



Association pour la participation des  
entreprises françaises à l'harmonisation  
comptable internationale



— AFEP —

ASSOCIATION FRANÇAISE DES ENTREPRISES PRIVÉES

EFRAG  
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Paris, 29 June, 2012

Re: *Discussion Paper “Improving the Financial Reporting of Income Tax”*

We welcome the opportunity to comment on the EFRAG/ASB discussion paper dealing with the Reporting of Income Tax (the DP).

### **General comments**

- We are aware that the financial reporting of income taxes is currently very complex and difficult to understand, both for external users and internal users who are not tax specialists. Such complexity seems to stem both from the complexity of the subject itself and from the complexity of a standard based on a principle (the basis for which is itself not obvious to all) which is burdened by many exceptions.
- We regret that the DP was not used as the vehicle for a deeper study of the problems of recognition and measurement. We think it would have been very useful, on the one hand, to confront this old standard with the definitions of assets and liabilities in the Conceptual Framework for Financial Reporting (the Framework) and some more recent standards, and on the other hand, to look for an accounting model which could improve the quality and usefulness of the information.
- Instead, the authors of the DP seem to have chosen to concentrate on additional information to be provided in the notes to the financial statements, a choice which we think was not appropriate for two reasons :
  - The information given in the notes should not be used to compensate for an unsuitable or flawed accounting model. It is important to try to develop as the priority the recognition and measurement model.
  - We think that the DP proposals are limited to identifying the need for additional disclosures compared to what is already provided today. This appears to be going against the current drive to rationalise and reduce the volume of disclosures.

In addition to these principal comments of a general nature, we provide responses to the detailed questions of the Invitation for comment in the appendix.

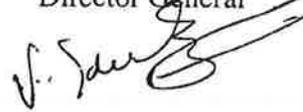
Should you require any further comments or explanations, please do not hesitate to contact us.

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## APPENDIX

### Answers to the specific questions raised in the invitation for comments

#### General

*Q0.1. Do you consider that there are deficiencies in IAS 12 that should be addressed? If so, should they be addressed through limited amendments to the standard or by developing a new standard based on different principles?*

It is difficult to reply to this question without having performed a thorough comparison with the potential alternative models.

As a general comment, it may be said that a standard which contains so many exceptions to general principles must be a weak standard. However, we are not sure that one can easily find a better set of principles for accounting for income taxes, and we note that our member-groups have come to terms with the current standard.

nonetheless, we think that the subject is so important that it deserves further research and proactive work in order to try to find a better model for the future.

We think that in order to make a judgement about whether the standard is still of satisfactory quality, it is necessary to answer the question of what the purpose of deferred taxes is, and then to ascertain the circumstances in which the current model gives an unnecessary result:

- Is the purpose to show the assets and liabilities on the balance sheet, that represent the future in- and outflows of cash? If so, one then has to verify that deferred tax assets and liabilities always satisfy the criteria for recognition ; or
- Is the objective to present a net result for the period which takes into account the full fiscal impacts of all the gains and losses of the period? If this is the case, it is perhaps less important to ensure that the assets and liabilities which are necessary to achieve this result fully satisfy the Framework's definitions.

Finally, the main areas we have identified which we think call for improvement are (i) the treatment of intra-group profits and (ii) deferred taxes on non-amortisable assets revalued in the context of a business combination.

*Q1.1 Under current IAS 12 a difference between the tax paid and the current tax expense reported in the income statement leads to misunderstandings of these relationships.*

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

We understand that the proposal is in essence to provide for current taxes a reconciliation of the opening and closing balance sheet amounts similar to those required for other balance sheet captions. This reconciliation would include as reconciling items the current tax charge and the cash payments made in the period in respect of taxes, distinguishing between settlement of previous periods' taxes and payments on account..

Some of our member-groups already provide such information and we do not think that it would be onerous to provide.

***Q1.2 Do you agree that additional more detailed disclosures regarding deferred tax assets, especially unused tax losses and unused tax credits are necessary and useful? (Paragraphs 1.23 to 1.24)***

We think that requiring such disclosure is tantamount to requiring entities to provide forecasts of future results. We do not think that this is appropriate as such information can greatly influence an entity's market values. Moreover, IAS 12 currently already requires disclosures about the amount and the expiry date of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised. In our view, such disclosures are sufficient and should not be supplemented.

