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Dear Sir/Madam

### **Discussion Paper: Improving the Financial Reporting of Deferred Tax**

We welcome the opportunity to comment on the discussion paper and provide our views on IAS 12 'Income Taxes', how it could be improved and whether an alternative approach would be more appropriate.

Our responses to the questions raised in the Discussion Paper are set out in the Appendix to this letter.

Although there are many positive aspects of IAS 12 which have been highlighted in the discussion paper, the balance sheet method of accounting is often criticised for its complexity. In our view, this is due to the underlying principle that deferred tax is recognised on differences that arise between the carrying value of the asset / liability and its tax base. The term 'tax base', in the UK, was an unfamiliar concept when International Accounting Standards were adopted, that created significant challenges for preparers, users and auditors alike. Although the UK accounting standard terminology 'timing and permanent differences' are probably still more familiar, a certain level of understanding of IAS 12 has developed over time through its application, which we understand is a trend experienced in other jurisdictions. For this reason we continue to support the development of IAS 12 as an international principle based standard for recognising and measuring deferred tax.

If you would like to discuss any aspect of this response further, then please do not hesitate to contact me.

Yours faithfully



**Nicky Warburton**  
**Baker Tilly UK Audit LLP**

- 1.1 Under current IAS 12 a difference between the tax paid and the current tax expense reported in the income statement leads to misunderstandings of these relationships.

Do you agree that additional disclosure that would provide a reconciliation of the taxes paid and current tax expense will help in understanding this relationship? (Paragraphs 1.15 to 1.18)

We do agree that a reconciliation of the tax paid in the period with the tax liability in the comparative period, the current year's tax expense and the tax liability at the reporting date would enhance the users understanding of the impact of tax on the financial statements as a whole. In addition, we consider that a narrative explanation as to why the tax paid in the period differed from the tax liability in the comparative period would be beneficial in understanding why the estimate made by management differed from the actual tax paid.

- 1.2 Do you agree that additional more detailed disclosures regarding deferred tax assets, especially unused tax losses and unused tax credits are necessary and useful? (Paragraphs 1.23 to 1.24)

Whilst we support the principles of avoiding boiler plate disclosures and cutting clutter in financial statements we agree that maturity disclosures in respect of deferred tax assets would be beneficial to the users particularly where deductible temporary differences are in excess of taxable temporary differences.

- 1.3 Do you agree with the identified users' information needs in Chapter 1 of Part 1? Do you have any suggestion for additional information requirements regarding reporting of income taxes? (Paragraphs 1.8 to 1.24)

We agree that it would be as relevant for the users to understand the entity's tax strategy and objectives as it is to for them to understand the entity's objectives and strategies for managing risk. However we appreciate that there may be reluctance on the part of some entities to disclose details of their tax planning strategy and in consequence it may not be appropriate to require additional information if it will provide no added value to the users. In addition, the tax strategies for international groups may be extremely complex which could lead to voluminous and onerous disclosures or disclosures that are not readily understandable by users. In our opinion if such disclosures are going to be imposed, then guidance should be given as to the level of detail that is necessary to enable users to have a sufficient understanding of the strategies without burdening them with unnecessary complexity.

- 1.4 Do you agree that tax strategies to accommodate user information needs should be disclosed in the management commentary and not in the financial statements? Why or why not? (Paragraphs 1.8 to 1.9)

Yes we agree that such information would be more appropriately disclosed in the management commentary for consistency with other disclosures regarding management's objectives and strategies.

- 1.5 The reconciliation of the actual tax charge to the charge on profit at the statutory tax rate (tax rate reconciliation) is quite complicated and leads to some misunderstandings. Do you agree that the suggestions made in the paper are helpful by clarifying the explanation why the current tax charge is not equivalent to the standard rate of tax applied to the accounting profit? Why or why not? (Paragraphs 1.19 to 1.20 and 2.21 to 2.34)

We are supportive of the recommendations to make the reconciliation more meaningful, transparent and user friendly.

- 1.6 The amounts currently disclosed provide limited information about future tax cash flows.  
How would you suggest the disclosures in IAS 12 be improved to provide better information about future cash flows? (Paragraphs 1.13 to 1.14 and 2.35 to 2.40)

We are supportive of additional disclosures in respect of future tax cash flows as highlighted above. However predicting what future tax rates will be for international tax groups may be unduly onerous and unreliable since the entity itself has no influence or control over those future rates. What would be more useful is an estimate of the future tax cash flows based on substantively enacted rates at the reporting date and sensitivity of future cash flows if those rates were to increase or decrease by a reasonably expected amount. Maturity analysis in respect of the realisation of significant deferred tax assets and liabilities would also in our view be useful information.

- 1.7 The possibility of discounting deferred tax balances is discussed in paragraphs 2.44 to 2.50. In your view, should discounting deferred tax amounts be required? Please explain.

Although discounting may give a more relevant measurement of the value of deferred tax assets and liabilities to a business, a requirement to discount would add a further layer of complication to an already complex accounting issue. Providing information about cash flows and maturity of significant deductible and taxable temporary differences would in our view provide the users with sufficient and reliable information to make informed decisions without adding further complexities to the calculations that preparers need to make.

- 1.8 Currently IAS 12 neither provides explicit guidance for accounting for uncertain tax positions nor contains any specific disclosure requirements regarding the tax risk position

(a) Do you agree required information regarding uncertain tax positions should be disclosed? If so, which of the following do you prefer:

Alternative 1: Disclosure requirements should be included in management commentary.

