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

EFRAG

UK ACCOUNTING STANDARD BOARD

OIC – ORGANISMO ITALIANO DI CONTABILITA’

PASC - POLISH ACCOUNTING STANDARDS COMMITTEE

15 MAY 2012
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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 PASC and the OIC attending the event.
Panel

- Joanna Dadacz – Chairman of the Polish ASC
- Sigvard Heurlin – EFRAG Senior Manager
- Andrew Lennard – UK ASB Director of Research
- Alessandro Sura – OIC Director of Research
- Prof. Gertruda Świderska – Polish ASC
- Prof. Radosław Ignatowski – Polish ASC
- PhD Wojciech Więcław – Warsaw School of Economics
- Giorgio Alessio Acunzo – EFRAG Project Manager

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 Contabilita (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 includes a comprehensive analysis of the issues drawing on the relevant IFRS literature. In addition, it notes that there is no ‘ideal’ approach to Business Combinations under Common Control 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 on income tax accounting should be pursued. Several commentators argued that IAS 12 is a difficult standard to understand and apply. Also, users do not find the information reported on income taxes to be useful.
Reporting of Income Taxes

Income tax represents one of the most significant single costs to most businesses and so the accounting for it is important.

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 Warsaw on 15 May 2012 arranged in cooperation with the Polish Accounting Standard Committee (the PASC), the Komitet Standardów Rachunkowości. The event has also been co-organised with the Accountants Association in Poland (SKwP) and the National Chamber of Statutory Auditors (KiBR).

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 also hoping 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

Next Step

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. At that stage a decision will be taken about what further steps to take which may include 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 four strategic aims that underpin proactive work:

EFRAG proactive activities
• 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, academics, members of the National Standard Setter and regulators.

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

The EFRAG 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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<th>Nature</th>
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Opening and Introduction

The Chairman of the Polish Accounting Standard Committee (the PASC representative) welcomed participants and introduced the agenda. She stressed the importance of the topics dealt with in the EFRAG Discussion Papers and the relevance of these European outreach events in the context of influencing the future IASB agenda.

Proactive activities

The EFRAG Senior Manager welcomed the participants at the event and emphasised the importance of gathering views from European constituents and their comment letters in response 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 Senior Manager 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.

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 recalled 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 the standard. The first one was aimed at improving IAS 12 through a number of limited amendments. One such change that was discussed in the paper, was to enhance the presentation and disclosure requirements by improving the tax rate reconciliation to provide more transparent information (e.g. by segregating current income tax effects and deferred income tax effects). In addition, he noted that recognition and measurement could be improved by (a) Introducing discounting of deferred taxes, which would reflect the time value of money (and make the liability smaller); and (b) revisiting the issue of uncertain tax positions.

The second strategy reflected the idea that it would be 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 IAS 12 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. In more detail:

a) Under the temporary difference approach (the current approach in IAS 12), the effect of all differences between the carrying amount for financial reporting purposes of an asset (or liability) and its tax basis is recognised. If the carrying amount of an asset (liability) is more (less) than its tax basis, there is a tax liability and a tax asset if the carrying amount of an asset (liability) is less (more) than its tax basis;

b) Under the flow through approach, the tax expense reported for a period is simply the tax assessed on the income of that period as the tax expense. No deferred tax is recognised;

c) Under the valuation adjustment approach, timing differences do not give rise to deferred tax assets and liabilities, but affect the amount of assets and liabilities, which should be adjusted accordingly. Assets are seen as having two components: the service potential and tax benefits. As the tax benefits are received, the asset is written down;

d) Under the partial allocation approach, the effect of timing differences is recognised only to the extent to which they are expected to lead to future cash flows; and

e) Under the accruals approach, the reported tax expense reflects the tax effect of all transactions and events that are reported in the period. No formal distinction between current and deferred tax is made. The tax effects are allocated to the relevant period.

Prof. Gertruda Świderska (member of the PASC) and Mr Wojciech Więcław requested participants at the event to express their views on the Discussion Paper.