***Q1.3 Do you agree with the identified users' information needs in Chapter 1 of Part 1? Do you have any suggestion for additional information requirements regarding reporting of income taxes? (Paragraphs 1.8 to 1.24)***

We do not think that the approach adopted in the DP is appropriate. As we have stated in our general comments, disclosures should not be used to compensate for unsuitable or flawed accounting models. Rather than looking for a "quick fix" involving more disclosure, we think that the priority should be given to developing an appropriate accounting model.

The DP appears to propose only additional disclosures, whereas in our view, it should take into account the current generally accepted view amongst preparers and many users that there is too much disclosure in IFRS, and that what is really needed is a rationalisation of what is required to ensure that only essential and useful information is imposed on entities.

***Q1.4 Do you agree that tax strategies to accommodate user information needs should be disclosed in the management commentary and not in the financial statements? Why or why not? (Paragraphs 1.8 to 1.9)***

We assume that the question is: Do you agree that, to accommodate the information needs of users, tax strategies should be disclosed, and that such disclosure should be made in the management commentary rather than the financial statements?

No, we disagree with the requirement to disclose tax strategies for two principle reasons: (i) it could be very onerous and (ii) the information is generally very sensitive.

To be useful such information needs to be reasonably detailed. International groups can operate in a large number of jurisdictions within each of which the fiscal strategy can be different and can evolve over time. A group can neither be certain that its strategy is fixed for the foreseeable future nor be certain of its appreciation of the tax environment in that jurisdiction. It is extremely difficult to summarise such information at the group level and a discussion of the strategy in each jurisdiction, even limiting this to the more material countries, would probably be onerous.

The disclosure of fiscal strategies can be a cause for concern about confidentiality in two ways. Firstly, the disclosure of a fiscal strategy can potentially lead to misunderstandings and difficulties with the authorities of the jurisdictions concerned. Secondly, such disclosure can result in information of a commercial nature, which would normally be kept confidential for obvious reasons, becoming more visible to competitors.

*Q1.5 The reconciliation of the actual tax charge to the charge on profit at the statutory tax rate (tax rate reconciliation) is quite complicated and leads to some misunderstandings.*

*Do you agree that the suggestions made in the paper are helpful by clarifying the explanation why the current tax charge is not equivalent to the standard rate of tax applied to the accounting profit? Why or why not? (Paragraphs 1.19 to 1.20 and 2.21 to 2.34)*

We agree that this reconciliation could probably be improved. However, we think that the combination of elements which are the most relevant within the reconciliation will vary significantly between entities, and that any guidance should consist of principles and the use of judgement rather than the requirement for a uniform reconciliation format.

While we agree with the categories of reconciling item, which are those that are generally already used by entities, we are not convinced that the layout of the proposed reconciliation table is completely logical. To give one example, while it may be useful to show the split between deferred tax elements and current tax elements, the proposed scheme shows the effect of foreign tax rates only as a deferred tax item, whereas one might expect this to affect current tax as well. This illustrates that any proposals should consist only of guidance and that entities are best-placed to make judgement about what best reflects their particular circumstances

Similarly, we do not agree with the 5% “rule” as proposed, as we think that, as with the issue of materiality in generally, this is a matter best left to the judgement of the entity. The guiding principle should be that the disaggregation of categories should highlight those material amounts and types of element in such a way as to help the user best understand the effects of tax on the income statement.

*Q1.6 The amounts currently disclosed provide limited information about future tax cash flows. How would you suggest the disclosures in IAS 12 be improved to provide better information about future cash flows? (Paragraphs 1.13 to 1.14 and 2.35 to 2.40)*

We do not think that a schedule of reversals of temporary differences helps to give a clear indication of future tax-related cash flows, as the latter are also affected by new temporary differences. It is more helpful to provide net reversals or originating differences.

One solution might be to provide information about the effective tax rate the entity expects to apply to the forecast results. This information is already provided by some entities. Furthermore, it would be useful to provide an “underlying” effective rate, free of any unusual or exceptional items.

*Q1.7 The possibility of discounting deferred tax balances is discussed in paragraphs 2.44 to 2.50. In your view, should discounting deferred tax amounts be required? Please explain.*

This is an important issue which merits more thorough examination as part of a comprehensive review of the topic, including the setting of the objective for deferred tax reporting. It will be important to address the question of the objective in order to understand and determine whether deferred tax assets and liabilities should or should not be discounted like all other long term items recognised in the Balance Sheet.

