a business combination. Our concerns are as follows:
 - a. If the IASB proceeds with the exception, an entity will arrive at a different value for goodwill depending solely on its choice of accounting policy for measurement of assets.
 - b. With application of the exemption dependant upon on whether the assets are subsequently measured at cost or fair value, the result will be a hybrid measurement for 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.
 - c. The exemption is drafted for assets acquired in a "business combination". The FRSB considers that 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 *Business Combinations*. If the exception were to apply to all business combinations, the FRSB considers there to be potential for abuse (at least at the subsidiary level, if not at group level).

Question 3 – Measurement basis used in the exception

The IASB proposes that, when the exception applies, deferred tax liabilities and deferred tax assets should be measured by applying a rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely through sale. This presumption would be rebutted only when an entity has clear evidence that it will consume the asset's economic benefits throughout its economic life.

Do you agree with the rebuttable presumption that the carrying amount of the underlying asset will be recovered entirely by sale when the exception applies?

Why or why not? If not, what measurement basis do you propose and why?

4. The FRSB is 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 is 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. The FRSB considers that the rebuttable presumption should be removed to permit such entities to apply the proposed exception.

5. Some might interpret the rebuttable presumption to mean that, generally speaking, the longer the economic life of the asset the more difficult it is to rebut the presumption. For example, the presumption can easily be rebutted 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. The FRSB recommends that the IASB clarify its intention.

Question 4 – Transition

The IASB proposes that the amendments should apply retrospectively. This requirement includes retrospective restatement of all deferred tax liabilities or deferred tax assets within the scope of the proposed amendments, including those that were initially recognised in a business combination.

Do you agree with the retrospective application of the proposed amendments to IAS 12 to all deferred tax liabilities or deferred tax assets, including those that were recognised in a business combination?

Why or why not? If not, what transition method do you propose and why?

6. The FRSB agrees that the proposed amendment should be applied retrospectively for the benefit of consistent application of the amendments by entities to all periods presented in the financial statements. The FRSB agrees that retrospective application would not be unduly burdensome for entities.

Question 5 – Other comments

Do you have any other comments on the proposals?

7. The FRSB is concerned that the proposed withdrawal of SIC-21 *Income Taxes-Recovery of Revalued Non-Depreciable Assets* could have significant consequences. Some might consider 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

withdrawn, it may mean that it is no longer appropriate to use the SIC-21 rationale for non-depreciable assets that are not revalued. Example A implies that the proposed exemption would not apply if the land is subsequently measured at cost rather than fair value.

8. 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.
9. The FRSB recommends 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.