EFRAG
35 Square de Meeus
1000 Brussels
Belgium

29 June 2012

Dear Sirs

Discussion Paper: Improving the Financial Reporting of Income Tax ("the Discussion Paper")

We are responding to your invitation to comment on the Discussion Paper on behalf of PricewaterhouseCoopers.

Following consultation with members of the PricewaterhouseCoopers network of firms, this response summarises the views of member firms who commented on this discussion paper. 'PricewaterhouseCoopers' refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

We welcome the opportunity to respond to the Discussion Paper, which identifies certain issues with the current accounting model for deferred taxes and explains the options that might be considered by the IASB and others to improve the usefulness of income tax accounting.

The Discussion Paper is a substantial and detailed analysis of a challenging topic that will be useful for any project that the IASB and other standard setters may take on as result of the current agenda consultation process. It explores a range of options that might improve income tax accounting, including amendments to the current model and a number of alternative models.

We agree with many of the concerns with the current model identified in the Discussion Paper. We also agree that existing accounting may not convey the information required by investors and might result in accounting that does not reflect the economics or cash-flows of transactions, or in detailed tax disclosures that are not easily understood.

Many constituents question the conceptual merits of the current model. They argue that the model is too complex and results in accounting that is difficult to understand and costly to produce. Investors would like to receive more relevant, decision-useful information about income taxes than is available from the existing accounting model and related disclosures. We believe it is unlikely that further limited amendments such as those suggested by the EFRAG in section 1 of the Discussion Paper would be sufficient to address the wide ranging concerns about the existing model. We therefore believe a wider project should be initiated to reassess income tax accounting once the revenue, leasing and financial instruments standards are finalised. The goal should be to improve reporting by reducing complexity and providing more decision-useful information to investors.

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We have explored and commented on these concerns in the PwC Point of View attached as an appendix to this letter. We believe that the issues identified in the Discussion Paper and the Point of View should be further considered and developed by the IASB and by other accounting standard setters as soon as their agenda allows. We have therefore not commented on the detailed questions in the Discussion Paper.

If you have any questions on the content of this letter, please do not hesitate to contact John Hitchins, PwC Global Chief Accountant (+44 20 7802 4555), or Tony de Bell (+44 20 7213 5336).

Yours faithfully

PricewaterhouseCoopers.

PricewaterhouseCoopers

Point of view

Accounting for income taxes – It's time for a comprehensive review

9 December 2011

What are the issues?

- The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) planned to reduce the relatively modest differences between their respective standards on income tax accounting as part of their original convergence agenda. However, the plan was ultimately abandoned, with the boards indicating that a comprehensive review would eventually need to be undertaken.
- Some constituents question the conceptual merits of the current income tax accounting model because it does not measure taxes on a discounted or cash flow basis. Many others say the model is too complex and results in accounting that is difficult to understand and costly to produce.
- Investors have shown increasing interest in deriving more relevant, decision-useful information from reported income tax amounts and disclosures.
- We believe a project should be initiated to reassess income tax accounting once the revenue, leasing and financial instruments standards are finalised. The goal should be to improve reporting by reducing complexity and providing more decision-useful information to investors.

Background – Concerns with the existing model

Investors and other users of financial statements place importance on the effective tax rate reported under the current standards. They are also interested in understanding entities' tax-related cash flows and expectations. This may include (1) cash tax rates and risks related to future income tax cash flows, and (2) the economic value of expected income tax obligations or benefits.

Today's standard (or 'model') does not readily convey this information and often results in detailed disclosures that are not easily understood. This causes investors to ignore much of what is reported or to search for alternative information.

Complexity and cost of reporting

Today's model tracks differences between the book and tax balances of assets and liabilities under the theory that such differences represent future taxable income or deductions. The model then calculates and records the future taxes that are to be paid (or reduced) as a result of those differences at the statutory tax rate. Since the model was introduced, changes in accounting standards and tax laws have made those differences more numerous and complex. Businesses have also expanded across more geographic markets and are subject to a wider range of tax laws.

The model also contains many intricate rules and a variety of exceptions that were designed to compensate for unintended consequences or impracticalities.

Entities need employees with deep knowledge of income tax laws and financial reporting standards to support their income tax accounting. The processes typically rely on spreadsheets that are outside of general ledger systems. Management often turns to outside service providers for help, increasing the cost of financial statement preparation. Yet, accounting errors and control problems persist.

Economic faithfulness

One criticism of the current model is that it may not show an economic measure of income tax costs or benefits. For example, deferred income tax amounts shown on an entity's balance sheet are not discounted and are not risk-adjusted to account for the probability of realising a future tax benefit or incurring a future tax cost. The amounts do not therefore reflect the economic value of expected future cash flows, particularly when future recovery or settlement periods are prolonged. An example is the recognition of a tax loss carry-forward that is expected to reduce taxes in 10 years, yet is measured on the balance sheet at the same amount as if it were expected to reduce taxes in the current year.

Some constituents question whether deferred taxes faithfully represent an actual future cash inflow or outflow. For example, they suggest that, as long as management expects to continually reinvest in capital equipment, the related deferred tax liability will replenish, thereby deferring cash settlement indefinitely. However, others believe that a deferred tax liability represents a future cash outflow even though future investments may give rise to a similar liability.