Pending completion of this review, we prefer to maintain the current provisions in IAS 12.

Furthermore, we note that discounting would require detailed scheduling of movements in temporary differences allocated to future periods, which is an onerous exercise requiring the extensive application of judgement. One must also deal with the difficult issue of the interaction between accounting book values which are stated at an amount which already reflects the effect of discounting (such as assets written down for impairment) and deferred tax provisions.

*Q1.8 Currently IAS 12 neither provides explicit guidance for accounting for uncertain tax positions nor contains any specific disclosure requirements regarding the tax risk position.*

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

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

In our view, the proposal to provide substantive information about uncertain tax positions could lead to a major problem for entities, insomuch as the information would be subjected to increased scrutiny from fiscal authorities with an increased risk of tax audits and penalties. Moreover, we note that for a risk to be judged necessary to be disclosed it would have to have a sufficiently high level of probability of occurring and its potential impact be judged material to the financial statements.

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

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

In our view, a risk of this nature should be dealt with within the scope of IAS 37. In this context, IAS 12 should, in our view, deal only with the current tax and deferred tax situations representing the items included in the entity's tax returns.

In applying IAS 37, it is of course necessary to apply the criteria for the recognition of a provision: the existence of an obligation from a past event at the balance sheet date, and the probable outflow of resources in settlement. The difficulty here is that of demonstrating the existence of an obligation. Uncertain tax positions are usually the result of a general risk that the fiscal authorities will interpret certain parts of the legislation differently from the entity's reading, rather than the result of a specific instance of an entity breaking a specific piece of legislation. This situation of uncertainty is more akin to other general risks the entity faces, such as commercial risks, and as such will usually not satisfy the conditions for recognition under IAS 37.

In respect of the likelihood of a tax review or audit taking place, we do not think that this element can be used to identify the existence of an obligation but it could be used in the assessment of the probability of the entity's having to use resources to settle the obligation.

We think that IAS 37 is the better standard to apply to uncertain tax situations as it will ensure consistency of treatment with other potential liabilities.

*Q1.9 Are there any issues with IAS 12, which are not addressed in Part 1, that would significantly improve the standard? What amendments would address these issues?*

See our answer to question Q0.1 where we call for improvement relating to (i) the treatment of intra-group profits and (ii) deferred taxes on non-amortisable assets revalued in the context of a business combination.

*Q1.10 What is your view on the exemptions that currently exist in IAS 12?*

We believe that all these exemptions are useful even though they might give the impression that the model is not robust enough. Perhaps it may be useful, in the analysis of alternative models, to identify those issues that require exceptions to be added (see our comparative analysis for two of the proposed models below)

*Q2.1 If the development of a new standard for income tax, based on different principles from those used in IAS 12 is to be considered, which of the approaches discussed in Part 2 seem to have most merit and should be considered as a basis for further development?*

*Q2.2 Do you think that there are any specific practical difficulties with implementing the approach(es) that you favour in practice?*

*If so, how can those difficulties be addressed?*

*Q2.3 Are there any approaches that are not discussed in Part 2 that should be considered?*

*Q2.4 In your view should a combination of approaches be considered? If so, which approach should be used in what circumstances?*

*Q2.5 Do you have any further comments on the discussion of the various approaches in Part 2?*

**Approaches rejected by our members:**

- Value adjustment approach

This approach does not solve the issue of recognition of deferred tax assets and liabilities and adds complexity since it requires the allocation of tax effects to all other assets and liabilities and their inclusion in the carrying amount. Moreover, in order to provide a complete picture of tax effects current tax also has to be allocated.

Other difficulties caused by this approach include the choice of the depreciable base for assets (the gross cost or the cost net of tax) and the clarity of a balance sheet in which assets and liabilities are presented net of tax.

- Flow-through approach

This alternative may seem consistent with the recent position of the IFRIC about Levies, in other words, there is no liability when the entity has the discretion, to avoid the future expenditure through its future actions. Indeed, entities may decide not to use or to dispose of an asset (even if that decision is not economically rational). In this case, there will be no generation of economic flows that generate a future income tax payable, and no liability should be recognized at the end of the reporting period.

However, this approach does not in our view improve financial reporting as it does not allow one to represent the full impact of a transaction (or other event) and its fiscal consequences over a period, and we therefore do not support this alternative model t.

