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vancouver 2010
OFFICIAL SUPPLIER

Special Edition / May 2009

# Countdown

Deloitte Canada's IFRS transition newsletter

The Exposure Draft on Income Tax seeks to clarify certain aspects of IAS 12: Income Taxes and achieve greater convergence between global standard setters

# The Taxing Steps Toward Global Convergence

## International Accounting Standards Board (IASB) Proposes Changes to Income Tax Accounting

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In late March, the International Accounting Standards Board (IASB) issued an exposure draft (ED) proposing amendments to International Accounting Standard 12: *Income Taxes* (IAS 12). The comment deadline is July 31, 2009, with a final standard expected to be issued in 2010. This ED is a culmination of a number of years of work on the part of the IASB and the U.S. Financial Accounting Standards Board (FASB). The FASB have indicated that they will issue the IASB's ED as an invitation to comment and, depending on comments received, may undertake a project to make similar amendments to the U.S. income tax accounting standard (FAS 109).

### What is the impact of this ED for Canadian companies transitioning to IFRS?

The issue date and effective date of this new standard are important for Canadian companies planning for IFRS implementation. Under the transitional rules of IFRS 1: *First Time Adoption of IFRSs*, a first time adopter is required to adopt the IFRSs that are in effect at the end of the year of adoption and apply those standards consistently to the opening balance sheet, comparative periods and in each interim period in the year of adoption. Therefore a calendar year Canadian company that is not an early adopter of IFRS is required to look to the IFRSs that are (or will be) in effect as of December 31, 2011 as they complete their conversion plan. Depending on when the income taxes standard is released and effective, a Canadian company may be required to adopt the new standard or may have a choice of adopting the current version of IAS 12 and

then changing to the new standard in 2012, or later, depending on the effective date of the standard. See Appendix B for a table which summarizes the applicability options.

### Will a Canadian publicly accountable enterprise be able to early adopt the revised version of IAS 12 under Canadian GAAP prior to IFRS changeover, for example, in its 2010 financial statements?

The Canadian Accounting Standards Board's (AcSB) project plan notes that they intended to publish the same proposals as a Canadian exposure draft shortly after the issuance of the IAS 12 ED, so the conclusions reached by the IASB are expected to be codified in Canadian GAAP shortly after they are finalized by the IASB. However, they are not expected to be effective prior to changeover to IFRS by public companies. Therefore, a Canadian publicly accountable entity will likely not be able to early adopt the new IFRS income tax accounting standard under Canadian GAAP.

The IASB intends to permit first-time adopters of IFRSs with a transition date prior to the date the new IFRS is issued to apply the new IFRS to all periods presented in the year of adoption of IFRSs. This would allow Canadian entities that adopt IFRSs in 2011 to apply the new IFRS in preparing comparative financial information for 2010 rather than applying IAS 12 for that purpose. The deadline for commenting on the AcSB exposure draft is July 31, 2009.

### What is the impact of this ED for Canadian companies not transitioning to IFRS, such as private enterprises?

The AcSB has announced their decision that private enterprises

will have a choice to either prepare their financial statements using the future income taxes method or the taxes payable method. We expect that private enterprises who expect to prepare their financial statements using the future income taxes method will continue to follow the existing version of Canadian Institute of Chartered Accountants (CICA) Handbook Section 3465 for the time being. In the future, it is possible that the AcSB will amend the accounting guidance for future income taxes to conform to IFRS. At that point, private companies that do not use the taxes payable method may have to change to an IAS 12-like standard under private company Canadian GAAP. However, the AcSB has not announced its plans in this regard.

This Countdown Special Edition highlights the significant changes proposed for income tax accounting under IFRSs and compares the proposals with existing practice under Canadian GAAP. A newsletter discussing the impact of the ED on entities that currently apply IFRSs will be available soon on Deloitte's IAS Plus Web site.

