

# IFRS News

Shedding light on the IASB's activities\*

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## Issue of the month

### Proposed revisions to IAS 12 – facelift or total makeover?

**IAS 12 is a well established standard, but deferred tax remains a difficult and complex area for many companies. The Board plans to revise the standard (ED expected later this year), but will the changes make deferred tax accounting more straightforward? Senior manager in PwC's Global Accounting Consulting Services group in Central and Eastern Europe, Gabor Balazs, explains the impact of the IASB's conclusions.**

The planned revisions to IAS 12 are part of the IASB's short-term convergence project with the FASB. IFRS and US GAAP share a common principle for deferred tax accounting but have different exemptions and exceptions. The two boards intend to eliminate some of the exemptions and harmonise most of the others. The IASB will also propose changes to some of the key principles of IAS 12, but will these make deferred tax accounting more intuitive and transparent? The impact of the most significant changes is explained below.

#### Tax base

Tax base is the amount attributed to an asset for tax purposes and is one of the building blocks on which accounting for deferred tax is constructed. Deferred tax is usually recognised for the difference between an asset's tax base and its carrying amount on the balance sheet. The tax base of an asset under IAS 12 might vary depending on whether management expects to use or sell the asset. For example, there might be no tax deductions for the cost of an asset used in the business, but a deduction for the entire cost when the asset is sold. Judgments and complex calculations are required when the tax consequences of use and sale differ.

The IASB will propose a significant simplification in this area. Tax base will be defined as the amount that would be tax deductible if the asset was sold at the balance sheet date. This proposal will make it easy for companies to determine the tax base of most assets and will align the IFRS definition with the equivalent in US GAAP.

#### Initial recognition exemption

The carrying value of an asset on initial recognition sometimes differs from its tax base. The bookkeeping to recognise deferred tax in these circumstances is confusing, because the deferred tax affects the carrying value of the asset. IAS 12 currently prohibits the recognition of deferred tax on initial recognition of an asset in a transaction that is not a business combination and does not affect accounting or taxable profit. This was included in the standard to simplify the accounting.

The Board will propose a new model for initial recognition. Assets will be measured initially using market participant assumptions about tax base, which might differ from the asset's actual tax base. Deferred tax will be recognised for this difference. The consideration given will not always be equal to the net of the initial carrying value, and the deferred tax and the difference will be recognised as a purchase discount and spread over the life of the asset.

This proposal will require complex calculations that will not obviously increase transparency.

**Group tax relief – separate financial statements**

Many tax jurisdictions permit the taxable profits and losses of companies in a tax group to be offset. The liability to the tax

authorities often rests with the parent or with a designated subsidiary. IAS 12 provides no guidance on accounting for these arrangements in the separate financial statements of subsidiaries that have no direct obligation to the tax authority. There is consequently diversity in practice.

The Board will propose that subsidiaries in a tax group recognise and account for current and deferred tax even if they have no direct tax liability and make no payments to their parent for income tax. Accounting for deferred and current tax will be based on the assumption that the entity is a tax payer in its own right or based on another method that is consistent with IAS 12. The proposal will align IAS 12 with US GAAP.

There are circumstances in which it might be useful and informative for a subsidiary with no direct tax liability to

recognise current and deferred taxes. This might apply, for example, when a subsidiary is about to be sold outside the tax group. However, in general the Board's proposal will impose an additional burden on wholly owned subsidiaries that have a statutory filing requirement but no tax obligations.

**Backwards tracing**

IAS 12 requires current and deferred tax related to discontinued operations or to items recognised directly in equity to be recognised as part of discontinued operations or in equity. Subsequent changes in tax balances because of a change in tax rates or a change in the assessment of a deferred tax asset are 'traced' to the original entry and also recognised in equity or as a discontinued operation. This can be complex, particularly when the tax balances relate to an operation that was discontinued