- *Partial tax allocation»*

This hybrid approach between the statutory rate and an economic effective rate does not seem satisfactory because it does not provide a good visibility of the tax charge.

Moreover, it is often very difficult to demonstrate that there will be no future cash-outflows for taxes, since tax laws frequently change very quickly.

Furthermore, this method relies heavily on the use subjective information and thus does not seem to be consistent with the generally desired direction of transparency and ease of understanding for users.

**Alternatives judged by our members to have merit:**

The two models we think are most worthy of further consideration are the current model of IAS 12 based on temporary differences (an approach focused on the Balance sheet) and the earlier model of the previous version of IAS 12, based on timing differences (focused on transactions and events reported in the income statement). However, both models have aspects which we think should be improved upon.

It seems that the choice between these two models will depend primarily on the objective that will be identified for the reporting of deferred taxes. Without this necessary first step, it is difficult for us to express a definitive option in favour of one of the two models.

However, we have attempted to assess which of these two models would achieve the desired outcome without requiring too many exceptions to the core principle, as we believe it will be an important step towards finding the appropriate model (see appendix 1)

Finally in any event, we think that it would be better to treat the impact of deferred taxes related to Business Combinations within IFRS 3, with specific provisions, rather than through IAS 12 which would require specific exemptions to be incorporated whatever the approach selected (temporary or timing differences).

IFRS 3 could require that the fair value allocated to recognised assets and liabilities must incorporate the expected tax effects which can be attributed to them, and that these tax effects must be isolated in separate lines of the balance sheet. Thus, in the case of a depreciable fixed asset, for example, the future tax effects would be taken into account by a market participant in its assessment of the fair value and must therefore result in the recognition of a deferred tax liability. In contrast, in the case of non-depreciable fixed assets no tax effect is expected by the market participant when attributing fair value to the asset and no deferred tax asset or liability should be recognised.

Appendix 1

	<b>Timing difference approach Focus on income (1)</b>	<b>Temporary difference approach Focus on Balance Sheet</b>
Intra group profit ...	<p>The margin is eliminated from consolidated income statement =&gt; there should not be any tax effect in consolidated net income =&gt; there is deferred tax asset to offset exactly the current tax generated in subsidiaries.</p> <p>No need for exemption therefore</p> <p>(Outcome same as FAS 109 even if a different approach)</p>	<p>Accounting base (unchanged) different from the revalued tax base =&gt; a deferred tax should be recognized and computed using the rate of the buyer. This does not fully offset the current tax paid by the vendor on the realized margin.</p> <p>Need an exemption to reach the desired outcome</p>
Initial recognition of an asset or liability	As no impact in net income, even in case where the tax base is different from the accounting base, therefore no deferred tax to recognize.	If there is a difference at inception between tax and accounting basis, the principle requires to recognition of deferred tax asset or liability. An exception is required to avoid such outcome.
Investments in subsidiaries, branches and associates	Does not generate temporary difference although the original IAS 12 treated them as such => our members are of the view that one must recognize an deferred tax liability (DTL) when distribution is highly probable => ability to retain the old IAS 12 treatment (DTL unless it is reasonable to assume that profits will not be distributed). Alternatively, take the FAS 109 approach: no deferred tax unless it becomes clear that the difference will soon be reversed.	There is a difference between accounting and tax basis which requires deferred tax to be recognized => an exemption from current IAS 12 principle is required to avoid recognition.
Actuarial gains and losses on pensions	The total of the impacts on the P/L and OCI are different from the fiscal impact => approach allows for the computation of deferred	Carrying amount of the pension provision is different from its tax base => recognition of deferred tax asset on

	tax amounts on P/L and OCI individually.	the whole balance sheet difference.
Revalued assets (with no fiscal equivalent)	Revaluation does not generate timing difference, even though IAS 12 originally treated revaluations as giving rise to timing differences. Timing differences generated subsequently through depreciation of the assets (if applicable). No deferred tax on revalued non-depreciable assets (permanent difference).	Tax base different from carrying amount => deferred tax recognised from inception of revaluation.

- (1) Deferred tax recognised only for accounting impacts on P/L or OCI which are different from the fiscal impacts. No deferred taxes recognised for permanent differences (i.e. income and expenses have no fiscal existence).
- (2) Deferred tax recognised in respect of all differences between the balance sheet carrying amount and the tax base.