FEEDBACK REPORT ON THE EUROPEAN OUTREACH EVENT ON EFRAG PROACTIVE DISCUSSION PAPERS

EFRAG

UK ACCOUNTING STANDARD BOARD

OIC – ORGANISMO ITALIANO DI CONTABILITA’

AFRAC

18 APRIL 2012
Table of contents

Panel ....................................................................................................................................................... 1
Executive summary .................................................................................................................................. 1
Opening and Introduction .......................................................................................................................... 4
Proactive activities .................................................................................................................................... 4
BCUCC ....................................................................................................................................................... 4
Income tax .................................................................................................................................................. 10
Closing ...................................................................................................................................................... 14

DISCLAIMER

This feedback report has been prepared by EFRAG secretariat for the convenience of European constituents. The content of this report has not been subject to review or discussion by the EFRAG Technical Expert Group although it has been jointly approved for publication by representatives of EFRAG, the UK ASB, the AFRAC and the OIC attending the event.
Panel

- Prof. Alfred Wagenhofer – Chairman of the AFRAC IFRS Working Group
- Gerhard Prachner – PwC Austria and AFRAC moderator
- Mario Abela – EFRAG Research Director
- Andrew Lennard – UK ASB Director of Research
- Tommaso Fabi – OIC Technical Director
- Giorgio Alessio Acunzo – EFRAG Project Manager
- Katharina van Bakel-Auer - AFRAC General Secretary
- Leonardo Piombino (Observer) – IASB staff

Executive summary

Objective

In October 2011 and in December 2011 EFRAG issued two Discussion Papers; ‘Accounting for Business Combinations under Common Control’ and ‘Improving the Financial Reporting of Income Tax’. These publications have been issued together with the Italian standard setter Organismo Italiano di Contabilità (OIC) and the UK Accounting Standards Board (ASB) respectively.

The Discussion Paper on accounting for Business Combinations under Common Control represents a first step in responding to the diversity that exists in practice. It initially aims to set out the arguments and provide analysis to stimulate discussion and debate, and therefore includes a comprehensive analysis of the issues drawing on the relevant IFRS literature. In addition, it notes that there is no 'ideal' approach, but draws out three different views of looking at the problem, highlighting some of the strengths and weaknesses of each.

The Discussion Paper on Income Tax represents the first step to gain input on whether IAS 12 should be improved or whether there should be a fundamental rethinking and a new approach to be pursued. Several commentators argued that IAS 12 is a difficult standard to
Improving the Financial Reporting of Income Taxes

EFRAG together with National Standard Setter is engaged in organising outreach events to collect constituents’ views on the topics.

Next Step

understand and apply. Also, users do not find the information reported on to be useful. Income tax represents one of the most significant single costs to most businesses and the accounting for it remains relevant.

EFRAG and the National Standard Setters involved in these proactive projects are keen to gather views from constituents and obtain input in order to understand what practitioners and others think about the topics.

This feedback statement summarises the comments made at the outreach event held in Vienna on 18 March 2012 arranged in cooperation with the Austrian Financial Reporting and Auditing Committee (the AFRAC), the Beirat für Rechnungslegung und Abschlussprüfung.

It is expected that the input from this event (and similar events being held in other countries) will be beneficial to EFRAG, the National Standard Setters involved, and the future work of the IASB.

This feedback report is intended to be read together with EFRAG’s Discussion Papers, which details the arguments discussed at these outreach events.

EFRAG is expecting to receive comments from constituents on the Discussion Papers. The comment period on accounting for Business Combination under Common Control closed on 30 April 2012, and comments on Improving the Financial Reporting of Income Taxes are requested until 29 June 2012. Comments should be submitted to: commentletters@efrag.org

EFRAG has deliberately not taken a position in either Discussion Paper. Given the objective of both Discussion Papers, EFRAG has attempted to provide a comprehensive analysis of the issues and the clear intention is for constituents to consider the arguments set out and provide their views. The nature of comments received will form the basis for EFRAG’s re-deliberation of the issues that fall in the scope of the project. It will be at that stage that a decision will be taken about what further steps to take before putting forward views to the IASB.

