esma European Securities and Markets Authority

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PUBLIC STATEMENT

Considerations on recognition of deferred tax assets arising from the carry-forward of unused tax losses

1. In order to promote consistent application of the requirements set out in IAS 12 *Income Taxes*, the European Securities and Markets Authority ("ESMA") issues this Public Statement setting out its expectations regarding the application of the requirements in IAS 12 by issuers relating to the recognition, measurement and disclosure of deferred tax assets (DTAs) arising from unused tax losses in IFRS financial statements.

2. ESMA highlights the need for issuers to assess thoroughly the nature and extent of evidence which supports the conclusion that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised and, whenever relevant, the need to provide high-quality disclosures.

Background

3. Over the last few years, ESMA and European enforcers have discussed within the European Enforcers Coordination Sessions (EECS) several cases related to the recognition of DTAs arising from the carry-forward of unused tax losses. In some cases, enforcers have come across situations where despite having a history of recent losses, issuers have recognised material DTAs, sometimes over a prolonged number of years, without having sufficient evidence supporting their expectation that taxable profit will be available in future periods against which unused tax losses can be used.

4. ESMA has already highlighted that issuers should pay particular attention to the recognition of DTAs arising from unused tax losses[1] and identified significant shortcomings in the evidence issuers provided to support their recognition.[2] Nevertheless, the application of requirements on recognition of DTAs continues to cause concern.

5. This Statement addresses in particular two aspects which European enforcers often challenge regarding the application of IAS 12 by issuers, namely:

   - The probability that future taxable profits will be available against which unused tax losses and unused tax credits can be utilised (paragraph 34 of IAS 12), assessed through the criteria provided by paragraph 36 of IAS 12;

[1] ESMA/2014/1309 European common enforcement priorities for 2014 financial statements, 28 October 2014
[2] ESMA/2016/410, 2015 Activity Report on Enforcement and Regulatory Activities of Accounting, 29 March 2016

- The “convincing other evidence” that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the issuer (paragraph 35 of IAS 12), in cases where the issuer has a history of recent losses.

6. Although this public statement focuses on DTAs arising from carry-forward of unused tax losses, ESMA highlights that similar considerations may also apply to the assessment of other deductible temporary differences.

7. The considerations below should be assessed in light of the particular facts and circumstances of each issuer and when no sufficient taxable temporary differences related to the same tax authority and tax jurisdiction are available against which the unused tax losses can be used.[3]

Assessing the probability that future taxable profits will be available

8. IAS 12 does not define how probability is assessed when determining if DTAs arising from unused tax losses should be recognised. Therefore, ESMA is of the view that the concept of probability should be understood in the same way as in other Standards[4] and be based on a “more likely than not” threshold (i.e. > 50 percent).

9. Consequently, 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. In this respect, ESMA highlights the following:

   - Generally, the longer the estimates/forecasts extend into the future, the less reliable they are; their weight should be assessed accordingly.
   - The existence of unused tax losses is strong evidence that future taxable profit may not be available (paragraph 35 of IAS 12).
   - Forecasts/planning should be reasonable, realistic and achievable in all cases; and
   - When issuers have a history of recent losses and do not have sufficient taxable temporary differences, forecast/planning should provide convincing (other) evidence in order to recognise DTAs (refer to paragraph 14 of this statement).

10. When weighing the negative and positive evidence related to the recognition of DTAs, losses arising from operations (i.e. low product demand or sales margins) require stronger offsetting positive evidence to conclude that sufficient future profits will be available than profit or losses arising from a one-time event or from non-recurring events, such as a move to a new factory or a fire (IAS 12 paragraph 36c). Restructuring may provide positive convincing evidence if the business line which was the sole source of the past losses is closed.

[3] IFRIC Update, May 2014, agenda paper 5
[4] See, for example, IFRS 15 Basis for Conclusions paragraph 44 and the Glossary in the IFRS bound volumes published by the IASB.

11. When assessing the sustainability of future taxable profits, issuers should pay particular attention to one-time events (both gains and losses) in order to understand their probability of recurrence.

12. Although tax losses with no expiry date may be more likely to be offset by future profits, they alone do not provide evidence that 'sufficient taxable profits are probable' to enable DTAs to be recognised. The tax losses carried forward may only be recognised if it is probable that sufficient future taxable profit will be generated against which the tax losses can be used. It is not sufficient to simply discontinue making losses, but rather issuers need to provide evidence that sufficient future taxable profits will be generated. Similarly, when tax losses have short expiration periods, the DTAs should be subject to a more critical review since there will be less time to generate sufficient profits in order to use the available tax losses.

13. Likewise, management's assessment of the entity's ability to continue as a going concern[5] does not, in itself, justify recognising a DTA. On the contrary, if material uncertainties exist which may cast significant doubts on the entity's ability to continue as a going concern (e.g. due to liquidity problems), then the recognition of DTAs should be analysed with heightened scepticism.

14. When evaluating whether it is probable that sufficient future taxable profits will be available, the nature, origin and timing of such profit should be considered. The following examples of positive evidence, for instance, may support an assertion that it is probable that taxable profits will be available (this list is non-exhaustive and only indicative):

    - Losses occurred due to identifiable one-time/non-recurring events;
    - 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);
    - New business opportunities, e.g. new patents;
    - Restructuring or disposal which clearly eliminates the loss sources;
    - Convincing tax planning strategies;
    - Firm sales backlog or new contracts (considering also past realisation of sales backlog); and
    - 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).

