EUROPEAN OUTREACH ON EFRAG PROACTIVE DISCUSSION PAPER ON IMPROVING THE ACCOUNTING OF INCOME TAXES

SUMMARY OF THE FEEDBACK RECEIVED

SEPTEMBER 2012

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Executive summary

Objective

EFRAG's Discussion Paper issued within its proactive project

In December 2011 EFRAG issued a Discussion Paper entitled 'Improving the Financial Reporting of Income Tax'. This was issued together with the UK Accounting Standards Board (UK ASB).

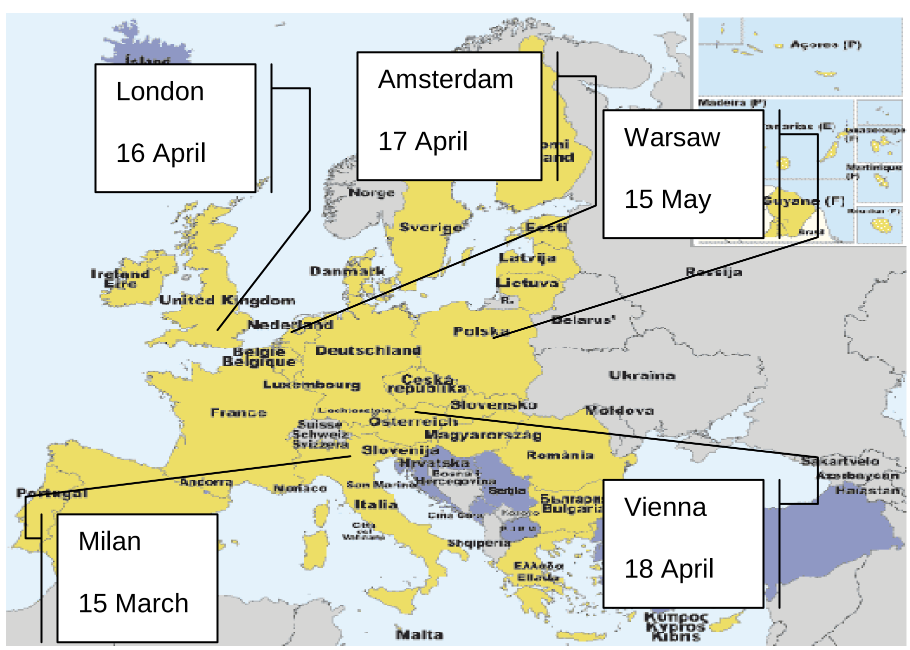
Improving the Financial Reporting of Income Taxes

The Discussion Paper on Income tax represents a first step in gaining input on whether IAS 12 *Income Taxes* should be improved, or whether there should be a fundamental rethinking and a new approach pursued. This consolidated feedback report should be read together with the Discussion Paper (DP).

Several commentators argued that IAS 12 is a difficult standard to understand and apply, and that users do not find the information reported on income tax useful. Some also suggested that income tax represents one of the most significant single costs to most businesses and the accounting for it remains relevant.

EFRAG and the UK ASB were willing to gather European Constituents' views

EFRAG and the UK ASB are keen to gather views from constituents and obtain input in order to understand what practitioners and others think about the topic. Accordingly, together with National standard setters, five meetings were held with constituents in several locations, illustrated on the chart below.



In addition to this summarised feedback report, EFRAG has issued detailed feedback reports on each outreach event for the convenience of the European constituents. These are available on EFRAG's website.

Next Step

EFRAG and the UK ASB will consider the feedback received as part of their deliberations on the Discussion Paper and the future work of the IASB on Income Taxes. They are also in the process of analysing the written comments received from constituents on the DP.

EFRAG proactive activities

It is important to set this project 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 the European level. There are four strategic aims that underpin the work:

- Engaging with European constituents to ensure we understand their issues and how financial reporting affects them;
- Influencing the development of international 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 the EFRAG's website (www.efrag.org).

Methodology

The Outreach events were conducted by presenting the main topics discussed in the DP. Participants at the outreach events included preparers, users, academics, regulators, and accountants.

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

Level of participation

The tables below show the number of participants by industry:

Participants by industry:	
Accountants	68
Automotive	1
Banking and Insurance	31
Government	2
Services	19
Telecommunications	10
Utilities	12
University	20
Others	49
	212

General outcomes and feedback on the project scope

Generally EFRAG staff gathered positive feedback on its proactive project on Income Taxes. European constituents see the project as a valuable attempt to stimulate the debate on improving the accounting for income taxes. The debate aims to identify the information needs of users. Participants recognised that there is a paradox about the information needs of users: users need information to evaluate future cash flows related to tax (cash basis accounting), but also prefer companies to report a stable tax rate to guide their investment choice (accrual basis accounting).