Before requesting participants to provide their views, Mr Więcław showed a short presentation including his personal views on the topic. On the proposal to introduce discounting in income taxes’ accounting, he believed that tax strategies are naturally based on applying tax opportunities to shift taxable profit or deductible costs in order to minimise or avoid the arising of tax liabilities. Accordingly, by denying the application of discounting in the tax
Introducing discounting may enhance the understandability of tax strategies.

The initial recognition exception should be removed as reduces the reliability of financial information.

The investments’ exception permits not to recognise significant liabilities.

Deferred tax asset should be recognised entirely and measured at their recoverable amount in order to reduce subjectivity.

The distinction between long and short term assets and liabilities is strictly related to the entity’s strategies in terms of their recoverability and settlement.

Investment tax relief should be further investigated in the DP accounting it would imply hiding entities’ tax strategy in reversing the temporary differences stemming from assets and liabilities.

Uncertain tax positions are a common issue companies are struggling with, and requiring enhanced disclosure on such a situation is right. However he believed that the DP has not tackled some issue which remain relevant.

He believed that in circumstances where temporary differences arise from transactions which are encompassed within the initial recognition exception, no tax liability is recognized and hence a misleading impact on income and therefore on the reported performance.

The exception currently in IAS 12 on the purchase of investments in subsidiaries and joint ventures is in his view another flaw of the standard as he believed that currently entities are not recognizing significant deferred tax liabilities.

He also expressed concern on the recognition criteria currently applied within IAS 12. He believed that a better representation could be depicted by recognizing the full amount of the deferred tax asset, therefore accounting for an impairment provision to measure it at its recoverable amount. He believed that such impairment evaluation should be made both at individual and at a consolidated level and he believed that numbers could significantly be affected by such tests.

Another issue is the presentation of tax asset and liabilities only as long term assets and liabilities. He struggled with understanding the reason why the IASB had chosen such requirements. He believed that the analysis of the timing of the reversal of temporary differences is almost unavoidable and therefore it should result quite easily and in a straightforward manner, as to not split amounts between long and short term. For comparison purposes, it would be preferable to have all assets and liabilities classified between the short and the long term categories instead of having such an exception on deferred tax assets and liabilities.

In addition, he pointed out that investment tax relief is a topic currently scoped out from IAS 12 and IAS 20, while he believed it to be a relevant phenomenon in Poland.

In summary, he supported the improvement of IAS 12 in respect of the matter highlighted above instead of throwing the entire standard away.

An academic noted that the debate fundamentally began in UK where the discussion on whether considering the temporary differences in accounting for income tax instead of developing an accounting for each temporary differences led to the choice of a
The 2009 ED should be considered in developing such analysis.

Simplicity in applying a standard represents a valuable and distinguishing feature which could lead to accepting some compromise in order to reduce the cost of financial information.

Improving disclosure of uncertain tax position should be an objective to reach without creating exposure for reporting entities.

Complexity is never to be introduced in accounting as it confuses users of financial statements.

The 2009 ED should be considered in developing such analysis. She believed that, in order to shape the future of tax accounting, the research should also consider which tentative solutions had been included in the 2009 exposure draft, even if the project had been dismissed.

An auditor did not support the potential departure from IAS 12 and believed that the simplicity in applying IAS 12 is a valuable characteristic in accounting which should always be considered. In addition, he believed that any alternative solution which would significantly increase the workload of constituents would be detrimental in terms of cost of financial information. He believed that the same arguments should be used to provide an answer both to the discounting topic and to the issue related to the distinguishing deferred tax assets and liabilities among short and long term. He expressed his feeling that complexity is never to be introduced in accounting and presented the fact pattern of discounting a deferred tax liability which has been determined on an asset whose carrying amount already includes a discounting factor. He supported such simplifications because they were easier and cheaper to achieve without increasing the work to be done to produce such financial information. Within the proposals so far presented, he would support those related to enhancing the disclosure on the effective tax rate as it would help users to understand how (from the reported profit) it is possible to reconcile the current tax expense on which permanent and temporary tax differences have an impact.

An academic believed that one of the topics where improvement was needed was the quality of the disclosure on tax uncertainties. She believed that such enhanced disclosure would have provided more useful information to assess the strategy on taxes. In addition, she believed that, in many jurisdictions, such disclosure would have provided more useful information on the stability of tax system.