## Background of IASB Project on Income Taxes

The income taxes project is one of the short-term convergence projects outlined in the Memorandum of Understanding (MoU) entered into by the IASB and the FASB in 2006. IAS 12, its U.S. GAAP counterpart, FAS 109 and our Canadian GAAP standard CICA 3465, are all based on the temporary-difference approach. The ED does not fundamentally change or challenge the underlying fundamental principles (in IAS 12, CICA 3465 and FAS 109), but rather is limited to addressing the differences between the International and US standards. Canadian GAAP income tax accounting is highly consistent with US GAAP so many of the issues addressed in the ED also close the gap between the current IFRS income taxes standard and Canadian GAAP. Both the IASB and FASB continued to deliberate potential changes to their respective standards through 2008. In September 2008, the IASB and the FASB issued an updated MoU that described the status and next steps of the short-term convergence projects and the priorities and milestones necessary to complete their major joint projects by 2011. As part of that update, the FASB decided to indefinitely defer its income tax project until it had an opportunity to evaluate its strategy on the ongoing short-term convergence projects, citing the possibility that U.S. issuers may be transitioning to IFRSs at some point in the near future.

To reduce differences between IFRSs and U.S. GAAP, the IFRS ED proposes a number of changes that are based on the guidance in FAS 109. The ED will create some new differences for Canadian companies converting to IFRSs, but some differences will actually be eliminated. Many of the proposed changes are principles-oriented and may not be as prescriptive as the guidance in Canadian GAAP. Accordingly, when comparing to Canadian GAAP, an entity must carefully assess the ED as to whether a change will converge with the application under Canadian GAAP.

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## Summary of the ED's Significant Changes to Accounting Under IAS 12

### The ED proposes significant changes to the accounting for income taxes under IAS 12, including the following:

- *Uncertain Tax Positions* — The ED proposes to address uncertainty as part of the guidance related to the measurement of current and deferred tax assets and liabilities. The measurement guidance will require the use of a probability-weighted average amount of all possible outcomes, assuming there is an examination by the taxing authority with full knowledge of all relevant information. IAS 12 contains no guidance on accounting for uncertainty.
- *Definitions* — Changes to the definition of "tax basis" and the addition of the definition of "tax credit" and "investment tax credit."
- *Initial Recognition Exemption* — Removal of the exception to the recognition of deferred taxes on the initial recognition of an asset or liability when a basis difference exists. The ED's measurement approach addresses this situation.
- *Exceptions for investments in subsidiaries and related entities* — Changes to the exception "relating to [recognizing] a deferred tax asset or liability arising from investments in subsidiaries, branches and associates, and [interests in] joint ventures." The proposed exception will relate only to foreign subsidiaries, joint ventures, and branches (not associates) that are essentially permanent in duration.
- *Deferred Tax Asset Recognition* — Change to the recognition of deferred tax assets such that deferred tax assets will be recognized in full, less a valuation allowance (if applicable). The ED also includes additional guidance similar to CICA 3465 on assessing deferred tax assets for realization (e.g., expenses related to tax planning strategies).
- *Tax Rate: Effect of Distributions* — Replacement of the requirement for entities to use the undistributed rate (for distributions to shareholders) when measuring tax assets and liabilities with an expected-rate approach. To determine the appropriate rate (distributed versus undistributed), entities should consider past experiences as well as the intent and ability to make distributions during the period in which the deferred tax asset or liability is expected to be recovered or settled.
- *Recording Subsequent Changes in Deferred Taxes* — Change in the allocation guidance to replace "backwards tracing" with an approach similar, but not exactly the same as that required by CICA 3465
- *Classification of Deferred Taxes* — Change from presenting all deferred taxes as noncurrent to classifying deferred tax assets and liabilities as either current or noncurrent, depending on the circumstances similar to the current guidance in CICA 3465.

A more detailed comparison between the ED and Canadian GAAP is included in Appendix A.

## Next Steps

- The IASB is accepting comments on the proposed changes until July 31, 2009. In light of the conversion to IFRSs in Canada in 2011 and the AcSB's possible adoption of this standard for private enterprises, Canadian constituents are encouraged to review the proposals in the ED and new Canadian exposure draft and submit comments to the IASB and AcSB.

