JANUARY 2018

MAZARS

IFRS HIGHLIGHTS

IFRS Foundation considers the contribution of IFRS standards to the public good

On 25 January the IFRS foundation published two presentations assessing the contribution of IFRSs to financial stability and long-term investment respectively.

These two topics are among the subjects that the European Commission has asked EFRAG to examine in its analysis of the public good as part of the process of endorsing IFRS standards in Europe. For example, in the course of endorsing IFRS 16 on Leases, the European Commission has asked EFRAG to ensure that it does not endanger financial stability.

Likewise, the European Commission has requested EFRAG to review the impact on long-term investment of the fair value through comprehensive income category for equity instruments in IFRS 9 (see European Highlights below).

EUROPEAN HIGHLIGHTS

Europe investigates the impact of IFRS 9 on long-term investment

On 17 January, EFRAG published its letter in answer to the European Commission's request that it investigate the effects for long-term investment of IFRS 9 on accounting for investments in equity instruments.

This letter, which is just the first phase of EFRAG's response, is a quantified survey of information about current holdings of equity instruments by the institutions concerned (mainly banks and insurance entities) and a review of annual financial statements.

EFRAG's investigations suggest that:

- The cumulative amount of equity instruments classified as available for sale is significant for entities that view themselves as long-term investors;
- participants in this consultation reported that the instruments classified as available for sale are always held with a long-term perspective;
- in most cases, the proportion of equity instruments classified as available for sale is above 60%. Some respondents reported a much lower ratio (the sample average was 22%) but this can be explained by the large trading portfolios held by some entities in addition to the portfolio of instruments held with a long-term perspective;
- the quantitative thresholds used to assess the "significant" or "prolonged" decline in fair value vary across industries;
- the majority of participants in the consultation do not expect to modify their holding period for equities following the introduction of IFRS 9;
- respondents say that IFRS9 might have more impact on their asset allocation strategies than on the holding period, partly due to the impossibility of accounting for gains on disposal of these instruments in profit or loss. However a number of other factors influence the allocation strategy.

The second phase in EFRAG's response will consider accounting solutions (for impairment, in particular) other than those provided for in IFRS 9.

The document is available at the following address: http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FEFRAG%2527s%2520letter%2520to%2520the%2520European%2520Commission%2520on%2520equity%2520instruments%2520%28assessment%2520phase%29.pdf

A CLOSER LOOK

ESMA publishes a statement on accounting for the income tax consequences of the US tax reforms under IAS 12

On 22 December last, the US President signed the tax reform law known locally as the Tax Cuts and Jobs Act. Given the late publication of this law, the US Securities and Exchange Commission (SEC) issued a bulletin on the same day (SAB 118) which gives entities reporting under US GAAP a degree of flexibility in reflecting the effects of the Act in the accounts at 31 December 2017. The SEC here states that it would not object to foreign entities listed on the US market (known as "foreign registrants") and reporting under International Financial Reporting Standards applying the same relief measures.

In order to avoid the risk of inconsistent application of the US tax reform by European listed companies, or the taking of too many liberties with IAS 12 using the US Act as a pretext, the European Securities and Markets Authority (ESMA) decided to publish a Public Statement on 26 January, entitled Accounting for Income Tax consequences of the United States Tax Cuts and Jobs Act under IFRS.

The accounting consequences of the US tax reforms under IAS 12

Effects of the Act on the 2017 annual financial statements

The new American tax law contains a range of varied and complex provisions, the main objective of which is to reduce tax rates while combatting tax evasion by taxing certain income earned abroad, or by taxing sums transferred to related entities established abroad.

Although the new tax provisions it introduces do not take effect until 1 January 2018, their impacts, in particular as regards deferred taxes, should be reflected in the accounts established under IFRSs at 31 December 2017. For some entities particularly exposed to US taxation, accounting for these impacts may well be complicated, either because of uncertainties about the way in which some provisions will be applied, or because of the need to collect historic information to calculate the tax. The

most emblematic aspects of this law are described below.