It is important to set these projects within the broader context of EFRAG’s proactive work. EFRAG aims to influence future standard-setting developments by engaging with European constituents and providing timely and effective input to early phases of the IASB’s work. This proactive work is done in partnership with National Standard Setters in Europe to ensure resources are used efficiently and to promote stronger coordination at a European level. There are
EFRAG proactive activities

four strategic aims that underpin proactive work:

- Engaging with European constituents to ensure we understand their issues and how financial reporting affects them;
- Influencing the development of global financial reporting standards;
- Providing thought leadership in developing the principles and practices that underpin financial reporting; and
- Promoting solutions that improve the quality of information, are practical, and enhance transparency and accountability.

More detailed information about our proactive work and current projects is available on EFRAG’s website (www.efrag.org).

Methodology

The outreach event was conducted by presenting the main topics analysed within the Discussion Papers to the audience made up of preparers, users, practitioners, and regulators.

Participants were requested to express their views in response to the questions included in the Discussion Papers.

EFRAG’s secretariat prepared this feedback statement for release on EFRAG’s website.

Level of participation

The tables below show the number of participants by nature and by industry:

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Opening and Introduction

The Chairman of the AFRAC IFRS working group (the AFRAC representative) welcomed participants and introduced the agenda. He stressed the importance of the topics dealt within EFRAG’s Discussion Papers and the relevance of these European outreach events in the context of influencing the future IASB agenda.

Proactive activities

The EFRAG Research Director welcomed participants at the event and emphasised the importance of gathering views from European constituents and their comment letters in reply to the Discussion Papers. He introduced the role of EFRAG in developing proactive activities in order to influence the shaping of the future of accounting on behalf of the European Area. In addition, the EFRAG Research Director provided participants with a brief summary of current proactive projects. He underlined that these projects are aimed at addressing perceived issues where there is a void in IFRS literature by promoting the voice of European constituents.

BCUCC

The OIC Technical Director provided a summary of the project background on accounting for Business Combinations under Common Control. He introduced the debate which had been opened earlier in Italy given the specificity of Italian listed companies’ group structure. He emphasised that in pyramid structures, where the ultimate parent company is not the listed company, transactions occur outside the consolidation area quite often – even if still within the group headed by the ultimate parent company. Therefore, in the absence of technical guidance on the accounting for similar transactions (currently scoped out of IFRS 3 Business Combinations) it was decided to set up the project to address such issues in order to convince the IASB to remove differences in practice. In addition, he noted that in Italy it had been decided to apply IFRS in individual annual accounts as well, and therefore the issue on BCUCC was perceived to have multiple and significant effects on both consolidated and separate financial statements of listed companies. He stressed the importance of the project as he believed that the choice among different possible accounting treatments could have resulted in changing preparers’ economic
The separate financial statements issue has been put aside waiting for a better understanding of what is a separate financial statements. Applying the IAS 8 hierarchy is the methodology followed in the analysis.

Three different views stemmed from the IAS 8 compliant analysis.

The separate financial statements issue has been put aside waiting for a better understanding of what is a separate financial statements. Applying the IAS 8 hierarchy is the methodology followed in the analysis. Three different views stemmed from the IAS 8 compliant analysis. The EFRAG Research Director continued illustrating (through an illustrative example) what the common structure of a BCUCC transaction is. He also presented the approach which had been followed by the working group. In details, he highlighted that it had been decided to borrow the application of the hierarchy set in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors from the existing IFRS guidance applicable to preparers. Accordingly, the working group analysed the existing worldwide literature on the topic and discovered that only in the US, in Canada, and in the UK a specific guidance had been developed on accounting for BCUCC. In addition, the working group had explored users’ needs in terms of relevant financial information. The analysis carried out introduced three different views. View 1 summarised the arguments of those who believed that the requirements in IFRS 3 always apply to business combinations even if they occur between entities under common control. Conversely, those who support view 2 argued that IFRS 3 never applies given the unique features of such transactions which are not market driven and usually carried out only to achieve reorganizational benefits; therefore no purchase accounting should be applied as no analogy occurs. Finally, view 3 sets itself in the middle of the previous ones and leads to an analysis of each individual transaction to assess what the most appropriate treatment for the specific transaction based on specific facts and circumstances is. The EFRAG Research Director presented the case when two entities merge and both have positive prospects in future cash flows; under such (and similar) circumstances, applying IFRS 3 would lead to a burdensome accounting treatment without any specific benefits for users. On the contrary, in a situation when the same merger occurs between two entities different in terms of future cash flows (e.g., one is a loss making entity while the other one is profitable), some argued that applying IFRS 3 would best represent the financial situation of the entity that resulted from the merger on behalf of creditors, lenders, and other stakeholders.
IFRS 3 tentatively is the favourite approach, clear anti-abuse guidance should be provided in circumstances when the predecessor basis of accounting must be used.