A preparer fully supported the view already expressed by the auditor referred to above. She believed that all the suggested enhancements could be implemented even if she doubted that users would therefore be able to read the information thereon. She presented her view that users read charts, financial tables, and reconciliations. She therefore wondered whether, if that is the users’ needs, the introduction of such new requirement would actually improve financial reporting. She believed that no further complexity should be introduced in financial reporting.

An academic presented some conclusion from a research she had conducted on disclosure of tax matters applying IAS 12. She expressed her view that currently the quality of disclosure is really
An academic research found out that disclosure on income taxes is poor.

Complexity does not mean impracticable; current IFRS literature is full of complex requirements which have been accepted as they improve the relevance of financial information.

Poor, even if IAS 12 already contains guidance on providing disclosure on income taxes. She believed that the weakest areas of income tax disclosure are those on tax risks and uncertain tax positions. On uncertain tax position, she believed that the reason why the attempt of the IASB to improve IAS 12 had failed is because entities would never be willing to disclose – for instance – that they have not taxed revenues or, generally, they had avoided taxation in some way as it would mean providing to tax authorities some kind of self accusation which would have facilitated the set up of tax inspections. On the discounting topic she believed that formulating an expectation on the reversal of tax differences is sometimes harsh to estimate and, accordingly, the same difficulties would arise in dividing tax assets and liabilities between short and long term. Overall, she believed that the same kind of simplification should always be introduced in order to balance the cost and the benefit deriving from financial information. However, she did not support those who were against the introduction of such enhanced requirements basing their view on the complexity of applying discounting, dividing between short and long term. She believed that in the current IFRSs’ literature complexity existed on consolidation and on financial instruments, but nobody had refused to apply the corresponding standard.

The UK ASB Director of Research considered the view expressed and understood that the majority of participants would like to retain IAS 12 as it is a standard constitutes were already familiar with. In addition, he had the impression that participants at the event generally supported the enhanced disclosure on the reconciliation of tax rate.

Business combinations under common control (BCUCC)

The OIC Director of Research provided a summary of the project background on accounting for BCUCC. 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 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 behaviour and influencing the occurrence of such transactions under common control. He pointed out that accounting for BCUCC in separate financial statements had been scoped out from the Discussion Paper, but he would welcome views on this decision from participants at the event. He noted that scoping out the issues related to separate financial statements from the project stemmed from the existing doubts on the role of separate financial statements in financial reporting.

The EFRAG Senior Manager continued illustrating (through an example) what a common structure of a BCUCC transaction considered in the Discussion Paper looks like. He also presented the approach which had been followed in the development of the Discussion Paper. He highlighted that it had been decided to apply the hierarchy set in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors, which is the existing IFRS guidance applicable to preparers in the absence of an applicable IFRS. 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 to IFRS 3 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 is the most appropriate treatment for the specific transaction based on relevant facts and circumstances.

Prof. Radosław Ignatowski opened the debate in order to gather views from the participants at the event on the presentation held so far. He underlined that the Polish ASC had some discussions about the BCUCC, but it had no final position on this issue, and therefore the EFRAG discussion paper was much appreciated. He expressed his personal concerns on the possibility to derive a single model which would be applied to all different cases and circumstances that occur in practice. With particular reference to the possible application of fresh start accounting included in
BCUCC encompasses several different typologies of transactions and the project of deriving a single accounting treatment could be unfeasible.

All kinds of transactions between entities under common control should be scoped in.

Control should be seen as a strong indicator to decide among the available accounting options.

The absence of an active market.

View 2, he wondered on how to apply such accounting in particular circumstances – for instance, when two entities within the same group merge only for group restructuring purposes. In his view if IFRS 3 did not allow the fresh start method, there would be no convincing reasons to apply this method to BCUCC. He believed that in similar circumstances revaluation of historical values could not apply. In addition, he stated that he would like to gather views on whether Polish accounting law should be applied instead of the IAS 8 hierarchy in the absence of IFRSs’ literature. He favoured the proposed starting point in the EFRAG discussion paper; which is the users’ needs.

