Exposure Draft of ASCG Interpretation (IFRS) No. 1 (ED ASCG Interpretation 1)

Accounting for Interest and Penalties Related to Income Taxes under IFRSs

Invitation to Comment

All interested individuals and organisations are invited to submit comments to info@drsc.de by August 31, 2018. Responses are invited in particular to the questions set out below. Comments are also invited on all issues addressed in this Exposure Draft. Please include a rationale for your comments.

The comment letters will be published on our website unless expressly requested otherwise by the submitter. Please consult the information on our website to find out how we use your personal data.

Question 1: Application of IAS 37 to the accounting for interest and penalties related to income taxes in the German legal context
The Exposure Draft prescribes the application of IAS 37 to the accounting for interest and penalties related to income taxes. IAS 12 cannot be applied because interest and penalties related to income taxes in the German legal context do not meet the definition of income taxes in IAS 12.2.
Do you agree with this approach? If not, what other approach do you propose, and why?

Question 2: Transition requirements – a change in accounting policy
Under the Exposure Draft, a change in the accounting treatment because of this pronouncement does not constitute the correction of an error, but rather a change in accounting policy in accordance with IAS 8. The justification for this is that existing IFRSs do not specifically address the accounting for interest and penalties related to income taxes.
Do you agree with this approach? If not, what other approach do you propose, and why?

Preliminary remarks

Accounting Standards Committee of Germany

The Accounting Standards Committee of Germany (ASCG) has been mandated to develop principles for financial reporting in consolidated financial statements, to advise the legislature on the development of financial reporting, to represent the Federal Republic of Germany on international accountancy bodies and to develop interpretations of international financial reporting standards within the meaning of section 315e(1) of the *Handelsgesetzbuch* (HGB – German Commercial Code).

Note on application

Interpretations of the international financial reporting standards within the meaning of section 315e(1) of the HGB ('ASCG Interpretations (IFRS)' or 'Interpretations') address issues of predominantly national relevance on which the IFRS Interpretations Committee is unable to issue a generally binding interpretation, and for which the ASCG therefore develops appropriate interpretations .

Interpretations are adopted after careful consideration of all relevant circumstances, in particular taking account of all effective IFRS®Standards (IFRSs), the IASB Framework and the comments received, and after holding public hearings. The Interpretations adopted by the ASCG provide guidance for the accounting treatment of the relevant issues in financial statements prepared in accordance with the applicable pronouncements of the IASB, unless other specific pronouncements have been issued by the IFRS Interpretations Committee or the IASB.

Entities in Germany which state that their financial statements have been prepared in accordance with IFRSs should therefore examine carefully whether, given all the circumstances of the individual case, application of the ASCG Interpretations is required.

Editor

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List of Abbreviations and Terms used

AO	*Abgabenordnung* (Fiscal Code of Germany)
ASCG	Accounting Standards Committee of Germany
eg	for example
f./ff.	and the following
IAS(s)	International Accounting Standard(s)
IASB	International Accounting Standards Board
ie	that is
IFRIC Update	IFRS Interpretations Committee Update
IFRS(s)	International Financial Reporting Standard(s)

Accounting for Interest and Penalties Related to Income Taxes under IFRSs

Relevant IFRSs

IAS 12 *Income Taxes*
IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Scope

1.
This Interpretation addresses the accounting for interest and penalties related to taxes within the meaning of section 3(4) of the AO that relate to current income taxes within the meaning of IAS 12.5 (interest and penalties related to income taxes) in financial statements prepared in accordance with IFRSs, as adopted by the EU.

Background and Issues

2.
In 2017, the IFRS Interpretations Committee discussed an issue relating to the applicability of IAS 12 to the accounting for interest and penalties related to income taxes and subsequently decided not to add the issue to its agenda. In its reasoning, the IFRS Interpretations Committee observed that entities do not have an accounting policy choice between applying IAS 12 and IAS 37.[1] It noted that the question of which standard to apply depends on the specific circumstances: if an entity considers that a particular amount payable or receivable for interest and penalties is an income tax, it must use IAS 12 to account for that amount. If this is not the case, it applies IAS 37. The IFRS Interpretations Committee does not describe the potential criteria to be applied in assessing whether an amount payable or receivable for interest and penalties is an income tax.