The AFRAC moderator opened the debate in order to gather views from the participants at the event on the presentation so far made.

A member of AFRAC shared the summary of the tentative conclusions reached at AFRAC level which will be included in their comment letter in reply to the Discussion Paper. He noted that usually such transactions are tax driven, and he therefore believed that in similar circumstances – if there’s a lack of economic substance – the predecessor basis of accounting would result in relevant information for users.

The AFRAC moderator asked whether a specific discussion had been held about the predecessor basis of accounting given that in Austria, under local GAAP, this was the required guidance to account for BCUCC in separate financial statements.

A member of AFRAC replied that the discussion had encompassed all relevant arguments and had come to the tentative conclusion that the majority of the AFRAC working group would have: (i) supported the application of IFRS 3 as general principle; (ii) required a clear set of rules and drivers to draw a bright line on when the predecessor basis of accounting would be permitted; and (iii) welcomed the application of IAS 24 to derive guidance on disclosure.

The OIC Technical Director asked whether the predecessor basis of accounting applies in Austria.

A user with an auditing background explained that in circumstances when the consideration is settled by the new issuance of shares, the predecessor basis of accounting applies; on the contrary, when the consideration is paid in cash, acquisition accounting should be applied.

The EFRAG Research Director noted that usually indicators and rules are difficult to reconcile with a principles based approached to accounting standards. Furthermore, he pointed out that it was also decided that the way the transaction price was paid would have no influence on the accounting treatment. The project had come to the conclusion that on a conceptual basis the substance of a BCUCC transaction should not be influenced by how it is put into practice from an administrative point of view.

A preparer struggled in drawing a bright line between view 3 and IFRS 3 and asked for some additional explanation thereof. He highlighted that BCUCC transactions are currently scoped out of IFRS 3 and therefore preparers could develop their own guidance while, view 3 mainly requires evaluating which accounting treatment best depicts the economics of the
Do we need a new standard or IFRS 3 could be improved?

Should the economic substance a relevant indicator to be further investigated?

Should minorities be considered

transaction between predecessor accounting and acquisition accounting.

The EFRAG Research Director explained that in applying the hierarchy set in IAS 8 existing preparers would have been brought to apply IFRS 3 with all the difficulties stemming from the absence of market based values. Conversely, implementing view 3 would imply the application of IFRS 3, unless the entity could prove that no stakeholders (e.g. creditors, investors) were affected by the BCUCC transaction.

Another preparer expressed his view that judgment in applying view 3 as well could be reduced to the extent that bright rules are defined. He supported the inclusion of other creditors as one relevant indicator to consider. However, he wondered whether the tentative guidance would be part of the existing IFRS 3, or whether a separate standard should be developed thereon.

The EFRAG Research Director expressed his opinion that a specific standard could be developed according to the Canadian experience; however, he recognised that it will be up to the IASB to decide on scope and how to take the project forward.

The AFRAC representative questioned whether focusing on the economic substance of the operation may further enhance the analysis.

The EFRAG Research Director doubted whether applying the economic substance concept alone would have provided any enhanced guidance, as it is an undefined concept; however, he would otherwise be in favour of applying the materiality concept in evaluating, for instance, how cash flows are affected and how the fundamentals of the entity are transformed due to the BCUCC transaction.

The AFRAC representative expressed his view that the substance over form criteria should be further investigated. The EFRAG Research Director agreed.