Stable tax rate against expected future cash flows.

All participants expressed their support for the existence of one standard that is capable of addressing a variety of legislative frameworks and jurisdiction-specific issues. Participants agreed that diversity can impair – especially in the context of multinational groups – the attempt to identify a unique principle based standard to be applied both in accounting for and in disclosing taxes related transactions. Ideally, users would like information on each tax jurisdiction: some participants believed that it might be an acceptable compromise for a standard to permit disclosure for a cluster of similar tax regimes/jurisdictions.

Diversity and complexity arise where there are several tax regimes.

Another point made was that the tax standard should provide an enhanced definition of income tax. The definition should be able to cover all issues concerning preparers. This is a particular issue for the oil and gas industry. Some suggested merely changing the definition so that it uses the word 'corporate' instead of the word 'income'.

Current definitions are ineffective.

The main output that emerged from the outreach events was the support expressed by participants for the existing standard on income taxes. Whilst they generally recognised the existence of several areas in which IAS 12 *Income Taxes* ('IAS 12') could be improved, they generally had reservations about the idea of re-writing the standard using a so called 'blank page' approach.

Although there is room to improve current standard, constituents expressed their concerns on the idea of changing existing guidance.

Participants believed that constituents are familiar with applying the mechanics of IAS 12 and how to interpret the related outcomes. Most believed that being easy to apply in practice contributes to the property of relevance. However, they were concerned about the quality of existing disclosure requirements and believed that improved narrative could enhance the understandability of the effects of taxes on entities' performance and financial position. In particular users had struggled to understand the nature of tax

IAS 12 is considered easy to apply and interested parties are familiar with its mechanics.

figures reported within the income statement. Whilst supporting enhancement of disclosure on tax matters, participants believed that providing too many disclosures would confuse the users of financial statements. Nevertheless, they thought it would be more beneficial to focus on disclosures about significant tax issues and clarify (in an international context for instance) how different tax regimes impact the group's tax position.

While supporting the underlying principles of IAS 12, constituents believed there are many areas for improvement.

In addition, participants agreed that a sound standard based on principles should not include any exceptions as they increase the complexity in accounting. Accordingly, participants identified some general areas of improvement which they would be pleased to see included within the discussion paper's scope:

- Introducing a discounting procedure for the recognition and measurement of deferred tax assets and liabilities;
- Removing the initial recognition exemption;
- Recognising the gross amount of deferred tax assets and measuring them at their expected recoverable amount;
- Identifying and separately presenting the short term component of deferred tax assets and liabilities;
- Providing guidance on tax reliefs.

However some participants expressed their concerns at the cost of producing such additional financial information and argued that it is hard to evaluate whether the benefits deriving from the additional financial information would outweigh the associated costs.

Part1

As previously highlighted, participants expressed their general support for the retention of IAS 12 with amendments to better cater for needs of users and preparers.

Participants believed that the existing guidance should be improved not only in recognition, measurement, presentation and disclosures but by removing all the exceptions allowed under IAS 12. The exceptions currently introduce complexity, impair understandability and lead to questions over the principles on which the standard has been built.

Disclosures on Income Tax Rate Reconciliation

The possibility of improved disclosure of the tax reconciliation has been generally welcomed by participants because they believed it would improve transparency of the information on reported tax figures. Nevertheless, several comments were received to further develop the analysis included in the DP. In particular, participants emphasised that in a principle-based accounting system, materiality should always be considered in deciding whether and which information should be provided.

Participants were supportive of the EFRAG proposal for improving disclosures on the tax rate reconciliation even though:

A) It should consider the existence of more general tax phenomena in respect to those included in the DP; and

Some participants wondered whether presenting only three major categories of tax phenomena in the tax rate reconciliation table really improved financial disclosure and understandability in respect of tax. It was noted that different income tax rates may apply on the same income according to different tax regimes and, therefore, the reported figures appeared to be an un-homogeneous mix of numbers. Finally the existence of permanent differences further increases complexity in providing effective and relevant information within the tax reconciliation

Regarding the location of the additional disclosures, generally participants stressed the importance of providing disclosure on tax matters primarily in the notes while agreeing that additional information could also be included in the management commentary.

At the events, the value was recognised of cross referencing numbers presented to the corresponding disclosures. There was also general agreement on the disclosure of few relevant tax drivers, which had affected the entity's tax position, instead of presenting irrelevant disclosure.

Some noted that the analysis set out in the discussion paper should also cover those taxes that have been recognised outside the primary income statement.