3.
In connection with this agenda decision by the IFRS Interpretations Committee, the ASCG established that this issue is handled in different ways by German companies. Because of a lack of explicit guidance in the IFRSs, accounting and auditing practitioners assumed up to now that entities had the choice of accounting for interest and penalties related to income taxes by applying IAS 12 or IAS 37. However, the agenda decision referred to above clarified that a choice is not available in IFRSs. For this reason, the ASCG decided to analyse this issue as it applies to the German jurisdiction and to develop a related interpretation.

4.
This pronouncement is designed to answer the following questions:
a) Should IAS 12 or IAS 37 be applied to the accounting for interest and penalties related to income taxes in the German jurisdiction?
b) What requirements must be considered for the recognition, measurement and presentation of interest and penalties related to income taxes?
c) What transition requirements should be applied if the previous accounting policy is different?

[1] IFRIC Update September 2017, page 7f.

Definitions

5.
The following terms are used in this pronouncement with the meanings specified:

Interest and penalties relating to taxes: Payments of money within the meaning of section 3(4) of the AO.

Interest and penalties related to income taxes: Payments of money within the meaning of Section 3 (4) of the Abgabenordnung (AO) relating to current income taxes within the meaning of IAS 12.5.

Requirements

Application of IAS 37

6.
Interest and penalties related to income taxes shall be accounted for in accordance with IAS 37. They shall not be accounted for in accordance with IAS 12 because such interest and penalties are not calculated on the basis of taxable profit and hence do not meet the definition of income taxes in IAS 12.2.
[Basis for Conclusions, paragraphs B1–B6]

Recognition

7.
The recognition criteria in IAS 37.14 shall be applied to <u>obligations</u> arising from interest and penalties related to income taxes. These require a provision to be recognised if there is a present obligation as a result of a past event, an outflow of resources embodying economic benefits that will be required to settle the obligation in the future is probable and a reliable estimate can be made of the amount of the obligation.

8.
A present obligation exists if an entity cannot avoid settling this obligation by means of an early payment to the tax authority.
[Basis for Conclusions, paragraph B7]

9.
The recognition criteria in IAS 37.33 and 35 shall be applied to <u>assets</u> arising from interest and penalties related to income taxes. These require an asset to be recognised when an inflow of economic benefits is virtually certain.

10.
The timing of the recognition of the principal tax payment – an income tax liability – does not necessarily coincide with the timing of the recognition of interest and penalties relating to that income tax liability. To the extent that the applicable tax law defines an origination date for certain interest and penalties related to income taxes that differs from the origination date of the principal tax payment, that different date shall apply to the recognition of the corresponding interest and penalties related to income taxes. This affects, for example, the provision for interest on additional tax assessments that must be recognised when the interest accrual period begins. In accordance with section 233a(2) sentence 1 of the AO, the interest accrual period begins 15 months after the end of the calendar year in which the tax deficiency arose.

Measurement

11.
Obligations arising from interest and penalties related to income taxes shall be measured as the best estimate of the expenditure required to settle the present obligation at the end of the reporting period (IAS 37.36).

12.
IAS 37 does not contain any guidance regarding the measurement of assets. However, as IAS 37.33 requires the future inflow of economic benefits to be virtually certain when an asset is recognised, the amount of this inflow – the amount of interest and penalties related to income taxes to be refunded by the tax authority – will generally be known.

13.
Obligations arising from interest and penalties related to income taxes shall be discounted as at the end of the relevant reporting period where the effect of the time value of money is material (IAS 37.45). The discount rate is governed by IAS 37.47. Discounting does not normally play any role for assets arising from interest and penalties related to income taxes because they are not recognised until the inflow of economic benefits is virtually certain.