The OIC Technical Director pointed out that the Discussion Paper investigated how BCUCC transactions affect the claim that creditors and investors have in terms of changes of the amount, the timing, and the uncertainty of future cash flows. Once cash flows are significantly affected by the BCUCC transactions, it is presumed within view 3 of the Discussion Paper that both creditors and investors are willing to evaluate the corresponding effect on financial statements, and therefore purchase method accounting responds best to such needs.

The AFRAC moderator expressed his view that also minorities could be one possible (among a set of) key indicator(s) in
among the relevant indicators to choose the accounting treatment?

Do the phenomena of BCUCC interact with the application of the control model in IFRS 10?

Should the related parties issue be included in the debate? What is the difference between selling an asset between related parties under common control and selling a business in the same conditions?

choosing the adequate accounting treatment.

The EFRAG Research Director agreed that minorities represent a relevant factor and cited the example of the UK standard (FRS 6); however, he pointed out that in preparing the Discussion Paper it has been tentatively agreed that minorities represent only one category of stakeholders involved and therefore – in order to explore the issue from all the angles – all other parties involved needed to be considered.

A user with an auditing background (looking at the diagram which has been presented at the event) questioned whether the occurrence of a BCUCC transaction within a group where the parties involved only receive instructions from the ultimate parent company would provide evidence of the lack of control. He wondered whether such analysis may have any effect on the application of other relevant standards.

The AFRAC representative stressed the importance of the distinction made in the Discussion Paper among the transfer of a business and a contribution from the parent company. However, he wondered how such distinction could affect the asset transactions within a group. In other words, he pointed out that transactions scoped in IFRS 3 are usually accounted for using fair value, while transactions between related parties usually are not priced using fair values. He believed that the analysis should be widened in order to investigate whether differences exist between transactions among parties under common control having different objects (e.g., an asset or a business) and transactions between related parties under common control.

The EFRAG Research Director explained that, in practice, different views also exist on the accounting for asset transactions between related parties under common control. For the purpose, he presented a fact pattern when an entity sells an asset for 1CU to another entity within the group and both entities are under common control of an ultimate parent company. In such circumstance, he emphasised that some believed that the transaction should have been accounted for 1CU providing also the disclosures according to IAS 24, while others argued that the asset should be recognised at its fair value and the difference from the transaction price should be accounted for as a contribution from the parent company within equity.

The OIC Technical Director pointed out the importance of the distinction between contributions/distributions and ordinary transactions, and also stressed the importance of the joint proactive project on separate financial statements, as it might be helpful in developing further guidance to address such issues.
arising from transactions between related parties. He presented a fact pattern when an asset is contributed at a nil value between related parties, questioning what the proper accounting treatment might be.

The AFRAC representative wondered whether the core issue would be the accounting for transactions between related parties rather than the accounting for BCUCC.

The EFRAG Research Director appreciated the comment; however, he pointed out that the scope within the IASB agenda was currently only focused on BCUCC.

The AFRAC moderator expressed his view on fresh start accounting given as an opportunity together with the predecessor basis of accounting within view 2; in particular, he felt it was not compliant with the Framework.

The EFRAG Research Director noted that the Framework does not deal with measurement issues. Fresh start accounting had been discussed by the IASB in developing IFRS 3 and it was concluded that, in situations, when an acquirer cannot be identified, it may represent the best accounting treatment to depict the economics of the transaction. He pointed out that within BCUCC transactions such situations may often occur and he presented an illustrative example: when twenty different entities in a group carved out a part of their business in order to contribute them into a new entity, he questioned whether the new entity could be deemed to be the acquirer.

The UK ASB Director of Research added that the rationale for applying purchase accounting in an acquisition is to fairly represent the cash flows of the business purchased which will be added to the book value of the assets and liabilities of the acquirer, and, conversely, continue to represent the history of the entity. He noted that in a merger between equals there is no need to depict the history of the companies which take part in the business combination, and therefore the only useful information to provide refers to updated forecasts on combined future cash flows. Finally, he noted that applying fresh start accounting is significantly expensive as it requires assessing fair values for all the assets and the liabilities included in the book of the company arising from the merger.