## Appendix A — Significant Differences Between Accounting Under Canadian GAAP and the IFRS Exposure Draft

| Area of Difference | Canadian GAAP | IFRSs (as proposed) | Considerations |
|---|---|---|---|
| Uncertain tax positions | Uncertain tax positions are not specifically addressed under Canadian GAAP. Practice varies. | Entities address uncertainty in measurement of tax amounts by using a one-step approach. There is no recognition threshold, and measurement is based on a probability weighted average of **all** possible outcomes, assuming the taxing authority will examine the position and has full knowledge of all relevant information.<br><br>The ED allows for a policy election regarding the income statement classification of interest and penalties but includes no accounting guidance. | The proposed IFRS approach may seem onerous because entities would need to address all tax positions by using the probability-weighted-average approach. Paragraph BC63 of the ED's Basis for Conclusions states that the IASB did not intend for entities to seek additional information to apply this proposed change. This proposal is expected to receive significant attention during the comment period. |
| Special deductions | Canadian GAAP is generally silent on accounting for special deductions, but addresses certain specific ones, for example, resource allowances. | Accounting for special deductions is not specified in the ED. | The IASB decided to remain silent on the matter of tax benefits related to special deductions because the global application of IFRSs involves numerous jurisdictional issues that could not all be mentioned specifically. |
| Exceptions for temporary differences on investments in subsidiaries and related entities (outside basis differences) | Future income tax assets or liabilities are not recognized on temporary differences arising from investments in **any** subsidiaries and joint ventures that are essentially permanent in duration unless it is apparent that this difference will reverse in the foreseeable future. | Deferred tax liabilities or assets are not recognized on an investment in **foreign** subsidiaries, joint ventures, or branches that are essentially permanent in duration unless they are expected to reverse in the foreseeable future. | The IASB had considered eliminating all exceptions to recording deferred taxes on investments in subsidiaries and related entities but was convinced that the calculations necessary to do so for foreign interests were so complex that the cost would outweigh the benefits. Accordingly, the IASB has proposed an exception for foreign subsidiaries, joint ventures, or branches that is similar to the exception under U.S. GAAP but differs from Canadian GAAP. If the proposal is finalized, the exceptions for investments in domestic subsidiaries and joint ventures in CICA 3465 will not be converged. |
| Intercompany transfer of assets | Tax expense from intercompany sales is deferred until the related asset is sold or disposed of, and no future taxes are recognized for the purchaser's change in tax basis. Any taxes paid or recovered by the seller as a result of the transfer are recorded as an asset or liability in the consolidated financial statements until the gain or loss is recognized by the consolidated entity. | No such exception is provided to the temporary-difference approach. | This exception never existed in IAS 12 and the IASB decided not to include it in the ED because the application of the temporary-difference approach reflected the economic events involving a transaction between the enterprise and two outside parties (i.e., the tax authorities in each tax jurisdiction involved). |

| Area of Difference | Canadian GAAP | IFRSs (as proposed) | Considerations |
|---|---|---|---|
| Foreign nonmonetary assets/ liabilities remeasured from local currency to functional currency | Future tax is not recognized on differences related to nonmonetary assets and liabilities that are remeasured from the local currency into the functional currency and that result from changes in exchange rates with respect to the integrated foreign operations. | Deferred tax is recognized on differences related to nonmonetary assets and liabilities that are remeasured from local currency to functional currency. | This exception never existed in IAS 12, and in deciding not to include it in the ED, the IASB noted that one of the objectives of the project was to minimize exceptions to the temporary difference approach. |
| Tax rate used in measurement | Use tax rates and tax laws that have been substantively enacted. Detailed guidance pursuant to Emerging Issues Committee (EIC) 111 applies this standard specifically to the Canadian context. | Use tax rates and tax laws that have been substantively enacted. The ED's Basis for Conclusions notes that in the United States, substantive enactment occurs only upon enactment. | The IASB observed that the announcement of tax rates or laws by governments in certain jurisdictions has the substantive effect of actual enactment because often the event of enactment is only a formality. The definition of substantively enacted may be interpreted differently than under existing Canadian GAAP. |
| Tax rate — tax effects of future distributions | Under the refundable tax guidance in CICA 3465 and EIC 104, generally, enterprises use the undistributed rate when measuring tax liabilities. If it is more likely than not the refundable taxes will be recovered, the refundable portion is charged to retained earnings or recorded as a future income tax asset.<br><br>Under EIC 107, certain trusts take expected distributions into account in determining whether, and the extent to which, they are taxable. | Entities should use the rate expected to apply when the tax asset or liability is realized or settled. To determine the appropriate rate (distributed versus undistributed), entities should consider past experiences as well as the intention and ability to make distributions during the period in which the deferred asset or liability is expected to be recovered or settled. | The proposed IASB approach requires entities to use a significant amount of judgment to determine the tax rate that is expected to apply when the deferred tax asset or liability is expected to reverse. This proposal is also expected to receive significant attention during the comment period. This difference may be significant in jurisdictions that either impose additional income taxes or refund income taxes when distributions are made to owners. |
| Assets acquired outside of a business combination where tax basis differs from cost | Entities record future taxes by adjusting the carrying value of the asset for the related future tax asset or liability..The computations and adjustments are determined by formula included in paragraphs 44 and 45 of CICA 3465. | Asset or liability that results in a temporary difference should be separated into (1) the asset or liability, excluding any entity-specific tax effects and (2) the deferred tax asset or liability determined when the carrying amount of asset or liability is compared to its tax basis. If the consideration differs from the sum of (1) and (2), an allowance or premium is recorded on the deferred tax amount. | The IASB opted for an approach that would not result in the carrying amount of the asset being adjusted for entity specific tax effects (e.g., an asset acquisition structured so that the acquirer receives carry-over tax basis from the seller). Accordingly, the IASB developed the proposed approach to separate the measurement of the asset acquired or liability assumed from the tax effects. |
| Investment tax credits | Investment tax credits are accounted for in the same manner as government assistance and are specifically excluded from the scope of CICA 3465. Investment tax credits are accrued when reasonable assurance of recovery exists using the cost reduction method. | No specific guidance is provided on the accounting for investment tax credits, however the ED added a definition of "investment tax credit." | Because no specific guidance on investment tax credits exists under IFRSs, users must consider the IFRS Framework to determine the appropriate accounting policy. |