An academic believed that Polish commercial law codes apply as the European legislation in the absence of specific guidance within IFRSs. In addition, he believed that it would be useful to explore the concept of control before trying to develop guidance on similar transactions. Moreover, he expressed his concern that the analysis had been restricted only to business combinations occurring between entities under common control while he would have welcomed a broader scope which would have encompassed all transactions between such entities. On the proposed alternative views he did not support the use of IFRS 3 in accounting for BCUCC. On the contrary, he believed that the way the BCUCC affects the strength of the existing control over the entities involved within the business combination should be seen as a driver to determine the corresponding accounting treatment.

Another academic (also a member of the Polish ASC and of the National Chamber of Statutory Auditors,) believed that the general recognition criteria set in the Framework could help in deciding the accounting treatment. Her arguments were based on the lack of a marked based transaction in the context of BCUCC, while transactions scoped in under IFRS 3 are featured by the existence of an acquirer and an acquiree which rely on the market to determine the fair value of assets and liabilities transferred, and accordingly determines the amount of consideration. As a consequence she would support an accounting treatment for BCUCC, which would imply the valuation at fair value of the net assets of the acquiree, in other words, the valuation at fair value of all assets and liabilities included in the books of the acquire. In substance, the recognition of any new intangibles and goodwill resulting from the BCUCC should be forbidden considering that the whole transaction is decided, planned, and executed by the same ultimate investor. There is a question whether the EFRAG Discussion Paper assumes that the underlying Conceptual Framework will not change – if there is no change in the asset
might lead to a choice of view 1, variant 3 – i.e. no recognition of new intangibles and goodwill

Current market practice should be considered

When fair values could be reliably estimated and the transaction has economic substance IFRS 3 should always be applied

One accounting method for all BCUCC, irrespective of the specific facts and circumstances, may not faithfully represent the transaction

recognition criteria, the IFRS 3 approach (with exemption of the recognition of goodwill and intangible assets) would be the most appropriate one.

An academic supported the fresh start accounting without recognising goodwill.

A preparer explained that she had, in recent years, experienced six business combinations which were undertaken under common control. She believed that standard setters - in approaching the relevant topic - should have to consider which the current market practice in accounting for BCUCC is. She believed IFRS 3 is currently used in the majority of circumstances, even if BCUCC is clearly scoped out of IFRS 3. Moreover, she expressed her view that, as long as it was feasible to identify a business substance within the transaction, IFRS 3 should apply as fair appraisals of the transferred net assets and the related consideration could be obtained from independent advisors. Therefore IFRS 3 should be used in such cases as it is per se a standard whose application could provide useful information on which to base users’ decisions.

Another preparer supported such a view because he believed that any solution would have to be identified within existing standards as it will not be possible to avoid financial engineering in order to structure several and different kinds of BCUCC.

An auditor supported the use of the pooling of interest method (identified within the paper as the predecessor basis of accounting) as he believed that BCUCC transactions significantly differ from those scoped in under IFRS 3 for the reason highlighted in the Discussion Paper. In addition, he believed that (in a group) the financial information should be relevant mainly at consolidation level, being the level where decisions are taken.

The EFRAG Senior Project Manager believed that many different typologies of transactions are encompassed in the business combinations under common control notion, and noted that arguments on how to identify users’ needs were discussed in the Discussion Paper. Therefore, identifying one unique accounting treatment for all BCUCC might be complex. In addition, replying to those who supported the use of local legislation in the absence of applicable IFRS he stated that entities applying IFRS should do that as required. Local legislation does not belong to the sources to consider when preparing consolidated financial statements under IFRS.

The OIC Director of Research appreciated those who favored the fresh accounting approach as he personally believed that in some
circumstances (e.g. creating a Newco and contributing a business in it) this approach might represent the accounting which best depicts the economics of the transactions. In addition in replying to those who favored the application of the concept of the economic substance, he underlined that it may be difficult as in current IFRS literature there is no unique definition of business substance and therefore reliance of this notion may lead to more differences in practice.

Closing

After noting that the participants at the event had no additional comments, the Chairman of the PASC closed the event.