EFRAG
European Financial Reporting Advisory Group

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Dear Mr Faull

Adoption of Deferred Tax: Recovery of Underlying Assets (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 we are pleased to provide our opinion on the adoption of Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12) ('the Amendments'), which were issued by the IASB on 20 December 2010. It was issued as an Exposure Draft in September 2010 and EFRAG commented on that draft.

The objective of the Amendments is to introduce an exception to the measurement principle in IAS 12 in the form of a rebuttable presumption that assumes that the carrying amount of an investment property measured at fair value will be recovered through sale and an entity will be required to use the tax rate applicable to the sale of underlying asset.

The Amendments become effective for annual periods beginning on or after 1 January 2012. Earlier application is permitted, however entities shall disclose that fact.

EFRAG has carried out an evaluation of the Amendments. As part of that process, EFRAG issued an initial assessment for public comment and, when finalising its advice and the content of this letter, it 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.

EFRAG supports the Amendments and has concluded that they meet the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards in that they:

- are not contrary to the principle of 'true and fair view' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; and

- 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.

For the reasons given above, EFRAG is not aware of any reason to believe that it is not conductive to the European public good to adopt the Amendments, and accordingly, EFRAG recommends their adoption. EFRAG's reasoning is explained in the attached 'Appendix - Basis for Conclusions'.

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

Yours sincerely

Françoise Flores
EFRAG Chairman

APPENDIX 1
BASIS FOR CONCLUSIONS

This appendix sets out the basis for the conclusions reached, and for the recommendation made, by EFRAG on Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12) ('the Amendments').

In its comment letters to the IASB, EFRAG points out that such letters are submitted in EFRAG's capacity as a contributor 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 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 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 IFRSs 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 criteria for EU endorsement?

1 EFRAG has considered whether the Amendments meet the 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, in other words that the Amendments:

(a) are not contrary to the 'true and fair' set out in Article 16(3) of Council Directive 83/349/EEC and Article 2(3) of Council Directive 78/660/EEC; 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.

EFRAG also considered, based only on evidence brought to its attention by constituents, whether it would be not conducive to the European public good to adopt the Amendments.

Relevance

2 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.

3 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.

4 The Amendments introduce an exception in the form of a rebuttable presumption to the measurement principle in IAS 12. The Amendments require an entity to measure deferred tax on investment property carried at fair value, based on the tax consequences of selling that asset, unless an entity rebuts this presumption. This

presumption is rebutted if the investment property is depreciable and is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. The Amendments are intended to provide relief to entities that find it difficult to determine the manner of recovery of *depreciable* investment property measured at fair value, and thereby reduce subjectivity.

5 A fundamental principle in existing IAS 12 is to measure deferred taxes based on the manner in which an entity expects to recover the carrying amount of an asset. As explained below, the relevance of information produced under the Amendments is unaffected in most circumstances, because entities will rebut the presumption in paragraph 51C of the Amendments when it is appropriate to do so.

6 The information resulting from the application of the Amendments would be relevant in the following circumstances:

(a) When an entity has a clear expectation of recovering the carrying amount of the investment property through sale.

(b) If the investment property is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. In this case, the presumption would be rebutted and the measurement principle in IAS 12 would apply.

7 In EFRAG's view, only in rare circumstances would an entity produce information that does not reflect the real tax consequences that are expected to arise when the underlying asset is recovered. Such circumstances might arise when an entity does not have sufficient evidence to rebut the presumption, even though it might be more appropriate to do so.

8 The IFRS Interpretations Committee discussed a request to clarify whether the presumption can be rebutted in cases other than the case described in paragraph 51C of the Amendments. As noted in the November 2011 IFRIC Update, the IFRS Interpretations Committee commented that a presumption is a matter of policy in applying a principle (or an exception) in IFRSs, which can be rebutted when there is sufficient evidence to overcome it. The Committee also noted that the Amendments do not preclude the presumption to be rebutted in circumstances other than those in paragraph 51C. On this basis, the Committee decided not to take the issue to its agenda.