Without going into too much detail, the main provisions likely to have an impact on the 2017 financial statements are the following:

Tax rate changes
The federal tax rate on corporate income falls from 35% to 21% on 1 January 2018. This tax rate reduction must be taken into account when measuring deferred tax assets and liabilities at the end of 2017, and the resulting change in deferred taxes will be recognised:

- through profit and loss in most cases,
- in equity if the deferred tax basis was originally accounted for in equity, and
- in other comprehensive income, if the deferred tax basis was originally accounted for in OCI.

Tax on undistributed foreign profits
This provision, known as the Deemed Repatriation Transition Tax, requires a mandatory deemed repatriation of certain post-1986 foreign earnings and profits accumulated by the foreign subsidiaries of US entities, with a tax exemption on any future distributions of these profits. The resulting tax charge can be paid in instalments over eight years.

Entities that have organised part of their business around a US holding company with subsidiaries outside the United States are affected by this provision. They should therefore recognise a current (and not deferred) tax liability, the measurement of which will entail the collection of historical information that may require long and onerous efforts.

Past tax loss carry forwards may be set against this tax expense, and thus reduce its amount. Its measurement may therefore have impacts on the measurement of deferred tax assets, and in particular lead to the additional recognition of loss carry forwards hitherto regarded as uncollectible.

Global Intangible Low Tax Income (GILTI)
This measure aims to tax in the United States the profits of a subsidiary based in a low-tax jurisdiction which exceed "normal" profitability calculated on its tangible assets.

Since is expected that the reversal of a temporary difference in the subsidiary would create a profit subject to GILTI, the impact of the GILTI should be included in the tax rate used to measure the corresponding deferred tax liability. However, as the GILTI is heavily dependent on the future results of the foreign entity, measuring its effects in the year of reversal of temporary differences may be particularly tricky.

Minimum taxation on certain intragroup payments
This provision, known as the Base Erosion Anti-Abuse Tax (BEAT) proposes to compare the tax on profits after adding back payments to related entities abroad, at a rate of 5% in 2018, 10% from 2019 to 2025 and 12.5% from 2026, with the current tax at the rate of 21%. Any excess would be added to the current tax liability.

The BEAT has the effect of increasing the tax rate applicable to a given year. In theory, this increase should be included in the measurement of deferred taxes at 31 December 2017. However, it is certainly difficult to assess whether the BEAT will be paid and when, and the extent to which it will alter the current tax rate. For all these reasons, in most cases, the BEAT for a given year will be considered as supplementary current tax, with no impact on deferred taxes.

Numerous other provisions to be taken into account in calculating the tax
The provisions set out above are those which are likely to have the greatest impact on the financial statements at 31 December 2017.

But the American tax reform contains many other elements that could affect the calculation of current taxes and deferred taxes in the coming financial years. For example:

- the rules on accounting for carry forward tax losses are amended for losses arising from 2018, with the removal of carry-back options, indefinite carry forward of losses and a limit on carry forwards to 80% of taxable income for the year;
- deductions for interest expense are limited to 30% of adjusted taxable income, but interest not deducted for this reason can be carried forward for deduction in future years;
- the Alternative Minimum Tax (AMT) regime has been repealed, but AMT credit carry forwards existing at the date of the reform can be used to offset current tax, or be refunded in 2021;
- American companies manufacturing in the US that export all or part of their production can take advantage of special deductions for Foreign-Derived Intangible Income (FDII).

SAB 118 reliefs for entities reporting in US GAAP

Faced with the complexity of some of the Act's provisions, the uncertainties as to their application arrangements and the need to collect historical data over a prolonged period, the SEC has decided to establish a provisional accounting approach for the effects of the Act in the 2017 financial statements.

