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Technical Accounting Alert TA 2019-12

Recognition of Deferred Tax Assets from Tax Losses – Additional Guidance

Introduction

AASB 112 *Income Taxes* (AASB 112) requires that Deferred Tax Assets (DTAs) be recognised "to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised" [AASB 112.34]. Entities are then required to reassess the probability of future taxable profits being available to utilise these unused tax profits and tax credits [AASB 112.37]. The effect of these two paragraphs is a requirement that DTAs not be recognised to the extent that it is not probable that they will be utilised, and recognised to the extent that they are.

The European Securities and Markets Authority (ESMA) has found, during its work with European enforcers, that there is a lack of authoritative interpretation of certain terms and guidance on their application as it specifically relates to probability of realisation of DTAs arising from unused tax losses and unused tax credits (Unused Tax Losses) and has issued a Public Statement (ESMA 32-63-743) to assist entities in this matter. While the Public Statement issued by ESMA is not authoritative outside of ESMA's jurisdiction, it provides useful guidance and clarity on certain judgemental matters that have been identified as areas of confusion and disparity in practice.

It has been observed by ESMA that a significant number of enforcement activities conducted in Europe related to improper recognition of DTAs relating to Unused Tax Losses. Broadly, DTAs are required to be recognised only to the extent that it is probable that their benefit will be realised – that is, they will be absorbed via the generation of taxable profits.

In its Public Statement, ESMA has noted that multiple issuers have recognised material DTAs arising from tax losses despite a history of tax losses.

Summary of guidance

ESMA has determined that "probable", despite not being defined in IAS 12 (or AASB 112), should be applied consistently to other standards. In the application of other IFRS standards, the definition is "more likely than not" – also interpreted as ">50% probability of occurring". In determining probability, information available may be "more reliable" or "less reliable", altering the potential weighting of different data points when considering their impact on assessing recoverability.

In determining whether sufficient taxable profits will be available, an entity should start with its latest forecasts. However, forecasts may not always be a reliable starting point in all cases. Indicators of more or less reliable forecast data, as provided by ESMA, include:

Category	More reliable	Less Reliable
Forecast Period	Short-term forecasts	Longer-term forecasts
Forecast assumptions	Forecasts are reasonable, realistic and achievable in all cases	Forecasts rely on events outside the control of the entity

Of particular note, we make reference to the terminology “in all cases” in the category of Forecast Assumptions. Grant Thornton’s interpretation is that a range of reliability exists, with “in all cases” being those forecasts that are most reliable, with decreasing reliability as risk of forecasts not being achieved increases.

Information should also be ‘normalised’ to make it more reliable – one-off events (such as a fire or a move to a new factory [IAS 12.36(c)]) should be removed, and losses driven by a discontinued product line should be adjusted to arrive at profitability reflective of ongoing operations and expectations of its performance, thus improving the relative reliability of data (by the use of ‘convincing other evidence’).

When assessing if it is probable that future taxable profits will be available, issuers should consider all available evidence, both negative and positive. Issuers should determine whether sufficient positive evidence outweighs existing negative evidence and thus the 50% threshold is passed. ESMA has provided a list of examples of indicators to consider in assessing whether it is ‘probable’ that sufficient future taxable profits will be available. Some examples given, which is not an exhaustive list, include:

Positive Indicator	Negative Indicator
Losses occurred to identifiable one-time / non-recurring events	A recent history of operating losses for tax purposes
A strong earnings history exclusive of the loss that created the unused tax loss carried forward (provided that the loss is not expected to recur)	The taxable entity is a start-up business
New business opportunities (e.g. patents)	History of significant variances of actual outcomes against business plans
Restructuring or disposal which clearly eliminates the loss sources	Losses of major customers and/or of significant contracts
Convincing tax planning strategies	Uncertainty regarding the issuer’s going concern
Firm sales backlog or new contracts (considering also past realisation of sales backlog)	History of restructuring without returning to profitability or emerging from a bankruptcy
Business acquisitions generating sustainable profit margins which are sufficient to enable the issuer to utilise existing tax losses carried forward and which can be utilised for that purpose (e.g. in the same tax jurisdiction)	The taxable entity expects losses in early future years

Positive Indicator (continued)	Negative Indicator
	The taxable entity has a history of unused tax losses and/or credits expiring
	The losses relate to the core activity of the issuer and thus may reoccur in the future

ESMA has stated that available information should be considered as a whole, weighing the likelihood of various conflicting scenarios such that objective, reliable evidence should have greater weight in any consideration than less reliable evidence. Indirectly, this acknowledges that there is no "one size fits all" rule that would be applied to all issuers for determining the period during which future taxable profits should be taken into account and that a considered analysis of all the relevant facts and circumstances must be made. This must also take into consideration the general principle that reliability decreases as the period to the forecast event increases.

ESMA has issued the following guidance:

- Negative evidence is often sufficient to place less reliance on positive projections
- Long-term contracts are better evidence than start-up entities or entities with volatile earnings
- Future events that the entity cannot control and are still highly uncertain should not be anticipated. These include:
  - Changes in tax law or rates (other than those substantively enacted)
  - Possible business combinations
  - Events that are not consistent with previously communicated strategies
- Forecasts should be consistent with those used in broader business planning and impairment testing (to the extent possible).

Disclosure

ESMA has issued specific guidance related to disclosures specifically related to DTAs. Generally, disclosures should not be boilerplate and should be specific both to the entity and to the nature of the DTAs reported; wording copied directly from AASB 112 is not appropriate. These disclosures should also be proportionate to both the materiality of the DTAs and the relative uncertainties and judgements used surrounding their recognition. Therefore, the more material and complex the DTA, the greater the expectation of detailed disclosure. Some examples given of appropriate elements to be disclosed include:

- Taxable entity location and applicable tax rules
- Period of expected usage of the DTA (which may be multiple periods, depending on jurisdiction)
- Explanation and impact assessment on the recovery of DTAs of any significant changes in key DTA assumptions
- Indication of evidence considered
- Critical judgements used in the recognition of the DTAs, including any uncertainties
- Significant unrecognised DTAs
- Sensitivity analysis on assumptions, if relevant

Conclusion

While the ESMA guidance may seem detailed, the principles included within are consistent with those included in AASB 112 and with other non-authoritative guidance otherwise available to entities reporting using IFRS. Entities should consider whether any DTAs reported by them are appropriately measured in the context of the available guidance and whether their disclosures are adequate.

For Australian preparers, ESMA's Public Statement is not considered authoritative, however we view the content as being highly informative and providing improved clarity. We would encourage users to consider the above when considering the measurement and reporting of DTAs.

Further information

If you wish to discuss any of the information included in this Technical Accounting Alert, please get in touch with your local Grant Thornton Australia contact or a member of the National Assurance Quality Team at national.assurance.quality@au.gt.com.