9 EFRAG agrees that the Amendments do not provide an exhaustive list of cases in which the presumption in paragraph 51C can be rebutted and do not preclude the presumption from being rebutted in other cases. Furthermore, if the presumption is rebutted, an entity must apply the measurement principles in IAS 12.

Conclusion

10 For the reasons stated above, EFRAG's assessment is that the Amendments satisfy the relevance criterion.

Reliability

11 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 that which it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

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

13 Under the existing IAS 12, in the absence of specific plans to dispose of an investment property, an entity is required to estimate the portion of its carrying value that is expected to be recovered through future cash flows from use (for example rental income) and the portion that is expected to be recovered through cash flows from its sale. In some cases, it is difficult to undertake this exercise, given the degree of subjectivity involved in assessing future recovery of an asset.

14 The Amendments aim to reduce the subjectivity by shifting the focus away from the notion of 'manner of recovery' for investment property measured at fair value, and introducing a single measurement approach that provides relief to entities that find it difficult to determine the manner of recovery of investment property. This approach does not involve significant judgements or estimates, and would not raise any significant issues with regard to freedom from material error and bias, faithful representation or completeness.

Conclusion

15 For the reasons stated above, EFRAG's assessment is that the Amendments satisfy the reliability criterion.

Comparability

16 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.

17 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.

18 As explained above, the Amendments introduce a single measurement approach to calculate deferred tax on investment property measured at fair value. Therefore, the measurement of deferred tax balances of like investment properties held at fair value would be accounted for in a consistent way.

19 However, in the rare cases identified in paragraph 7 above, where information produced by the Amendments is not relevant, the information would represent transactions as similar when they are not.

Conclusion

20 For the reasons stated above, EFRAG's assessment is that the Amendments satisfy the comparability criterion.

Understandability

21 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.

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

23 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.

24 As previously explained the Amendments aim to provide relief to those entities that find it difficult to determine the manner of recovery of investment property measured at fair value, and do not introduce new accounting requirements.

<u>Conclusion</u>

25 EFRAG's assessment is that the Amendments do not introduce any new complexities that may impair understandability and therefore satisfies the understandability criterion.

True and Fair

26 EFRAG has concluded that the information resulting from the application of the Amendments would not be contrary to the principle of true and fair view.

European public good

27 EFRAG is not aware of any reason to believe that it is not conducive to the European public good to adopt the Amendments.

Conclusion

28 For the reasons set out above, EFRAG's assessment is that the Amendments satisfy the technical criteria for EU endorsement and EFRAG should therefore recommend its endorsement.

29 As explained in Appendix 2, one EFRAG TEG member has concerns with the Amendments that cause that member to believe that EFRAG should not recommend the Amendments for endorsement.

APPENDIX 2

DISSENTING OPINION

1 Andy Simmonds (EFRAG TEG member) dissents from recommending endorsement of *Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12)* ('the Amendments').

2 Andy Simmonds believes that the Amendments should not be endorsed for use in the European Union and therefore dissents from EFRAG's decision to recommend its endorsement. Andy Simmonds has reached this conclusion because he believes aspects of the Amendments do not meet the criteria for endorsement. In particular:

(a) Paragraph 51C of the amended IAS 12 requires that, in measuring deferred tax on an investment property carried at fair value, there is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. In Andy Simmonds view, this presumption of recovery through sale is unnecessary, and may result in measurement of tax at an amount which is misleading.

(b) As IASB note in paragraph BC8 to the Amendments, IAS 12 includes a principle 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. Paragraph BC8 further notes that in many cases, an entity expects to rent out investment property to earn rental income and then sell it to gain from capital appreciation at some point in the future. Andy Simmonds believes that the principle is adequate to deal with investment property which is used and then sold, and should result in deferred tax that reflects a period of use followed by sale. In practice, the resulting amount of deferred tax may be the same as that based on an assumption of sale. In such cases the Amendments are unnecessary, and promote a rule-based approach at the expense of principles.

(c) In cases where the resulting amount of deferred tax under the Amendments differs from the tax based on an assumption of use followed by sale, as occurs in the 'Example illustrating paragraph 51C', the deferred tax calculated under the Amendments will not represent a best estimate of future cash flows and may thus be misleading.