



Tax alert

IFRS and Tax



Tax accounting implications of the new IFRS standard for small and medium-sized entities (SMEs)

Background

The International Accounting Standards Board (IASB) has issued its International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs or “the standard”). This standard is the culmination of a five year project to address the financial reporting needs of small and medium-sized entities (as defined in the standard and described later in this Alert).

The IASB published the Exposure Draft (ED) of an IFRS for SMEs in February 2007 and began its redeliberations in May 2008. As a result, there have been changes to a significant number of the proposals originally contained in the ED. Perhaps the most significant change is that the IFRS for SMEs is now a stand-alone standard, with no fall back to full IFRS.

The accounting for income taxes section of IFRS for SMEs closely mirrors the proposals contained in the Exposure Draft (ED) to replace IAS 12 Income Taxes. The impact of this and other key requirements are outlined below.

Continued overleaf ►

Overview of IFRS for SMEs

The standard consists of 230 pages of text, arranged into 35 chapters that cover all of the recognition, measurement, presentation and disclosure requirements for SMEs. There is no cross reference to other IFRS (with one exception relating to financial instruments). This underscores the fact that IFRS for SMEs is viewed by the standard setter as stand-alone from full IFRS.

On adoption of IFRS for SMEs, an entity must apply the provisions contained in Section 35, which deals with the transition to IFRS for SMEs. This requirement applies to all entities adopting IFRS for SMEs, irrespective of whether they are migrating from a national GAAP or full IFRS. Furthermore, if an entity were to change from local GAAP to IFRS for SMEs and subsequently wished to change to full IFRS, it would be required to apply IFRS 1 First-time Adoption of International Financial Reporting Standards.

IFRS for SMEs is based on the fundamental principles of full IFRS, but in many cases, it has been simplified to make the accounting requirements less complex and to reduce the cost and effort required to produce the financial statements. To achieve this, the IASB has removed a number of the accounting options available under full IFRS and attempted to simplify accounting for SMEs in certain areas. However, in the income tax section, the incorporation of many provisions of the ED to replace IAS 12 is a surprise and may lead to additional complexity for SMEs.

Scope of the standard

The standard is intended for use by SMEs. SMEs are defined in the standard as entities that do not have public accountability and which also publish general-purpose financial statements for external users. An entity has public accountability if its debt or equity instruments are traded in a public market, or it holds assets in a fiduciary capacity for a broad group of outsiders. While this definition in the standard is necessary for an understanding of which entities may apply IFRS for SMEs, the preface to the standard indicates that often jurisdictional regulatory and legislative authorities set the qualifying criteria as to what would constitute an SME. However, if a publicly accountable entity uses the standard, it may not claim that the financial statements conform to IFRS for SMEs even if its application is permitted or required in that jurisdiction, as the entity would not meet the definition of an SME.

For a full analysis of IFRS for SMEs, see the Ernst & Young Supplement to IFRS Outlook issued on 14 July, 2009, which can be found on ey.com/ifrs. The remainder of this Alert focuses on the tax accounting considerations of IFRS for SMEs.

Tax accounting considerations

Section 29 of IFRS for SMEs deals with accounting for income tax. The standard retains the key principles of accounting for income taxes in IAS 12 *Income Taxes* (and the ED) namely, the recognition of deferred tax assets and liabilities under the temporary difference approach. The IASB had considered, but rejected suggestions to allow SMEs to follow a simpler "current tax payable" (or "flow-through") approach which would have resulted in no deferred taxes being recognized for SMEs.

Significant differences from current IAS 12

IFRS for SMEs contains, in final form, many of the proposals currently open for public comment as part of the ED to replace IAS 12. This was intentional on the IASB's part since the IFRS for SMEs explicitly states that its requirements for income taxes "follow the approach set out in the ED Income Tax, published in March 2009". (For an analysis of that IAS 12 ED, see the Ernst & Young Tax Alert dated 03 April 2009).