Presentation

14.
Interest and penalties related to income taxes shall be presented in the statement of financial position under other assets or other provisions/liabilities. Presentation in the statement of comprehensive income depends on the substance of the relevant interest and penalties related to income taxes. They shall not be presented as tax expense or tax income.
[Basis for Conclusions, paragraph B8]

15.
Any subsequent reversal of discounting of the carrying amount of interest and penalties related to income taxes shall be presented in net financial income or net finance costs in the statement of comprehensive income.

16.
Presentation in the statement of cash flows depends on the substance of the relevant interest and penalties related to income taxes. The requirements of IAS 7.35f. are not applicable.

Disclosures

17.
The accounting for interest and penalties related to income taxes shall be disclosed in the summary of significant accounting policies or in the other notes (IAS 1.112(c), 117(b) and 122) if they have a significant effect on the financial statements. The requirements of IAS 37.84ff. shall also be observed.

Transition requirements

18.
If an entity changes its accounting treatment because of this pronouncement, the lack of explicit guidance previously means that this does not constitute the correction of an error, but rather a change in accounting policy within the meaning of IAS 8. This change shall be applied in accordance with the requirements of IAS 8.19–27.

Basis for Conclusions

The Basis for Conclusions is an integral part of the Interpretation.

Application of IAS 12 or IAS 37

B1.
IFRSs do not specifically address the accounting for interest and penalties related to income taxes. Different approaches have therefore emerged in accounting and auditing practice and in the specialist literature.

B2.
In the course of its deliberations, the IFRS Technical Committee responsible for the accounting principles applicable to publicly traded entities came to the conclusion that the room for judgement on whether to apply IAS 12 or IAS 37 referred to in the IFRS Interpretations Committee's agenda decision dated September 2017 could only exist at a conceptual level between different tax jurisdictions. Within the same tax jurisdiction, the entities would have to arrive at the same outcome for similar fact patterns. The interest and penalties related to income taxes appearing in a German tax assessment notice would therefore have to be accounted for in the same way by all German entities. This consistent accounting treatment within the German tax jurisdiction is the goal and subject of this pronouncement.

B3.
The accounting for interest and penalties related to income taxes depends on the judgement whether or not they fall within the scope of IAS 12. In accordance with IAS 12.2, income taxes include all domestic and foreign **taxes which are based on taxable profit**. Consequently, interest and penalties related to income taxes would have to meet the definition of income taxes in IAS 12.2 for them to fall within the scope of IAS 12. If they do not meet this definition, interest and penalties related to income taxes must be accounted for in accordance with IAS 37. They cannot be accounted for in accordance with IFRS 9 *Financial Instruments* because there is no contractual basis.

B4.
The wording of IAS 12.2 does not indicate unequivocally whether the calculation has to be made **directly** or **indirectly** on the basis of taxable profit. It is beyond dispute that certain levies whose calculation is directly tied to taxable profit – eg a fixed percentage of the assessed income tax, such as the German 'solidarity surcharge' – generally meet the definition of income taxes in accordance with IAS 12.2. What is questionable, however, is whether the definition in IAS 12.2 is also met if the link to taxable profit is only indirect, ie if other components flow into the calculation formula in addition to taxable profit.

B5.
The IFRS Technical Committee addressed this question in great detail and considered the arguments for and against applying IAS 12 or IAS 37 to interest and penalties related to income taxes. Ultimately, the IFRS Technical Committee considered that accounting for interest and penalties related to income taxes in accordance with IAS 12 is not appropriate because it held that the definition in IAS 12.2 is not met. Instead, it considered accounting in accordance with IAS 37 to be appropriate. This outcome is based on the following arguments:

