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**Discussion Paper: Improving the Financial Reporting of Income Tax**

Dear Sir or Madam,

We like to take a position on their issue from their discussion paper "Improving the Financial Reporting of Income Tax".

**Q 1.1 Should the breakdown between paid tax and the tax charge be clearer? Do you think that reconciliation between the tax charge and the taxes paid would be helpful?**

In our opinion a sentence in which it is indicated that a provision/receivable has been reversed or formed in the amount of the difference between the tax payable and the tax charge should be adequate as clarification.

The significance of which assessment years the difference relates to or the extent to which a given provision or receivable is affected is very limited. In order to genuinely broaden the information provided to readers of financial statements it would be necessary to provide exact information on:

- the status of the tax assessment,
- the adjustments between the "estimated" tax charge at the point in time of drawing up the financial statements and the actual tax charge upon filing the tax declaration or assessment by the tax office,
- each change to the assessment (e.g. caused by decisions on objections or significant changes at controlled subsidiary companies or unincorporated partnerships),

Board of Managing Directors:  
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- development of the prepayments, and
- the detailed description of payments or reimbursement based on completed external audits.

However, the coherence and clarity of the financial statements would suffer with such a detailed explanation, especially as with a corporate group this information might be spread over a hundred different taxpayers and it would thus only be possible to produce it on a consolidated basis.

Whether readers of financial statements would thus be genuinely aided or merely bewildered by the multitude of figures could only be decided on a case-by-case basis.

### **Q 1.2 Should notes to the financial statements on deferred taxes be increased, in particular in respect of unused losses carried forward and tax credits?**

This relates to information on country distribution, temporal usability and other restrictions.

Already now the amount of the unused losses carried forward is indicated in the notes to the financial statements. The reasons for this should be clear to every reader. It is not assumed that within the planning horizon the deferred taxes are usable or that they are not available for use due to temporal or fiscal restrictions. If one wanted to provide the desired breakdown, considerable additional information would be necessary (amount of the unused losses carried forward of all subgroups broken down by country and, where applicable, due dates). The question is raised in this connection of what benefits the reader gains from this. This is because even very comprehensive information would not be sufficient for the reader to reach an opinion differing from that of the compiler of the financial statements to the extent that he would as a consequence capitalise more deferred taxes.

### **Q 1.3 Do you agree with the requirements of users on p. 7?**

In Int 2 it is stated that the users of financial statements do not consider the tax information based on IAS 12 to be adequate. In particular, there is a lack of information about future cash flows.

Where does this opinion come from? Which addressees does it refer to? Is it not already the case today that a large quantity of notes to the financial statements relating to taxes are made where it is doubtful whether they are read and understood at all (this is confirmed by the statement on Page 11 under 1.4)? This applies both to actual taxes and also to deferred taxes. There are many analysts who in principle neutralise deferred taxes. Here, too, the question is raised as to whether more information is of use here.

The subject of taxes is so complex that even within companies only a very limited group of people understands them. This is even true to the extent that in some cases compa-

nies are not managed on an after-tax basis, but instead on a pre-tax basis. Regrettable though this may be one must nevertheless ask the question as to whether financial statements can truly provide third parties with sufficient information for them to be able to form their own picture of the tax circumstances (also see Page 11 under 1.4).

On Page 8 Int 14 the Corporate Reporting Users' Form is designated as a "user" who requires a fundamental change in the way of thinking about taxes. Nevertheless, it appears to involve a group of institutional investors and analysts. The traditional shareholder does not appear to have any such demands.

**Q 1.4 Do you agree that the tax strategy should be disclosed in the management commentary and not in the financial statements?**

As the tax strategy is essentially a management decision, the choice proposed by you is perhaps the best. Indeed, readers are actually unlikely to be bothered where they find a given item of information.

It is nevertheless questionable whether they can really draw any benefit from knowledge of the tax strategy. It appears unlikely that anything more than a general statement will be found here about the fact that an aggressive tax strategy is not being pursued. As the readers of this information also include the external auditors of the respective company, any other view would be surprising.

**Q 1.5 The reconciliation statement is currently very complicated and ambiguous. Do you agree that the proposals in this paper would be helpful by way of explanation?**

There are no exact rules in IAS 12 currently stating what the reconciliation statement should look like. In the paper a proposal is made outlining the main points of a reconciliation statement. Each of these should be broken down into even greater detail, insofar as more than 5% has been stated by this main point.