**Implications for business**

	Convergence with US GAAP	Simplification	More transparency
<ul style="list-style-type: none"> <li>● <b>Simplification of determining tax bases:</b> judgments and complex calculations are required when the tax consequences of use and sale differ. The proposals will simplify the tax base of most assets and will align with US GAAP.</li> </ul>	Yes	Yes	–
<ul style="list-style-type: none"> <li>● <b>Increased complexity due to initial recognition proposals and no more transparency.</b> The initial recognition exemption will be removed and replaced with a model that will add complexity and no more transparency.</li> </ul>	Yes (new model for both frameworks)	No	No
<ul style="list-style-type: none"> <li>● <b>Additional requirement to account for tax consolidations.</b> Accounting for deferred and current tax in separate financial statements will be based on the assumption that the entity is a tax payer in its own right. This will align IAS 12 with US GAAP but might create an additional burden for companies in tax groups that have no tax obligations.</li> </ul>	Yes	No	Yes
<ul style="list-style-type: none"> <li>● <b>Additional complexity in accounting for changes in deferred tax because of changes in the tax rate or changes in deferred tax assets.</b> The Board will align with US GAAP, but this will not necessarily simplify what is already a complex and sometimes overlooked aspect of the deferred tax model.</li> </ul>	Yes	No	No
<ul style="list-style-type: none"> <li>● <b>No relief in requirements for discounting.</b> The revisions will not address discounting, so the challenges created by a model in which discounting is not permitted will remain.</li> </ul>	Yes	–	–
<ul style="list-style-type: none"> <li>● <b>New model for uncertain tax positions.</b></li> </ul>	No	No	No

several years ago or to a portfolio of items dealt with in equity.

The Board will propose the US GAAP model, in which most changes in deferred tax due to changes in the tax rate or changes in deferred tax assets are dealt with in the income statement. This might appear to be a simplification, but the US model contains complex rules that many find difficult to apply in practice. The proposal will change the IFRS accounting to converge with US GAAP without reducing the complexity of what is a difficult area.

### Discounting

IAS 12 prohibits discounting. This simplifies the accounting model, but creates other issues because long-term items, particularly deferred tax assets, are recorded at nominal value. Some aspects of IAS 12 that are more difficult to understand are exacerbated by the lack of discounting. For example,

deferred tax assets that can only be recovered through many years of profits are required to be recorded. Deferred tax liabilities on indefinite lived assets that would only be utilised in the event of sale or impairment of the asset are recorded. The IASB has decided that it will not address discounting in the current project, so the challenges created by a model in which discounting is not permitted will remain.

### Uncertain tax positions

Tax legislation in many countries is complex, and there is often uncertainty about whether the tax authorities will accept positions taken by a company in its tax return. There is no guidance in IAS 12 dealing specifically with accounting for these uncertainties; there is consequently diversity in practice. This diversity affects the unit of account and the basis used to measure the liability or benefit associated with uncertain tax positions.

The Board will propose a model for uncertain tax positions similar to the model proposed for non-financial liabilities in IAS 37. There will be no probability threshold for recognition, and the liability will be measured as a probability weighted average of all potential outcomes. This proposal differs from both the model used by many companies in practice and from the US model in FIN 48. It may require a change in accounting for many companies without achieving convergence with US GAAP.

### Summary

An exposure draft for the revisions to IAS 12 is expected later this year. It will be a facelift rather than a total makeover, and it will achieve convergence with US GAAP in many areas. Some of the changes will be significant, but it is unlikely that accounting for this complex area will be simplified.

## Carbon Emissions Reduction certificates

**IFRS does not address the complex issue of accounting for carbon emission reduction certificates (CERs). Yet the value of these certificates can be significant. Rahul Chattopadhyaya, senior manager in PwC India's Global Capital Markets Group, and Valerie Ribollet Pham Van Ba, senior manager in the firm's Global Accounting Consulting Services group, explain the background to CERs and the 'Clean Development Mechanism'. A subsequent edition of IFRS News will put forward a possible approach to accounting for CERs.**

There is an increasing number of entities in fast-growing economies that own and sell carbon emission reduction (CER) certificates received according to the Kyoto protocol's 'Clean Development Mechanism' (CDM). The CDM is a trading arrangement between industrialised countries that are committed to reducing their greenhouse gas emissions under the Kyoto protocol (so-called 'Annex 1 countries') and fast-growing economies such as China, India and Brazil (so-called 'host countries'). Annex 1 countries can invest in those entities based in the host countries that are eligible to receive CER certificates.