[5] Conceptual Framework, 3.9 and IAS 1 paragraph 26

15. Conversely, the following examples of negative evidence may indicate that it is not probable that future taxable profits will be available:

- A recent history of operating losses for tax purposes;
- The taxable entity is a start-up business;
- History of significant variances of actual outcomes against business plans;
- Losses of major customers and/or of significant contracts;
- Uncertainty regarding the issuer's going concern;
- History of restructuring without returning to profitability or emerging from a bankruptcy;
- The taxable entity expects losses in early future years;
- The taxable entity has a history of unused tax losses and/or credits expiring; and
- The losses relate to the core activity of the issuer and thus may reoccur in the future.

Assessing whether convincing evidence supports the expectation of future taxable profits

16. ESMA expects that convincing other evidence should be objectively verifiable to support the recognition of DTAs. For instance, a history of recent losses is verifiable objective negative evidence against the availability of sufficient future taxable profit. In this respect, it is also ESMA's view that, because estimates of future taxable profits require significant judgement, the more negative evidence that exists, the less reliance should be placed on the projections of future taxable income.

17. ESMA notes that reliability of profit forecasts also depends on the facts and circumstances of each case, such as the industry/sector of activity and/or the experience of issuers. For example, issuers with long-term contracts (e.g. in the real estate industry, or in concession agreements etc.) may be more easily able to convincingly support the recognition of DTAs even if their budgets are only short-term. On the other hand, start-ups with no extended history of financial results or issuers operating in sectors with a history of volatility in earnings may need to provide more extensive other convincing evidence of the reliability of their profit forecasts.

18. When estimating future taxable profit, it is ESMA's expectation that issuers should not anticipate or consider future events which cannot be controlled by them and are still highly uncertain. These include for example future changes in enacted tax laws or rates (other than changes that are already substantively enacted),[6] possible business combinations, events that depend on future market conditions or events that are inconsistent with financial reporting assertions / with previously communicated strategies.

[6] Refer to paragraph 46 and 47 of IAS 12

19. In addition, when assessing the probable future taxable profits, issuers should also ensure the reasonableness of their business plan and its impact on future taxable profits, (including their history / capacity of accomplishing their stated plans and the consistency with relevant industry data and trends), and the consistency of assumptions compared to prior periods and projections used in other financial statements estimates for elements that should be comparable (e.g. goodwill impairment).

20. In these regards, ESMA notes that while the underlying assumptions between impairment testing and budget planning need to be consistent, the objective of each analysis is different and therefore some key differences can be expected. For example, the risk/uncertainty inherent to the future should be reflected in the expected future taxable profits when applying the recognition criteria for DTAs under IAS 12. [7]

21. ESMA acknowledges that when currently profitable issuers without a recent history of loss recognise DTAs, they often use their current plan to support the recognition. IAS 12 does not define a time period over which an assessment of expected taxable profits is made. ESMA notes while there is no specific time limit in the standard concerning the period of the profit forecast, reliability decreases the further out into the future the forecast extends. The longer the forecast extends, the more unforeseen events and circumstances outside an issuers' control may arise that impact the reliability of taxable profit forecasts. Therefore, issuers should exercise caution when their planning period for purposes of DTA recognition exceeds their normal planning cycle.

22. Tax planning opportunities can also be used to support the recognition of DTAs (paragraph 29 (b) of IAS 12). ESMA considers that the actions foreseen must be realistic, tax profitable and consistent with the issuer business strategy. Furthermore, it is ESMA's expectation that the amount of the future taxable profits expected to be generated by such proposed strategies takes into account the expected incremental deductible costs of implementing them.

Disclosures

23. ESMA highlights that disclosures related to DTAs should be issuer-specific and not boilerplate (e.g. not merely replicating the relevant references included in IAS 12). Disclosures should be tailored to the facts and circumstances of the issuer and to the recognition of DTAs.

24. It is expected that the level of detail of the disclosures provided should be proportionate taking into account (i) the materiality of these assets in the issuer's financial statements, and (ii) the uncertainties and judgments used surrounding the recognition of DTAs. Consequently, the more material and the more judgements/uncertainties are attached to these assets, the more detailed the disclosures expected in the financial statements of an issuer.

[7] In addition, ESMA notes amongst others the following differences: discounting (possible in IAS 36 Impairment of Assets but not in IAS 12); differences between taxable reporting entity (IAS 12) versus Cash Generating Units (IAS 36); taxable profit versus cash-flows.

25. In the context of paragraphs 82 and 82A of IAS 12 and paragraphs 122, 125 and 129 of IAS 1 *Presentation of Financial Statements*, examples of the type of content issuers should consider when preparing their disclosures include:

- Indication of the taxable entity, location and applicable tax rules;
- Indication of the evidence (both positive and negative) considered;
- Period(s) over which the DTAs are expected to be used;
- Critical judgements used in the recognition of DTAs and related uncertainties (e.g. tax opportunities);
- Explanation and impact assessment on the recovery of DTAs of any significant changes in key DTA assumptions;
- Significant unrecognised DTAs; and
- Sensitivity analysis on assumptions used if relevant.

Final remarks

26. ESMA considers it relevant that issuers, auditors and audit committees take into consideration this public statement when preparing financial statements and, in particular, when assessing whether DTAs fulfil the recognition criteria set out in paragraphs 34 to 36 of IAS 12.

27. ESMA, together with the national competent authorities, will continue to pay particular attention to this issue when performing examinations of financial statements.