This principle is informed by the provisions of the standard on business combinations, when allocation of the acquisition price to the various assets and liabilities acquired is provisional. In practice, an entity publishing its financial statements under US GAAP may, for each aspect of the reform, find itself in one of the three following situations at the 2017 reporting date:

- Situation 1: it is able to calculate the precise consequences of certain aspects of the Act. In this instance, it recognises these impacts in its December 2017 financial statements;
- Situation 2: for other aspects of the reform, it is unable to calculate the precise effects, not least due to uncertainties of interpretation, or the incomplete collection of data, but it can nevertheless arrive at a reasonable estimation. In this instance, it recognises its estimations of the consequences of the Act, while making it clear that this accounting treatment is provisional. It will then have a year in which to finalise its calculation, and any subsequent adjustment of its provisional accounting treatment will be presented in the 2018 result;
- Situation 3: for certain aspects of the reform, there are too many uncertainties, or too much information is missing, to make a reasonable estimation of the impacts. Under these circumstances, the entity will recognise the tax in these areas on the basis of the former law, in a provisional manner. Again, it will then have a year in which to finalise its accounting treatment of the impacts of the law, through profit or loss.

In addition to the SEC's document, the FASB has begun to publish Q&A documents on how to account for these new provisions under US GAAP.

ESMA's statement on accounting for the reform in accordance with IAS 12

Neither the IASB nor the IFRS Interpretations Committee have published any guidance on accounting for the impacts of the US tax reform. It was therefore left to ESMA, although it has no regulatory powers in this area, to issue a reminder of the IAS 12 provisions that preparers must apply.

ESMA's statement observes that IAS 12 – Income taxes requires current and deferred tax assets and liabilities to be measured in line with the tax laws enacted by the end of the reporting period. Consequently, the financial statements at 31 December 2017 must reflect the impacts of the US tax reform, and IAS 12 provides no exemptions.

ESMA therefore expects the entities concerned to be able to make a reasonable estimate of the impact of the material aspects of the Act within a period compatible with the publication of their financial statements, although it acknowledges that a full understanding of the implications of some provisions may take time.

There is therefore no question of applying exceptional measures during a provisional measurement period, as under US GAAP. Quite simply, given the complexity of this reform, and the need to gather complex historical information, the amounts presented in the financial statements may be subject to a higher degree of estimation uncertainty than is usually the case.

In this context, ESMA highlights the need for transparent disclosure in the notes to the accounts. IAS 12 in any case requires disclosures on the impacts of changes in tax rates or the imposition of new taxes on the measurement of deferred taxes. In addition to this information, ESMA also expects that where material tax assets or liabilities are subject to increased estimation uncertainty, issuers will give specific disclosures on those estimates, the judgments and assumptions applied in reaching them, and the nature and sources of estimation uncertainty.

Subsequent adjustments to the amounts recognised, due to new information about the way that the law is applied, should be accounted for as changes in

estimates. However ESMA asks issuers to assess carefully whether, in some cases, a change in estimates represents the correction of an error.

ESMA, together with National Competent Authorities, will monitor the level of transparency that issuers provide in their financial statements about how they account for the effects of the US tax reform, changes in estimates resulting from its implementation and information relevant to assessing its possible impact on the issuers' future financial statements.

Key points

- While the American tax reform comes into effect in 2018, it must be taken into account in the measurement of deferred taxes and certain current taxes as from 2017, given its date of publication.
- Some of its provisions are likely to be complex to apply, and their impacts on tax assets and liabilities in accordance with IAS 12 may be difficult to assess in a tight timetable for publication of the financial statements.
- Unlike entities publishing under US GAAP, IFRS entities will benefit from no exemptions in 2017 and should recognise their best estimates of the overall impacts of the provisions of the new Act.
- ESMA and the National Competent Authorities will monitor the level of disclosures provided by listed European entities and the transparency of this information, in light of the increased estimation uncertainties associated with the effects of the Act.