IFRS for SMEs departs from the current IAS 12 (and adopts proposals contained in the ED on income taxes) in areas principally affecting:

- ▶ Definition of tax basis
- ▶ Recognition of deferred tax assets
- ▶ Uncertain tax positions
- ▶ Disclosures

Definition of tax base

IAS 12 currently defines the tax base of an asset as the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset. The tax base of a liability is its carrying amount, less any amount that will be deductible for tax purposes in respect of that liability in future periods. The entity's expectation as to the manner in which it will recover the carrying amount of an asset or settle the carrying amount of a liability can affect the tax base. For example, if an entity were to pay a different amount of tax depending on whether an asset is consumed in the business or sold, the entity measures deferred tax according to the expected method of realization. This effectively makes deferred tax under the current IAS 12 standard a function of management's intent, which the IASB has striven to eliminate from other areas of financial reporting.

IFRS for SMEs adopts a different definition, from that described above, of the tax base of an asset and liability. The tax base of an asset is determined by the tax consequences that would arise if it were recovered for its carrying amount through sale at the reporting date. The tax base of a liability is determined by the tax consequences that would arise if it were settled for its carrying amount at the reporting date. This change eliminates from the determination of tax base the entity's expectation as to manner of recovery of an asset (or settlement of a liability). This new definition of a tax base of an asset or liability is consistent with what has been proposed in the ED on income taxes.

Recognition of deferred tax assets

IFRS for SMEs requires entities to record deferred tax assets differently from the current IAS 12. IAS 12 currently requires a deferred tax asset to be recognized for all deductible temporary differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilized. IAS 12 also requires an entity to re-assess the recognition of deferred tax assets, and where appropriate previously unrecognized deferred tax assets, at each balance sheet date. A deferred tax asset is not reported gross, less a 'valuation allowance', but as a net amount representing the "amount of income taxes recoverable in future periods in respect of deductible temporary differences, the carryforward of unused tax losses; and the carryforward of unused tax credits."

IFRS for SMEs adopts a different approach to how deferred tax assets are recognized and disclosed in the financial statements as follows:

- ▶ An amount is recorded in the financial statements for a deferred tax asset for all temporary differences that are expected to reduce taxable profit in the future as a total amount.
- ▶ An entity shall recognise a valuation allowance against deferred tax assets so that the net carrying amount equals the highest amount that is more likely than not to be recovered based on current or future taxable profit.
- ▶ An entity shall review the net carrying amount of a deferred tax asset at each reporting date and shall adjust the valuation allowance to reflect the current assessment of future taxable profits. Such adjustment shall be recognised in profit or loss, except that an adjustment attributable to an item of income or expense recognised in accordance with this IFRS as other comprehensive income shall also be recognised in other comprehensive income.

Deferred tax assets that were previously not recorded under IAS 12 will now have to be recorded with offsetting valuation allowances. These changes are consistent with what has been proposed in the ED on income taxes.

Uncertain tax positions

IAS 12 currently does not explicitly address the recognition and measurement of uncertain tax positions. However, it notes that, while IAS 37 *Provision, Contingent Liabilities and Contingent Assets* generally excludes income taxes from its scope, its principles are relevant to the disclosure of tax-related contingent assets and contingent liabilities, such as unresolved disputes with taxing authorities. Since there is no direct guidance on this topic in IAS 12, there are some variations on how entities currently account for uncertain tax positions in practice.

IFRS for SMEs adopts explicit new guidance on uncertain tax positions, which draws on the proposals in the ED on income taxes. The standard states that an entity shall measure current and deferred tax assets and liabilities using the probability-weighted average amount of all the possible outcomes, assuming that the tax authorities will review the amounts reported and have full knowledge of all relevant information. Changes in the probability-weighted average amount of all possible outcomes shall be based on new information, not a new interpretation by the entity of previously available information.

IFRS for SMEs does not apply a probability threshold to the recognition of an uncertain tax position - implying an entity needs to review and measure all its uncertain tax positions. It also does not define how, or at what level of detail, or unit of account, a tax position is to be analyzed.