First of all the question is raised as to what annual profit before taxes should be used as a basis, that of the individual units or the entire group? EFRAG prefers both variations to be shown. The reason it gives for this is improved clarity in respect of the fiscal peculiarities of individual units as well as the disclosure of consolidation measures.

However, for purposes of clarification it should be determined what is to be understood by the individual unit (subgroup, individual company or permanent establishments) and which can be consolidated, where appropriate based on considerations of materiality. For larger groups, a detailed presentation would be confusing quickly.

The proposed scheme for tax rate reconciliation is as follows:

Annual profit before taxes
Income tax charge calculated at xx%
Current income tax effects:
(-) Tax-free income
(+) Non-deductible expenses
(+/-) Adjustments to current tax for previous years
Deferred income tax effects:
(+/-) Effects of tax losses
(+/-) Effects of foreign tax rates
(+/-) Effects of changes in tax rates
(+/-) Other items
Income tax charge

We welcome the introduction of rules for the design of the reconciliation statement. It is hard to understand why no global minimum standard has been established here. We consider specification of the main positions to be beneficial. This also makes it much easier for readers to compare the different sets of financial statements. However, the desired sub-positions should also be established, because it is not likely to be possible to quickly determine a further breakdown at the respective time of preparation. It should be taken into account that the reaching of a threshold can only be gauged if all the information relating to the individual companies and subgroups is available.

Furthermore, we do not have positions for variances due to other types of income tax or trade tax assessment rates or deferred income taxes relating to previous years or effects of permanent differentials. At present effects of permanent differentials at DZ BANK are stated under tax-free income and non-deductible costs. Nevertheless, based on the proposed presentation exclusively the effects of current taxes are considered. In our opinion, therefore, certain significant variances come under the item "Other" and there is a danger that a commensurate relationship with the other reconciliation effects can no longer be guaranteed.

**Q 1.6 There is currently only limited information about future tax payments. How do you recommend this could be improved?**

A more difficult question appears to be how the payments will develop in future. The reversal effects in respect of the deferred taxes only represent part of this question. However, further breakdown of the deferred taxes according to their due dates would represent an extreme increase in the complexity of the method used for determination of the deferred taxes. One would then have to state each individual difference in valuation separately. Furthermore, for each of these differentials – possibly also within a

differential with varying timings – one would have to estimate the reversal. It would have to be taken into consideration that this estimate could be so approximate that the additional information would only be of very limited benefit. Irrespective of this the deferred taxes would only be a part of the taxes payable over the subsequent few years. If one wished to know the total amount, the companies would have to disclose their complete forecasts.

As a result, by our reckoning the cost and complexity of estimating the future tax payments would not be commensurate with the benefits (also in respect of the probable poor accuracy of the estimate).

### **Q 1.7 Should deferred taxes be discounted in your opinion?**

Under IAS 12.53, IAS 12 has previously prohibited discounting. This prohibition is justified with efficiency considerations. Thus a detailed schedule of the temporal development of the reversal of each temporary differential is in many cases impracticable and not justifiable due to its complexity.

Naturally, in view of the fact that in the IFRS financial statements present values are mainly used, one can ask why this should not be valid for the purposes of deferred taxes. To this extent we can understand your proposal very well.

This applies in particular in the case of so-called quasi-permanent differentials, which are only reversed in the distant future or upon liquidation of the company. Given the usual application of the “going concern” principle, as a rule this means an infinite term. Discounting would produce a value of almost zero here. In Germany there is often an asset-side surplus of deferred taxes. Consequently, as a rule one can assume overvaluation of the deferred taxes due their not being discounted.

However, these extreme problems could also be solved – as regulated in German Commercial Code (HGB) financial statements before adaptation to IAS 12 – by prohibiting the allocation of deferred taxes in respect of quasi-permanent differentials. Examples of this are differences in valuations of business premises used in business operations.

For the rest, by our reckoning the arguments referred to in the IAS remain valid. There is no logical relationship between the costs and benefits. The differences currently consolidated at balance sheet item level would have to be broken down for each individual differential. For each of these differentials a term would have to be estimated, and there would be a considerable danger of inaccuracy. There are possibly also areas in which the differences would only be reduced over an extended period. Then various deferred taxes would have to be calculated here, too. Furthermore, as a rule the initial values will also already have been discounted in the IFRS and in the tax balance sheet.

Consequently one would then actually have to use the differential for non-discounted values. Then the question of the interest rate would have to be clarified. This would in principle vary depending on whether at the end of the term there was a reversal effect on the tax side or on the commercial law side.