A member of AFRAC expressed his view in support of including the related parties’ topic into the scope of analysis. He also believed that there might be the opportunity to call a fair value measurement of all transactions occurring between related parties.
Income tax

The UK ASB Director of Research introduced the Discussion Paper on the improvement of the accounting for income tax and gave some information on the background and the setup of the project. He reminded that it is often said that users of financial statements do not find information produced in accordance with IAS 12 Income Taxes useful. Accordingly, the working group had identified two different strategies that could be adopted to address deficiencies in IAS 12 Income taxes. The first one was aimed at removing perceived inconsistencies and issues through a number of limited amendments to IAS 12. The second one stemmed from the idea that it would have been more beneficial to re-write and develop a new standard on accounting for income tax. The Discussion Paper had been prepared accordingly; in Part 1, the issues arising in the application of IAS12 are reviewed, and possible amendments that might address them are discussed. In Part 2, the principles of tax accounting and a number of alternative approaches, based on different concepts, are reviewed and presented together with their respective main pros and cons.

The AFRAC moderator requested participants at the event to express their views on the Discussion Paper. He supported the discussion and welcomed it - as AFRAC had already set it into the agenda of the IFRS working group but without final results so far.

A preparer noted that he was satisfied with the current standard as, after having matured experience on how to apply IAS 12, it has become easily applicable. He believed that the request for enhanced clarity would have been achieved through a better disclosure and providing accurate narrative on the most significant transactions having tax effects.

Another preparer admitted that training was needed once the standard was implemented, but he also supported the view that IAS 12 – as it currently is – is understood by preparers who are also familiar with the way its mechanics apply. He believed that disclosure may represent the key to further enhance the understandability of tax within the financial statements on users’ behalf.

A user with an auditing background noted that he had collected preparers’ views on the difficulties preparers and users have in understanding the tax figures within the profit and loss accounts. He also supported the enhancement of disclosure on tax matters.
Too many disclosures clutter users

The exceptions within the IAS 12 reduce comparability and affect understandability

Tax reconciliation could be used as a summary of relevant information

Will only additional disclosure remove all the perceived inconsistencies?

but believed that providing too many disclosure would clutter users; however, he thought it would be more beneficial to focus detailed disclosure only on significant tax issues and clarify (in an international context for instance) how different tax regimes impact the group's tax position.

A preparer supported the analysis carried out in the paper and agreed that, whatever approach was pursued to account for income taxes, the exceptions currently included in IAS 12 should be removed. He argued that he had always struggled in accepting the initial recognition exception related to fixed assets and the prohibition in grossing up the goodwill to recognise the corresponding tax impact. In addition, he noted that he perceived an inconsistency in recognising deferred tax assets as he preferred to fully recognise the deferred tax asset once the trigger event occurs, and subsequently recognise an impairment allowance once events cast its recoverability. He believed that recognising the deferred tax asset only to the extent it was recoverable represented an inconsistency of the temporary difference approach.

A preparer supported EFRAG’s proposal to provide enhanced information on tax reconciliations; however, he believed that entities should also disclose information related to the reconciliation between taxes paid and tax expense recognised in the profit and loss account. In addition, he expressed his view that the information provided on uncertain tax positions is not readily understandable to users. Moreover, he noted that all the proposals included in Part 1 of the Discussion Paper implied an extension of disclosures and he was not confident that all perceived problems would have been resolved only by providing more disclosures.

The EFRAG Research Director observed that, after having reviewed a number of major publications on users’ needs, the working group had come to the conclusion that the tax reconciliation table presented in the Discussion Paper would have represented an effective starting point providing a summary of all major events affecting the tax position of the entity. He further noted that including disclosure related to the entity’s general tax strategy may improve the understandability of the notes which would then provide detailed information on facts and events reflected in the numbers within the financial statements.

A user with an auditing background supported EFRAG’s proposal to improve the tax reconciliation and, at the same time, reducing other non significant disclosure.
Guidance should be welcomed by preparers.

Consolidation procedures bring to fiction numbers, enhanced disclosure should be provided at a disaggregated level to understand phenomena at a jurisdiction level.

Discounting is not perceived as a top ranked issue ......

...... but it may help in removing some perceived inconsistencies within IAS 12.

Two preparers noted that - during the shareholders’ meeting - investors frequently asked questions on matters which, in the entity’s prospective, had been clearly and properly disclosed in the notes. They expressed their view that the information currently provided, even if deemed sufficient, was not able to satisfy users’ needs.