The requirements for the measurement of uncertain tax positions apply to current and deferred taxes alike, since an uncertain tax position may not simply affect the amount of current tax payable or receivable. For example, where an entity has claimed a deduction for an item in its tax return which is subject to uncertainty, the uncertainty will determine not only the measurement of current tax, but also that of the tax basis of the item recorded and, therefore, deferred tax. As a consequence, the Standard provides that the amount recorded for a tax asset or liability in the financial statements will be affected by the amount considered an uncertain tax position.

For disclosure of uncertain tax positions, the IFRS for SMEs standard contains less explicit disclosure requirements than those contained in the ED on Income Taxes. The disclosures are listed below.

Disclosures

IFRS for SMEs does not contain all the disclosures currently contained in IAS 12, yet introduces some new disclosures not currently in IAS 12, including:

- ▶ The effect on deferred tax expense arising from a change in the effect of the possible outcomes of a review by the tax authorities
- ▶ Adjustments to deferred tax expense arising from a change in the tax status of the entity or its shareholders (it is notable that IFRS for SMEs doesn't provide guidance on when or how to recognize the effect of the change in status, but requires disclosure of the effect).
- ▶ Any change in the valuation allowance
- ▶ An explanation of the significant differences in amounts presented in the statement of comprehensive income and amounts reported to tax authorities

These new disclosures are largely consistent with some of the new disclosures proposed in the ED on income taxes. While the overall objective of IFRS for SMEs is to simplify the accounting and disclosure requirements for SMEs, it could be argued that the disclosures in the income tax section are more onerous than current IAS 12, especially for uncertain tax positions.

Other topics

Similarities and differences between current IAS 12, the ED on income taxes, and what is contained in the IFRS for SMEs standard on other topics are described below:

Backward tracing

IAS 12 currently requires current tax and deferred tax to be charged or credited in other comprehensive income (OCI) or directly in equity if the tax relates to items that were credited or charged, whether in the current or previous period, in OCI or directly in equity. Subsequent changes to those amounts are also allocated to OCI or equity as applicable, a treatment commonly referred to as 'backward tracing'. By contrast, the ED proposes that any change to a tax asset or liability relating to an item accounted for in an earlier period should generally be recognized in profit or loss, without any backward tracing. However, the ED retains the current requirement for backward tracing of share-based payment transactions, (i.e., any tax deduction received in excess of the cumulative expense for an award is accounted for in equity). IFRS for SMEs appears to have retained (or intended to retain) the current IAS 12 approach to backward tracing, however, the wording of IFRS for SMEs is not entirely clear in a few locations in this regard.

Initial recognition exception

IAS 12 currently requires a deferred tax asset or liability to be recognized for all deductible or taxable temporary differences, except for:

- ▶ A deferred tax liability arising from the initial recognition of goodwill; or
- ▶ A deferred tax asset or liability arising from the initial recognition of an asset or liability in a transaction which is not a business combination, and at the time of the transaction affects neither accounting profit nor taxable profit or loss.

This 'initial recognition exception' (IRE) - as it has generally become known - appears somewhat arbitrary, but essentially, it is a pragmatic solution to what were seen as inappropriate accounting consequences of a strict application of the temporary difference approach.

The ED's proposals in this area are complex. The ED concluded that the initial recognition exception could no longer be justified conceptually. On the other hand, it clearly wanted to avoid the accounting consequences which the exemption seeks to prevent. Accordingly, the 'initial recognition exception' is abolished, with deferred tax being recognized on all temporary differences, whenever they arise, except that a deferred tax liability is not recognized on the initial recognition of goodwill.

Where a temporary difference arises on the initial recognition of an asset or liability, the ED requires that the asset or liability should be disaggregated into:

- ▶ The asset or liability, excluding any entity-specific tax effects; and
- ▶ The entity-specific tax effects - broadly, the extent to which the tax treatment of an item in the hands of the entity places the entity in a better or worse position than taxpayers as a whole.