B) it should provide an unbundled information which could help users in understanding the effect of applying single tax legislature on a consolidated level;

Many preparers having a multinational group background expressed their support for providing information on blended tax rate, believing it better provides information at a group level instead of providing the mere reconciliation of parent company tax costs. They also believed it could be beneficial to require some type of reconciliation between the parent company tax rate and the group one. Regarding applying the reconciliation table presented in the discussion paper, participants believed it could be beneficial to provide the information in a multicolumn table with each column representing a different geographical segment.

A minority of participants having an auditing background expressed concerns about a possible requirement to provide disclosures on the movements in the blended rate from year to year even when those participants supported the multicolumn presentation of tax figures in the consolidated financial statements.

C) it should help users in reconciling tax paid and tax accounted for both in the P&L and in the OCI.

Some participants believed the disclosure should cover also the reconciliation between tax paid and tax reported in the profit and loss so that users could benefit from relevant information on the movements in the tax rate, on the amount of tax currently paid and on tax which will eventually influence future cash flows.

Some participants would welcome reducing the current disclosure requirements at the same time as requirements for additional information were introduced.

Discounting

Participants were substantially split regarding discounting deferred tax assets and liabilities.

Discounting was generally welcomed but …

Those in favour mainly provided arguments supporting the removal of this exception in applying general accepted principles within accounting literature. They believed that dealing with tax planning already implied the forecast of reversal/occurrence of events on the time frame; consequently the value of deferred tax assets and liabilities should be measured such that users could appreciate how the entity plans.

In addition, participants believed that adopting the discounting principle in accounting for tax assets and liabilities would permit more entities to apply IFRSs as it would significantly reduce the effect of recognising the full amount of deferred tax liabilities (e.g. on investment property) and deferred tax assets (e.g. on tax losses carried forward).

Participants said they would welcome application guidance on discounting (e.g. what is the discount rate?).

All participants believed that introducing discounting in accounting for deferred income taxes would remove the current inconsistencies when evaluating the amount recognised on assets and liabilities which *per se* have already been discounted (e.g. a pension liability). In addition, discounting might provide more informative information on an entity's tax strategy.

It would increase the cost of producing financial information.

Allocation of the unwinding of temporary differences to time periods would also allow users to distinguish between short and long term tax assets and liabilities.

Participants also welcomed the separate presentation of short term and long term deferred tax assets and liabilities as tax strategies are naturally based on applying tax opportunities to time taxable profit or deductible costs in order to minimise or avoid the arising of tax liabilities.

Those against the introduction of discounting in recognising and measuring deferred tax assets and liabilities believed that the cost of introducing such requirement would not outweigh the additional workload of preparers. They argued that discounting was only used by utility companies or others with long-lived assets because it produced relevant financial information for users in those circumstances.

Uncertain tax Position

Disclosures on uncertain tax positions are poor and divergence is seen in practice.

All participants supported the analysis included in the discussion paper stating that the lack of guidance on uncertain tax positions resulted in complexity and divergence in practice, and that the application by analogy of US GAAP guidance (FIN48) was perceived to be complex and costly to implement. Some academics also provided updates on research they conducted on disclosure of tax matters applying IAS 12 and they noted that currently the quality of disclosure does not provide users with relevant information.

Generally participants supported the use of the best estimate approach in recognising and measuring uncertain tax positions and in providing disclosure in accordance with IAS 37 and other relevant standards.

In terms of presentation, users generally were in favour of clearly distinguishing within the amounts related to current taxes those that are non-recurring, for instance, those deriving from changes in estimates related to uncertain tax positions. In addition, they were in favour of separately presenting the expenses which had no immediate impact on current cash flows and which had been accounted for applying the general recognition criteria in IAS 12.

At one event participants argued that it was more difficult to deal with uncertain tax positions from which an outflow of resources was expected than with uncertain tax assets. This is because deferred tax assets arise from past events and thus entities have significant control over the numbers from which they derive; in addition, deferred tax assets should be evaluated only in terms of future recoverability and - in relevant circumstances – considering also whether they have been accepted by the tax authority. In contrast, tax liabilities derive from uncertain tax positions and therefore they are based on assumptions which do not have any reflection in the books and which are subject to the resolution and the reaction of the tax authority.

Regarding the quality and the quantity of disclosures on uncertain tax positions, participants emphasised the importance of applying materiality in evaluating uncertainties and in judging the level of information to disclose on uncertain tax positions. Participants believed that the disclosures should not distort and bias the conclusions users might reach in evaluating the sustainable tax rate of the entity. They believed information should be provided in order to allow users to evaluate entities' estimates with particular reference to the risks they have chosen to bear in disputing with the tax authorities and which might lead to the recognition of a different effect in the profit and loss as a result of the settling of it. Additional disclosure should also permit users to understand the assumptions underlying the best estimate evaluation. However, participants believed that preparers generally are reluctant to provide such disclosures as the information can create issues with the tax authority.