Alternative 2: Disclosure requirements should be split in two parts. Part 1 would include disclosure of all positions for which the tax payer must establish a tax provision under IFRS and will be disclosed in notes to the financial statements. Part 2 would include all other uncertainties regarding income taxes for which no provision is recognised. (Paragraphs 1.10 to 1.12)

See response to part (b). Existing accounting standards in our view already cover the disclosure of uncertain tax positions and these should be disclosed in the financial statements. However given the provisions are dealt with in IAS 37 and not IAS 12, preparers may conclude that such disclosures do not apply to uncertain tax positions. A cross-reference from IAS 12 to IAS 37 may therefore be useful.

(b) Do you agree that IAS 12 should address the recognition and measurement of uncertain tax position? Why or why not?

If you agree, should the measurement be based on the most likely outcome or a probability weighted method? Should measurement include the likelihood the tax position will be reviewed by the tax authorities or should that review be assumed? (Paragraph 2.51 to 2.59)

IAS 37 covers all provisions and contingencies except those arising from executory contracts and those covered by other standards. Uncertain tax positions appear to meet the definition of a provision or contingency as defined by IAS 37 and therefore the accounting appears to fall within the scope of this standard in the absence of any other explicit guidance set out in IAS 12. In our view, the recognition, measurement and disclosure provisions of IAS 37 are adequate to deal with uncertain tax positions and bringing in any additional requirements to IAS 12 will add more complication to an already complex accounting standard. It may however be beneficial to clarify in IAS 12, that the recognition, measurement and disclosure requirements of IAS 37 should be applied to uncertain tax positions.

- 1.9 Are there any issues with IAS 12, which are not addressed in Part 1, that would significantly improve the standard? What amendments would address these issues?

The application of the dual manner of recovery and the offsetting provisions can lead to significant debates. An example in the UK is when a taxable temporary difference arises from use due to the difference in depreciation and capital allowances but on sale a deductible difference arises which represents a capital loss. From a tax perspective an entity is restricted to

offsetting a capital loss against other capital gains and therefore it cannot be offset against trading profits of an entity. This would naturally lead to the conclusion that a deferred tax asset and liability should be recognised. However IAS 12 refers to “the” tax base of the asset which suggests that an asset cannot have more than one tax base and this supports the offsetting of taxable and deductible temporary differences in this situation. A clarification in the standard as to whether an asset could have more than one tax base would be beneficial in applying the offsetting provisions in circumstances such as these.

1.10 What is your view on the exemptions that currently exist in IAS 12?

We consider that improvements could be made to the current exemptions in IAS 12.

We understand and agree with the initial recognition exemption. However we see that improvements will aid consistent application of the principles. Firstly, anomalies arise when there is a change to tax legislation affecting the tax base of an asset which gives rise to a temporary difference which would have been subject to the initial recognition exemption had that tax legislation been in place when the asset was initially recognised. Amending IAS 12 to extend the exemption in this circumstance would lead to a more consistent application of the principles underlying the standard.

Secondly, confusion arises in determining the initial recognition exemption amount in respect of assets which are revalued upwards after there has been a reduction in the carrying value since the asset was initially recognised. Clarifying whether the initial recognition amount is the original carrying value or the written down amount at the time of the revaluation would be beneficial and lead to a more consistent application of the exemption by different entities.

2.1 If the development of a new standard for income tax, based on different principles from those used in IAS 12 is to be considered, which of the approaches discussed in Part 2 seem to have most merit and should be considered as a basis for further development?

The only method identified in Part 2 in our view that has merit for further development is the accruals method. The flow-through approach, although easily understood, is too simplistic and does not provide users with information that links the financial position with its related future tax consequences. The partial tax allocation method increases the exercise of judgment when determining the extent to which timing differences should be recognised. It is also inconsistent with other international accounting standards that deal with liability recognition and measurement principles. The valuation adjustment approach increases the level of complexity arising from the recognition and measurement of deferred tax liabilities. It is also, in our view, inconsistent with the offsetting principles that currently exist in other

international accounting standards. As established in our covering letter, our preferred approach would be to make limited amendments to IAS 12.

- 2.2 Do you think that there are any specific practical difficulties with implementing the approach(es) that you favour in practice? If so, how can those difficulties be addressed?

Although we consider that there is merit in considering the accruals method further, there are certainly drawbacks. Firstly, as there will be only one component to the tax charge, transparency will be lost with regards to the current tax and deferred tax components and the accrual/prepayment components. Offsetting will also be automatic even though there may be benefits and obligations which in practice cannot be offset and hence the balance sheet position may be misleading without further analysis. In addition, deferred tax assets may potentially be recognised when the recoverability is not probable. In such circumstances due consideration would need to be given to their recoverability and whether any provision may be required against the recognised asset. These factors add additional complexity to the proposed, simpler formulaic method of measurement.

- 2.3 Are there any approaches that are not discussed in Part 2 that should be considered?

Yes. We consider that consideration should be given to the timing difference approach proposed by the UK Accounting Standards Board. However we would suggest a subtle change in the definition of the term 'timing difference' so that it refers to differences between the entity's taxable profits and the entity's comprehensive income as stated in the financial statements, that arise from the inclusion of gains and losses in tax assessments in periods different from those in which those gains and losses are recognised in the financial statements. This, in our view would lead to a similar result to that arising from the application of the accruals method but with improved transparency and with the application of offsetting principles consistent to those in other standards.

- 2.4 In your view should a combination of approaches be considered? If so, which approach should be used in what circumstances?

In our view, one set of principles should be established that is applicable to all entities. Choices or combinations of approaches should not be permitted as this may result in inconsistency and potential manipulation of financial information.

- 2.5 Do you have any further comments on the discussion of the various approaches in Part 2?

No