| Area of Difference | Canadian GAAP | IFRSs (as proposed) | Considerations |
|---|---|---|---|
| Definition of tax basis | Canadian GAAP defines the tax basis of an asset as the higher of amount deductible on use or sale, regardless of intent. | Under applicable substantively enacted tax law, the measurement of a tax asset or liability related to an asset is determined by the consequences of the sale of the asset for its current carrying value. | The guidance in the IASB's proposal will result in differences in certain circumstances. |
| Share-based payments | Canadian GAAP does not address treatment of deductible stock-based compensation. | The tax benefit of the tax deduction in excess of the compensation cost recognized must be recorded as a credit to equity. The tax benefit of the shortfall between the tax deduction and the compensation cost is recorded as income tax expense. | The guidance in the IASB's proposal may result in differences in certain circumstances. |
| Compound Financial Instruments | Under CICA 3465 and EIC 164, when an enterprise is able to settle the instrument without the incidence of tax, the tax basis of the liability component is considered to be the same as its carrying amount and there is no temporary difference.<br><br>Where the instrument cannot be settled without the incidence of tax, a temporary difference exists that should be accounted for in accordance with CICA 3465. | Under IFRS, deferred taxes would be recorded if the carrying amount of the liability component differs from its tax basis. | The guidance in the IASB's proposal will result in differences in certain circumstances. |
| Alternative Minimum Tax | CICA 3465 specifies that when it is more likely than not that future income tax liabilities will be sufficient to recover the minimum tax, the minimum tax recoverable is recorded as an asset. | An entity determines the applicable tax rate in a manner consistent with the tax law while considering any interaction between the alternative systems. | The guidance in the IASB's proposal may result in differences in certain circumstances. |
| Rate–Regulated Enterprises | As a result of an action by a regulator, future income taxes may be expected to be included in approved rates charged to customers in the future and to be recovered from or returned to future customers. To the extent this is the case, an enterprise recognizes an asset or liability for that expected future revenue or reduction in future revenue. | No specific guidance. | Because no specific guidance on rate-regulated enterprises exists under IFRSs, users must consider the IFRS Framework to determine the appropriate accounting policy. |
| Flow-through Securities | The cost of future income taxes related to the resulting temporary difference is recorded as a cost of issuing the securities to the investors when the expenditures are renounced. | No specific guidance. | Because no specific guidance on flow-through securities exists under IFRSs, users must consider the IFRS Framework to determine the appropriate accounting policy. |