The AFRAC moderator questioned whether the proposed changes on uncertain tax position were promoted only for convergence reasons.

The UK ASB Director of Research thought that convergence had played a role somehow; however, he reported that also the US GAAP guidance had been perceived as ineffective, as it involved difficult calculations preparers were struggling with.

The AFRAC moderator also noted that, when he discussed the US requirements in terms of additional disclosure on tax strategies with local preparers, the majority of them believed it could have been read as a self-accusation towards the Tax Authority. The participants at the event unanimously supported such fear.

The AFRAC representative expressed his view that users could not understand the disclosure provided in the notes, amongst other reasons because they relate to numbers which have been aggregated while the information provided instead refers to something which has happened in a single jurisdiction and whose effect has disappeared in the consolidation procedure.

The EFRAG Research Director agreed with that view because the group as a single entity does not pay taxes. The aggregated number in the financial statements represents a pure accounting figure and does not represent an amount paid by a ‘taxpayer’. Therefore, he believed that information should have been provided on a more disaggregated basis.

The AFRAC moderator asked participants at the event to express their view on discounting deferred tax. He acknowledged that in Austria such topic was not perceived as an issue as on balance entities had recognised deferred tax assets on losses carried forward.

A user with an auditing background added that most of the liabilities had been recognised under push down accounting.

A preparer noted that in business combinations the price is to be allocated considering the discounted values of both assets and liabilities, while the corresponding deferred tax effect should be recognised entirely on a nominal basis. He also noted that discounting could have been considered in abandoning the initial
Interest and penalties on tax should be considered within the scope of the paper.

IAS 12 should be maintained.

recognition exception, whereas the grossing up would have been minimised by using discounted values. On balance, he supported the harmonisation of principles on recognition and measurement of deferred tax with other assets and liabilities.

The UK ASB Director of Research believed that the relevance of the application of the initial recognition exception varied according to countries and industries.

The AFRAC moderator questioned whether it would be achievable to identify a single standard which encompassed all applicable peculiarities in different tax regimes and jurisdictions; accordingly, a possibility would have been to focus the analysis on the major ten ones and, accordingly, define a single standard.

A preparer believed the analysis within the Discussion Paper should also encompass interest accrued on tax positions and related penalties. He believed that such a topic was strictly related to the concept of discounting.

A user with an auditing background believed that the perceived issue related to the initial recognition also applied in the recognition of a financial lease. He noted that some of his clients recognised deferred taxes if such leases qualified as operating under fiscal purposes and others applied the initial recognition exception in similar circumstances.

The AFRAC moderator asked participants at the event to express their view on the different approaches presented in Part 2 of the Discussion Paper.

A member of AFRAC with an auditing background questioned whether the accrual approach presented was consistent with the definition of assets and liabilities within the Framework.

The UK ASB Director of Research believed that defining the occurrence of the underlying transaction as trigger event for the recognition of the deferred taxes might represent a more robust recognition principle, and would obtain favour of those who argued that under the temporary different approach assets and liabilities were recognised mechanically on the difference between the tax value and the book value of the underlying asset.

The EFRAG Research Director explained that, when applying the temporary difference approach, preparers presume that they will entirely recover the asset at the balance sheet date to be permitted to recognise the deferred tax liability. Without such assumption no liability could have been recognised. This has been the reason to investigate an income statement approach.
rather then re written

which would have been consistent with the previous FAS 109.

The preparers at the event unanimously believed that the current approach within IAS 12 was effective as well, because it had permitted to set up database to work with the accounting for temporary differences. Therefore, instead of changing the overall approach, an effort should be made to remove the perceived inconsistency and the issue within it.

The AFRAC moderator summarised the views expressed at the event which supported the current IAS 12; however, it has been unanimously agreed upon to consider a way to remove the exceptions currently in the standard, as they impair understandability and reduce comparability. In addition, improvements have been welcomed on disclosure even if participants doubted a solution could be found to uniform specificities arising from different jurisdictions and industries and to define a single set of consistent disclosure to fairly represent different regimes.

**Closing**

After having asked participants at the event for additional comments the Chairman of the AFRAC IFRS working group closed the event.