Some argued, though, that introducing the most likely outcome method in measuring liabilities stemming from uncertain tax positions would not avoid the risk of applying a probability weighted approach, given that in the IFRS literature there are no clear definitions of such terms and therefore the best expected value appears to have a different meaning in different standards.

Interest and ancillary costs (i.e. penalties) should be included in the scope of the DP.

Participants believed the analysis within the discussion paper should also encompass interest accrued on tax positions and related penalties as such topics were:

- necessary to perform an accurate and complete analysis of possible outcomes;
- strictly related to the concept of applying discounting to tax balances.

Part 2

All participants were in favour of removing existing exceptions included in IAS 12 and in resolving some anomalous outcomes arising from applying the current guidance (e.g. intra-group selling transactions).

Some believed further consideration should be given to how the IASB had tentatively decided in 2009 to address such issues, in order to evaluate existing opportunities.

Temporary difference approach

Participants on balance supported such approach being simple to apply.

Preparers and users at the events expressed their comfort with both the mechanics and the output deriving from the application of IAS 12 after such a long period of training and implementation of its requirements. In addition, they believed in a principle based accounting system, the requirement to account for a deferred tax asset or liability, every time there is a difference between the book value and the corresponding tax value, appears to be consistent with the underlying principles of IFRS.

Flow through approach

Participants did not express support for such approach believing that the disadvantages identified in the DP outweigh its advantages.

Participants, while appreciating the simplicity in applying the flow through approach, believed it could not be implemented given that current IFRS literature is based on the accrual principle and therefore IFRS do not allow to recognise tax on a cash basis.

Some wondered whether there are any academic studies on the effects of applying such an approach in practice.

Valuation adjustment approach

This approach had been generally perceived as burdensome. In addition, both preparers and users had concerns about the potential outcome.

Participants did not support such approach, considering it difficult to apply.

Users believed it would have decreased the understandability of the entity's tax position.

Users struggled with the idea of recognising several tax assets spread out over the asset side of the balance sheet; in addition, they believed it would clutter the users' analysis of the entity as all those piecemeal assets would remained hidden within the line of the assets they related to.

Others were concerned about overstating income reserves and therefore allowing the distribution of unrealised income through dividends by unbundling the tax component from the assets' carrying amount.

Finally, some others believed that looking at the assets by considering the tax effect may not faithfully represent entities' investment decisions, which may well encompass optimisation of the tax effect but do not usually stem directly from considering these effects.

Partial allocation approach

Participants did not express support for such an approach believing that the disadvantages identified in the DP outweigh its advantages.

At the events some participants expressed some interest in such approach as it might be effective to consider only the deferred taxes which are foreseen to reverse in the near future (i.e. next four or five years) believing it may represent a compromise for those who struggle with recognising deferred taxes on a balance sheet basis as they believed this to be inconsistent with the definitions of assets and liabilities included in the framework.

Also in debating on this approach some had concerns about understating tax expense, and therefore distributing unrealised profits.

Accruals approach

Participants sympathised with this approach, nevertheless they believed it would result in a significant increase in terms of costs to manage the tax area on a transaction by transaction basis.

At the events generally this approach, from a conceptual point of view, was considered as the one which best complied with the Framework. However, some were concerned that choosing the single transaction as the unit of account would be burdensome and complex and, therefore, participants expressed their concern over applying the accrual approach due to the work needed to implement it which probably would not be outweighed by the corresponding benefits in terms of enhanced disclosure.

Many participants believed that both the tax authority and users look at the entity's tax position on an overall basis and are not interested in evaluating entities' performance on a transaction by transaction basis. In addition, the application of the accrual approach would lead to the disappearance of the distinction between current and deferred taxes: this was perceived to be a significant change in an aspect of current practice which is familiar to all interested parties.

In addition, preparers noted that this approach does not help in predicting future cash flows as it recognises only current expenses based on the application of the accrual principle.

Tentative conclusions reached at the events

The temporary difference approach was perceived to be easy to apply and participants were familiar with its application; therefore, instead of re-writing the standard on accounting for income taxes interested parties expressed their support in maintaining IAS 12 in order to:

- provide enhanced definition of taxes in accounting in order to cover relevant issues entities are struggling with;
- remove perceived inconsistencies in the recognition, measurement, presentation and disclosure of entities' taxes (i.e. the exemptions included in the standard);
- introduce improved guidance - such as discounting – after having carefully considered the cost of applying it and the benefits derived.