Consequently so many different assumptions and estimates and probably also simplifications (consolidation into clusters) would be necessary that improvement of the reporting would be unlikely.

Insofar as one really wanted to introduce more “accuracy” here, a prohibition of the allocation of deferred taxes on quasi-permanent differentials should be introduced. By contrast, we disagree with removal of the discounting prohibition.

**Q 1.8 IAS 12 does not currently provide any information on accounting for uncertain tax positions.**

**a) Are you of the opinion that such information would be necessary? If yes, which of the following two alternatives do you prefer?**

As it currently stands IAS 12 contains no rules for consideration of tax risks. This naturally leaves broad scope for interpretation. This is not beneficial. In principle, therefore, rules on how the risks are to be determined and evaluated would be useful.

It should be noted that the scope of the expected value method is limited. In general the method of evaluation will be based on the approach of tax provisions in the case of a risk of over 50 % is applied. Therefore, both methods should be possible.

**Alternative 1: The information should appear in the management commentaries.**

**Alternative 2: The information should be divided into two parts. The first part contains all positions necessary for the tax provisions. This part should be explained in the balance sheet. The second part contains the risks for which no provisions had to be formed.**

In our view it is essentially unimportant where the information is given. However, in principle it is likely to be simpler for readers if they can find it all in one place with the provisions.

**b) Are you also of the opinion that IAS 12 should include the determination and measurement of uncertain tax positions? Why, or why not? If yes, should the measurement be based on the most likely outcome or should an expected value be determined? Should the likelihood that**

**an external audit will examine this question be taken into account or should a review be assumed in principle?**

Both methods of determination would have their advantages and disadvantages, so in our opinion it depends on the individual case as to which method leads to the appropriate results. We therefore consider it logical not to stipulate either method.

It should be pointed out in this connection that tax risks affect not only the current taxes. Consequences for the deferred taxes must also be taken into account, insofar as temporary differentials or losses carried forward are affected as a result. In respect of several alternatives this point, too, would make the determination and reassessment of the “uncertain tax positions” very time-consuming and for all practical purposes impossible, because “risk-adjusted tax balance sheets” would be required for their calculation.

**Q 1.9 Are there any further issues with IAS 12 that we have not addressed and that would significantly improve the standard?**

The meaning of IAS 12 29 a), Sentence 2 remains unclear. We therefore request that representations be made for its removal.

**Q 1.10 What is your view on the current exemptions in IAS 12?**

n/a

**Second part – alternative options for determination of deferred taxes**

**1. Presentation of the current method in IAS 12 from Page 38**

Here we intend to use the following example to demonstrate that the current approach does not result in correct distribution between the periods (2.13).

A company purchases an asset for 100 which it will later sell for 180 in another period. Under the applicable tax law the acquisition cost of 100 is not a deductible cost. Accordingly it must pay 54 (=180 times 30%) in taxes on a once-off basis. Consequently, based on the current method the fiscal value would be zero. Correspondingly, non-capitalised deferred tax of 30 could be reported as early as the year of purchase, even though the profit from sale is not booked until a later year.

In this case it is legitimate to ask whether the early reporting of the tax charge is beneficial. It is nevertheless questionable whether such a case is relevant throughout the

world, that is to say whether there are many countries with many practical examples which would make amendment of IAS 12 necessary.

There are other individual cases in which IAS 12 does not produce any useful solutions. However, one must ask whether such problems are not present in all types of system. Essentially there are two options here for dealing with this in an existing system:

1. Extend IAS 12 with an appropriate special rule.
2. Use a sort of general standard for which, unless upon application of the rule the desired results emerge that are in keeping with the objective of the rule, a corresponding restrict interpretation is necessary.

We believe the second option appears most beneficial.

A further example where a production building is revalue in the IFRS financial statements (150) and continues to be valued at 100 in the tax balance sheet. Under IAS 12 deferred taxes to the value of 15 (= 50 times 30%) are now due, even though the company does not intend ever to sell the building, as it is required for the company's operations.

This problem could be solved by means of the prohibition of stating deferred taxes on quasi-permanent differences.

## **2. Description of the flow-through approach, or current taxes payable approach (from Page 44)**

Under this approach the only taxes stated are those applicable to current profits. Notwithstanding this the deferred taxes must be explained in the notes to the financial statements. This would lead to an even more confused portrayal of the deferred tax, as the reader would be unable to obtain a full picture of the overall effects of the tax with just the balance sheet and the profit and loss account.