| Area of Difference | Canadian GAAP | IFRSs (as proposed) | Considerations |
|---|---|---|---|
| Disclosures | | | |
| Uncertain tax positions | Canadian GAAP does not require any specific disclosures to be made with respect to uncertain tax positions. | Entities are required to disclose the effects of any adjustments of current and deferred income taxes included in tax expense as well as the major sources of uncertainty related to income taxes. | The proposed significant change regarding information provided to users of financial statements is expected to receive considerable attention during the comment period. |
| Dividend disclosures | No specific disclosure requirement. | The estimates related to future distributions and their effect on the tax rate used to measure deferred taxes, if any. | Disclosure requirement is the result of the proposed change in the rate an entity uses to measure tax amounts when a different rate applies because an entity makes distributions to owners. |
| Investments in subsidiaries and related entities | Paragraph 96 of CICA 3465 states that it is desirable to disclose the amount of the temporary differences and, where practicable, the amount of the future income taxes when the least cost method of realizing the investment in subsidiary or interest in joint venture would give rise to a liability for future income taxes. The least cost alternative method would reflect available tax planning strategies that would, if necessary, be utilized to realize the investment. | Aggregate amount of temporary differences associated with investments in subsidiaries and interests in joint ventures for which deferred tax liabilities have not been recognized. | The ED does not amend the disclosure requirement in IAS 12, which, like Canadian GAAP, emphasizes the aggregate amount of the temporary difference associated with the investment. The IASB concluded that additional disclosures would not be useful or practicable. |
| Disclosure of the expiry date (if any) of deductible temporary differences | The amounts and expiration dates of unused tax losses and income tax credit carryforwards, and the amount of deductible temporary differences, for which no future income tax asset has been recognized. | The expiry date, if any, of temporary differences, unused tax losses, and tax credits. | The ED expands on the requirement in CICA 3465 to disclose temporary differences that expire. Expiring temporary differences are not common in Canadian tax legislation. |
| Intragroup transfers of assets between jurisdictions with different tax rates | No disclosure requirement, since recording of tax effects is specifically prohibited under CICA 3465 paragraph 35. | For transfers between taxing jurisdictions with different tax rates: (1) deferred tax assets and liabilities arising from the transfer, (2) the net effect on tax expense, and (3) tax effect of modifications since end of reporting period. | The IASB added this new disclosure to the IAS 12 requirements because of concerns about the perception of earnings management through intragroup transfers of assets. |

## Appendix B — Applicability of ED to Canadian Companies Adopting IFRS

The following table is intended to assist Canadian companies adopting IFRS in determining which version of IAS 12 should be the focus of the IFRS conversion plan. The IASB has not yet reached a conclusion about the effective date of IAS 12 and therefore some uncertainty about the mandatory effective date will likely exist until the final standard is issued in early 2010. Canadian companies who plan on including quantitative information in their MD&A about the adoption of IFRS in accordance with Canadian Securities Administrators (CSA) Staff Notice 52-320 *Disclosure of Expected Changes in Accounting Policies Relating to Changeover to International Financial Reporting Standards* should consider adding specific caveats about such information due to changes in the numbers which may result from the issuance of new or revised standards subsequent to the date at which such disclosures are made.

Revised IAS 12 Applicability[1]

| Assume a calendar year end entity | Assume the standard is... | | |
|---|---|---|---|
| | Mandatorily applicable for periods ending on or before December 31, 2011 | NOT mandatorily applicable until after 2011 but entity chooses to early adopt revised IAS 12. | NOT mandatorily applicable until after 2011 and entity does not early adopt revised IAS 12 |
| Opening balance sheet (January 1, 2010) | Apply revised IAS 12 | Apply revised IAS 12 | Apply prior version of IAS 12 |
| Restated 2010 comparative interim and annual information | Apply revised IAS 12 | Apply revised IAS 12 | Apply prior version of IAS 12 |
| Interim financial statements as at and for the period ended March 31, 2011; June 30, 2011; September 30, 2011 | Apply revised IAS 12 | Apply revised IAS 12 | Apply prior version of IAS 12[2] |
| First IFRS Financial Statements as at and for the year ended December 31, 2011 | Apply revised IAS 12 | Apply revised IAS 12 | Apply prior version of IAS 12 |
| Period that IAS 12 becomes mandatorily effective | | | Apply new version of IAS 12 and restate prior periods, if necessary under transitional provisions |

[1] IFRS 1.7-8 states that an entity shall use the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements. Those accounting policies shall comply with each IFRS effective at the end of its first IFRS reporting period.… An entity shall not apply different versions of IFRSs that were effective at earlier dates. An entity may apply a new IFRS that is not yet mandatory if that IFRS permits early application.

[2] Note disclosure will be required if revised IAS 12 has been issued in final form but has not yet been adopted by the entity.

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