The model's asymmetric treatment of deferred tax assets and liabilities is also a concern. That is, assets must be supported by the likelihood of having future taxable income; whereas liabilities are recorded even when future losses are anticipated.

The treatment of economically equivalent tax law changes can vary depending on how legislation is written. Tax rate changes produce an immediate adjustment to deferred taxes and tax expense, whereas tax credits and deductions are sometimes not recognised until the tax benefit is claimed.

Lastly, one of the more significant shortcomings of the existing IFRS standard is the absence of any guidance related to income tax uncertainties – that is, situations in which the application of the relevant tax rules is unclear.

What is the response?

Investors want more decision-useful income tax accounting. There is a range of possible approaches to income tax accounting reform. Each may have advantages and drawbacks, but the standard setters should take on this difficult project and consider possible alternatives that might provide investors with more decision-useful information.

Alternatives range from abandoning the existing model at one extreme, to modifying it by targeting specific problem areas at the other – with many variations in between.

Starting anew

Some of those who would like a completely new approach believe that reporting only current tax obligations (and liabilities for risks of additional assessments) would present more relevant information for investors while minimising complexity. This 'as-incurred' approach is already applied to a variety of excise, property, gross receipts, production, duties, value-added and other non-income-based taxes. Proponents of this approach suggest that deferred taxes do not meet the conceptual accounting definitions of assets and liabilities. This is debatable, but if this approach were taken, we would expect that supplemental forward-looking disclosures would be needed to provide investors with information about future expected tax cash flows. Disclosures might include, for example, information about tax loss or credit carry-forwards, as well as estimates of future effective tax rates.

Continuing with the 'model'

Others believe that we should continue with the existing approach, but within that model, where appropriate, deferred tax amounts should be adjusted for the time value of money and the risk of realisation. They believe that discounted information more closely reflects the economic value of tax assets and liabilities. If this approach were taken, discounting may need to be limited to deferred tax amounts that are not implicitly discounted because they relate to pre-tax balances that are already discounted, such as pension and other employee benefit obligations.

The operational challenges associated with discounting would also need to be considered. Proponents suggest that those challenges, using improved tools and more experience, may not be as difficult to overcome as when income tax accounting was last deliberated. They believe that if the discounting of deferred tax amounts were required, certain existing exceptions would no longer be needed, and other shortcomings of the current model would be reduced. They also believe investors would be provided with more decision-useful information. For example, the impact on net income from recording a one-time adjustment to discounted deferred tax amounts for changes in tax laws would more closely reflect the economics.

Variations in between

A variety of alternatives has been proposed that are between the two broad approaches above. One is to limit deferred taxes solely to profit and loss items that are reported in different periods for book and tax purposes. Another is to limit deferred taxes to amounts likely to be settled, for example, in the next three-to-five years. This approach might not be theoretically pure, but proponents suggest that such approaches are practical and can be developed in a way to provide investors with relevant near-term tax cash flow and other economic information through additional disclosures.

What does this mean?

We believe the key objective of standard-setting is to develop high-quality standards that do not create unnecessary complexity. To us, high-quality accounting standards provide decision-useful information for investors, reflect the economics of transactions and are sustainable.

There is an opportunity to (1) increase the quality of income tax accounting, (2) improve disclosures and (3) decrease complexity, all of which would benefit investors and preparers. We believe a comprehensive review of the accounting model for income taxes should be on the standard-setting agenda – to begin once the major new standards currently under discussion have been finalised.

Questions and answers

Q: Eliminating exceptions in the income tax model could help reduce complexity and improve the quality of information for investors. Can you provide an example?

A: One example, among many, is recording some of the benefits of income tax deductions from share options and similar awards in shareholders' equity instead of income. This results in reported tax expense being higher than the related cash outlay for taxes and makes it difficult for investors to assess the impact of share options on future tax cash flows. At the same time, extensive record-keeping is necessary in order to determine the timing and measurement of the effects on the shareholder equity accounts.

Q: What are examples of more decision-useful disclosures for investors?

A: Investors want to be able to better understand current and expected income tax cash flows. This would include information relating to risks and the extent to which tax cash flows may be affected by non-recurring items or events. It could also include more information on the expected reversal period and impact of deferred taxes. This might be accomplished, for example, by disclosing the weighted average life of deferred tax assets and liabilities.

Investors have also expressed an interest in obtaining better information on non-income-based taxes as they become more prevalent. At the same time, consideration should be given to simplifying or eliminating certain existing disclosure requirements that do not provide clear, decision-useful information.

Q: What should the next steps be in a comprehensive review of the income tax accounting model?

A: The first step is putting this topic on the standard-setting agenda. We recommend that the project commence after the major pending projects are completed. We also suggest that an early-stage user survey and consultation be conducted. A robust research process should then follow.

Q: Should the IASB and FASB co-ordinate comprehensive reviews of their accounting for income tax models?

A: The IASB and FASB models for income taxes are similar and were introduced around the same time. We believe the concerns and opportunities for improvement largely apply to both standards. Both boards have indicated that a comprehensive review would eventually be undertaken. We encourage the boards to include this on their agendas and co-ordinate their review processes, with the ultimate objective of achieving comparable income tax accounting standards.

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