## **3. Description of the method of partial allocation of deferred taxes (from Page 46)**

Under this method deferred taxes should only be stated where a real payment effect can be expected. The following example is intended to illustrate the problem:

A company may depreciate machines for tax purposes more quickly than is permitted under commercial law. However, as this involves a company with expanding business it will purchase more and more machines and will initially also continue in future to save



on taxes. For all practical purposes in this case the deferred non-capitalised taxes have no actual impact.

It is likely to be very difficult to establish whether or not such a case exists. The decision would also depend on the company's forecasts (is business expansion planned? etc.).

In any case this method does not lead to any simplification. Furthermore it can be assumed that the tax levels resulting from this would be understandable neither intern nor to third parties.

#### 4. Description of the method of assessment correction (from Page 48)

With this method no deferred taxes are determined. By contrast it is assumed that an asset (e.g. a machine, acquisition cost of 1,000, tax rate 40%) creates two advantages:

- The use, e.g. to render a service (600)
- The tax advantage, as the acquisition cost will at some time be deductible for tax purposes (400 = 1,000 times 40%).

The 600 for the use is spread over the four years (thus 150 per annum). The tax advantage of 400 is spread (on the basis of degressive tax depreciation, as follows: 160 in T1, 120 in T2, 80 in T3 and 40 in T4).

Consequently the asset is stated as follows (after taxes):

		<b>Tax amortisation</b>	<b>Use of tax advantage</b>	<b>Book value at end of year</b>
Acquisition	1,000			
<b>T1</b>		-150	-160	690
<b>T2</b>		-150	-120	420
<b>T3</b>		-150	-80	190
<b>T4</b>		-150	-40	0
		-600	-400	

Using this method the book value of each individual economic asset is corrected by the respective tax effect.

This is most certainly an interesting new approach. Nevertheless, the difference in the result is not much different to the previous approach of non-capitalised deferred taxes (here, in respect of commercial law the asset at the end of T1 would be stated at 800

(600 for tax purposes) and 80 of non-capitalised deferred taxes (40% of 200), thus 720 in total). We cannot tell whether the difference of 30 is logical. In any case it is not very high in relative terms. Previously, however, the deferred taxes have been booked in summa and not shared among individual assets. With this method this would have to be completely changed. Considerable costs would have to be expected as a result. Furthermore, deferred taxes themselves are currently assessed. It is questionable how such an assessment would be possible/necessary with such an approach. If it were necessary, how would it be shared? This can make sense for depreciation, nevertheless there are also repeatedly effects that are unforeseeable or cannot be allocated to individual balance sheet items (e.g. utilisation of losses).

If the taxation effects were stated in the individual balance sheet items, it would no longer be possible to net out capitalised with non-capitalised deferred taxes. This would result in extension of the balance sheet total. We do not therefore consider this method to be beneficial.

## **5. Presentation of the profit-oriented approach (from Page 52)**

Before the current balance-sheet-oriented approach was introduced, the so-called profit-oriented method was used (also applied to old German Commercial Code (HGB)). Rather than balance sheet differences, this approach is based on differences in the profit and loss account. Nevertheless, even previously the balance-sheet-oriented approach was in fact used (comparison of balance sheet values). If one really wants to compare profit and loss values with each other, annual recalculation of the values is for all practical purposes impossible. Reintroduction of the old method therefore makes no sense in our view.

### **Q 2.1 Which of the options is to be given preference if IAS 12 is to be amended extensively?**

We are in favour of there being no extensive change to IAS 12.

### **Q 2.2 Are there in your view any special implementation difficulties in connection with your preferred method?**

See above

### **Q 2.3 Are there any further options not discussed in Part 2 that should be taken into account?**

No

**Q 2.4 In your view is it beneficial to combine different alternatives? If yes, which?**

No

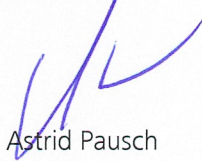
**Q 2.5 Do you have any further comments on the various alternatives in Part 2?**

See above

Should you have any questions, please don't hesitate to contact either Mrs Pausch or Mrs Heß.

Yours faithfully

DZ BANK AG

A handwritten signature in blue ink, appearing to be 'Astrid Pausch', written over a light blue horizontal line.

Astrid Pausch

A handwritten signature in blue ink, appearing to be 'Melanie Heß', written over a light blue horizontal line.

Melanie Heß