- <u>Strength of the link to taxable profit:</u> Interest and penalties related to income taxes are often linked to taxable profit. However, this does not appear to be sufficient because the amount of interest and penalties related to income taxes depends not only on the amount of the outstanding principal tax payment, but also on other factors such as the timing of the payment of income tax and the intention and severity of the non-compliance with applicable income tax law.
- <u>Opinions in the IFRS Interpretations Committee:</u> The IFRS Technical Committee examined in detail the previous deliberations of the IFRS Interpretations Committee on the topic of 'Scope of IAS 12' and established that the scope was always interpreted narrowly in the present decision and in earlier discussions. In addition, IASB staff set out on several occasions in agenda papers for the

meetings of the Interpretations Committee their understanding that amounts identified as interest and penalties are often not based on taxable profit, and hence do not typically fall within the scope of IAS 12 (see paragraph 27 of agenda paper 5B dated September 2017, paragraphs 40 and 41 of agenda paper 6 dated March 2017 and paragraph 20 of agenda paper 11A dated June 2004).

- Legal nature of interest and penalties related to income taxes: In Germany, interest and penalties related to income taxes are frequently linked to a greater extent to the tax assessment procedure than they are to taxable profit.
- Substance of interest and penalties related to income taxes: In Germany, and in contrast to income taxes, interest and penalties related to income taxes do not serve to generate income for a public body, but rather serve certain other purposes, eg to offset the liquidity advantage of the entity liable to pay tax and the liquidity disadvantage of the body to which tax is owed, to ensure the smooth running of the tax assessment procedure through the punctual receipt of tax returns, the enforcement of assessed taxes that fall due, etc.

B6.
The IFRS Technical Committee notes that the preceding analysis relates only to the German jurisdiction. This means that multinational companies operating in tax jurisdictions outside of Germany would need to apply judgement in assessing whether interest and penalties meet the definition of income tax in those jurisdictions. IFRS Technical Committee believes that it is possible that the application of IAS 12 may well be appropriate in other tax jurisdictions. In some jurisdictions, for example, the clarification of facts and circumstances with the tax authority in the event of disputed issues related to income taxes effectively extends to the tax liability as a whole, with the result that it is not always possible to distinguish clearly between the principal tax payment and tax-related interest and penalties, even when relevant local regulations are taken into consideration. In such cases, the IFRS Technical Committee believes that it is appropriate to account for the entire amount in accordance with IAS 12. This must be done consistently for similar fact patterns within the same tax jurisdiction. The IFRS Technical Committee believes that the requirement to be unable to split the tax liability into a principal tax payment and interest and penalties is not met for the German tax jurisdiction because the nature and amount of interest and penalties related to income taxes are explicitly described in the tax assessment notices.

Amount of interest to be recognised

B7.
The question arises in the context of recognising interest on income taxes of whether the portions of interest accruing between the end of the reporting period and the expected completion of the tax audit represent a present obligation arising from a past event or a future obligation. Under IAS 37.19, an obligation arising from past events must exist independently of an entity's future actions in order to justify recognition of a provision. The decisive factor in this respect for determining the amount of interest to be recognised is whether or not an entity can avoid possible payment of arrears of interest in the event that the entity loses the tax case on final appeal (eg by a payment to the tax authority):

- The entity cannot avoid paying **interest accruing** on the additional tax assessment **up to the end of the reporting period**. These portions of interest must be recognised at the end of the reporting period.
- In the case of portions of interest that are attributable to **future assessment periods** and which the entity **can avoid paying** by means of an early payment to the tax authority, there is no present obligation from a past event at the end of the reporting period, so these portions of interest cannot be recognised.
- By contrast, in the case of portions of interest that are attributable to **future assessment periods** and which the entity **cannot avoid**, there is a present obligation from a past event at the end of the reporting period. These portions of interest must be recognised at the end of the reporting period.

Presentation of interest and penalties related to income taxes in the statement of comprehensive income

B8.

IAS 37 does not contain any guidance about the presentation of amounts accounted for in accordance with that standard. In accordance with IAS 1.85, an entity must present additional line items, headings and subtotals in the statement of profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity's financial performance. As a result, the decision on the presentation of interest and penalties related to income taxes is a matter for the reporting entity. However, they cannot be presented as tax expense/tax income because those line items only contain amounts from the application of IAS 12.