The ED requires that the former amount becomes the carrying amount of the asset or liability. Deferred tax is recognized on any temporary difference arising from this carrying amount. Where an asset or liability is recognized other than in a business combination or in a transaction that affects comprehensive income, equity or taxable profit, the entity also recognizes a premium or allowance (the difference between the amount paid for an asset, or received for a liability, and its carrying amount together with any associated deferred tax asset or liability). Such a premium or allowance is offset against the deferred tax balance. The impact of this, in net terms, is that the former initial recognition exception is retained, in the sense that any deferred tax recognized on initial recognition of an asset or liability, other than in a business combination or a transaction that affects comprehensive income, equity or taxable profit, is immediately offset by a premium or allowance.

IFRS for SMEs simply states that an entity shall not recognise a deferred tax liability for a temporary difference associated with the initial recognition of goodwill. Similar to the ED, this appears to be an attempt to abolish the IRE (except for the initial recognition of goodwill). However, unlike the ED, IFRS for SMEs does not describe how to account for temporary differences on the initial recognition of items that are not goodwill. It remains to be seen what practice will develop in this area for SMEs in the absence of specific guidance.

Investments in subsidiaries, branches and associates and interests in joint ventures

IAS 12 currently requires an entity to recognise a deferred tax liability for all taxable temporary differences associated with investments “in subsidiaries, branches and associates and interests in joint ventures”, except to the extent that both of the following conditions are satisfied: (a) the parent, investor or venturer is able to control the timing of the reversal of the temporary difference; and (b) it is probable that the temporary difference will not reverse in the foreseeable future. A deferred tax asset for all deductible temporary differences arising from investments in subsidiaries, branches and associates, and interests in joint ventures, is not recorded, except to the extent that, and only to the extent that, it is probable that: (a) the temporary difference will reverse in the foreseeable future; and (b) taxable profit will be available against which the temporary difference can be utilized.

The ED proposes that an entity should recognise a deferred tax asset or liability for any temporary difference associated with an investment in “subsidiaries and joint ventures” except for a difference relating to an investment in a foreign subsidiary and or foreign joint venture that is essentially permanent in duration, and it is apparent that the temporary difference will not reverse in the foreseeable future. There is no exception for an investment in an associate, thus an entity should recognise a deferred tax asset or liability from that investment.

IFRS for SMEs appears to have intended to follow the proposal in the ED. However, the wording is not the same as the ED and could cause confusion. IFRS for SMEs states that “an entity shall not recognise a deferred tax asset or liability for temporary differences associated with unremitted earnings from foreign subsidiaries, branches, associates and joint ventures to the extent that the investment is essentially permanent in nature, unless it is apparent that the temporary difference will reverse in the foreseeable future”. It is unclear why this is referring to “unremitted earnings”. Also unclear is why there is a reference to branches, which, by their nature, do not have unremitted earnings as they are typically not separate legal entities that have to declare dividends to “remit” their earnings.

Distributed or undistributed tax rates: certain jurisdictions tax corporate income at different rates depending on whether or not it is distributed to the entity’s shareholders. IAS 12 currently requires the use of the tax rate applicable to undistributed profits in measuring tax assets and liabilities. The ED proposes that an entity should take into account, and disclose, expectations regarding future distributions and the ability to make distributions in determining the applicable tax rate to use (i.e., use the distributed rate for profits that are expected to be distributed; otherwise, use the undistributed rate).

IFRS for SMEs retains the current IAS 12 treatment and does not follow the ED in this regard.

Balance sheet classification

IAS 1 *Presentation of Financial Statements* currently requires all deferred tax assets and liabilities to be classified as non-current, regardless of the classification of the underlying asset and liability giving rise to the temporary difference. The ED proposes to amend IAS 1 and require the classification of deferred tax assets and liabilities to be consistent with the underlying asset or liability. A deferred tax asset or liability not related to a recognized asset or liability (such as a deferred tax asset relating to an unused tax losses or tax credits) should be classified as current or non-current depending on when the entity expects the temporary difference to reverse.