The process for a project to qualify as a CDM is complex. The project must meet

specific criteria; for example, it must be environmentally friendly (such as involving the management of biodegradable waste or the production of 'green' fuel), and the host country must authorise the project (for example, the host country checks if the project complies with its sustainable development strategy).

The entity that is based in the host country and enters into a CDM does not have an emission allowance obligation. On the contrary: this entity receives the CER certificates and can trade or sell them to other entities, or may use them to fulfil a company or group's requirements as part of the EU emissions trading scheme.

Many industries based in host countries can benefit from CDM projects; for example, chemicals, steel, textiles, fertilisers, oil and gas, and utilities. The value inherent in the CERs may be a significant element in the financial statements of the entity that receives the certificates. A refrigerant maker and mid-sized company in India said it expects revenue of about US\$120 million over the next six to seven years through the sale of carbon credits. News of the carbon credit sale lifted the stock of the company by 19%, at a time when the broader stock index grew by only 8%.

The accounting for CERs is not addressed in IFRS. The CER schemes are not a 'cap and trade' scheme. The

process and criteria to be eligible to receive CERs are initially reviewed by the respective regulatory frameworks in the host countries. However, the CERs are finally granted by the CDM Executive Board working under the guidance of United Nations Framework

Convention on Climate Change. It is management's responsibility to understand these processes and criteria, which may differ from one country to another. The processes and criteria are critical in defining the appropriate accounting policy.

We will explore the accounting treatment further in a later edition of *IFRS News*. Current market practice is highlighted in the box below.

## Survey of accounting for CERs

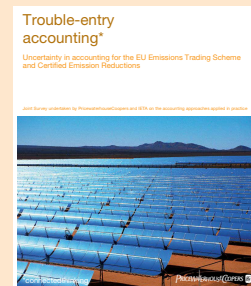
Entities are applying a range of approaches when accounting for CERs, according to a recent survey carried out by PricewaterhouseCoopers and the International Emissions Trading Association:

- **Classification:** CERs are classified differently by different entities. 40% of the respondents classify the CERs as intangible fixed assets; 40% recognise them as inventory. The remaining 20% of the respondents show the CERs on the face of the balance sheet either as 'other current assets', 'trading securities' or 'short-term financing assets'.
- **Measurement:** All respondents recognise CERs initially at cost. 40% of respondents revalue the CERs after initial recognition.
- **Recognition:** Most respondents credit the income statement at the point of receipt of the CERs, but there is a lack of consistency in how they are recognised in the balance sheet (see 'classification'). For example, one respondent recognises the self-generated CERs within inventory at an allocated cost of production; other respondents do not recognise the CERs on the balance sheet until the CERs are used or sold. Another respondent recognises the self-generated CERs as intangibles and as a government grant, measured as the difference between their fair value and their production cost, with the grant

being released to the income statement when the CERs are sold or used.

- **Differences between IFRS and local GAAP:** nearly half of respondents report under accounting standards other than just IFRS – mostly US GAAP. Most reporters do not consider there to be many significant adjustments between IFRS and other frameworks. However, the differences that are raised differ between respondents. Those reporting under US GAAP tend to refer particularly to differences in valuation treatments of the forward contracts and allowances held on the balance sheet.

The survey on the accounting for EU Emissions Trading Schemes and CER certificates, *Trouble-entry accounting – uncertainty in accounting for the EU Emissions Trading Scheme and Certified Emissions Reductions*, covered 26 organisations in a range of industries and countries around the world. The publication covers current practice; PwC does not opine on the appropriateness of the approaches within. For more information on the survey, contact [richard.french@uk.pwc.com](mailto:richard.french@uk.pwc.com) or [jonathan.a.rose@uk.pwc.com](mailto:jonathan.a.rose@uk.pwc.com) or visit [www.pwc.com/energy](http://www.pwc.com/energy)



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