IFRS for SMEs retains the current IAS 1 treatment and does not follow the ED in this regard.

Transition

IFRS for SMEs has no effective date. This will presumably be determined by the regulators in each country when usage of the standard is endorsed. The Standard has transition rules that apply equally to all entities on its first-time adoption. The transition rules are based on the requirements of IFRS 1 *First-time Adoption of International Financial Reporting Standards* but, in certain cases, the standard has been designed to make the transition rules simpler to apply.

Under the transition rules, restatements to the opening statement of financial position do not need to be made if it is impracticable for the entity to do so. In some cases, this may relieve the need for restatement, although the ability to meet the impracticability hurdle may prove difficult. For example, an entity may find that certain information needed for reporting under IFRS for SMEs was never needed for the purposes of reporting under previous GAAP and such information about past transactions may now no longer be available. This could make it impracticable to restate the opening statement of financial position for certain items.

The standard clarifies that an entity can be a first-time adopter of IFRS for SMEs only once. Therefore, if an entity stops applying this standard and then chooses to adopt it again in a later period, it would have to apply all the requirements of IFRS for SMEs fully retrospectively to when it was first adopted.

Business impact

The publication of a simplified form of IFRS for private entities has been long awaited by national standard setters and small and medium-sized entities that have been required to apply full IFRS in the past.

While the application of this standard is intended to reduce the compliance costs for many smaller entities and help make the financial statements of such entities less complex, the same may not be said for the income tax section of this standard. As the standard is very much principles based, interpretation issues are likely to arise. IFRS for SMEs includes a number of references to requirements not having to be applied if they require undue cost or effort to determine. This is likely to require significant judgment by preparers of financial statements to ensure consistent and high quality application of the standard.

Entities need to review which books and records are the starting point for the tax return in countries and jurisdictions in which they operate, and how will the taxing authorities view this new accounting standard. Some tax authorities may accept it as a “starting point” for the tax compliance process, and others may not, necessitating the maintenance of books and records (based on statutory accounting or a national GAAP) that is being used currently by the entity.

An entity will also need to consider whether changes are required to information systems and financial statements processes. In some cases the requirements may be significantly different from those currently applied under either full IFRS or national GAAP. As the IFRS for SMEs is a complete standard, any entity wishing to apply it will also need to consider the impact of not applying full IFRS, particularly as there is no short-cut approach if the entity later decides to adopt full IFRS.

Clearly, this standard will have an impact across the entire spectrum of an entity's tax life cycle – tax planning, tax provision, tax compliance and tax controversy, as well as the tax accounting on transactions. The requirements surrounding the accounting for and disclosure of uncertain tax positions, in particular, may have far-reaching data gathering, documentation and support implications for the entity and could potentially affect its dealings with tax authorities worldwide.

The introduction of the concept of valuation allowances to offset deferred tax assets will require additional tracking and documentation. For this and the other reasons discussed above, adjustments may need to be made to an entity's tax processes, technology, internal controls and training of its people following the adoption of the income tax section of this standard.

Public companies and entities that are not otherwise defined as SMEs should also take note of this standard in the context of what may happen to the ED to replace IAS 12. Since this standard incorporates many of the principles contained in that ED, entities may wish to watch what challenges SMEs face in their accounting for income taxes under this new standard.

Ernst & Young can help

Please call your local Ernst & Young representative or contact one of our Global IFRS Tax or Tax Accounting and Risk Advisory Services leaders below.

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About Ernst & Young's Accounting for Income Taxes under International Financial Reporting Standards (IFRS)

The move to IFRS is an important initiative in the financial reporting world, the impact of which stretches far beyond accounting to affect every decision you make. Tax is prevalent throughout your entity's operations – potentially affecting every transaction made. Understanding the impact on accounting for income taxes under IFRS is fundamental to an efficient tax life cycle: tax planning, tax compliance, tax provisions and tax controversy.

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