Our ref: ICAEW Rep 81/12

29 May 2012

Mme Françoise Flores
Chair
European Financial Reporting Advisory Group
35 Square de Meeûs
B-1000 Brussels

By email: commentletter@efrag.org

Dear Mme Flores

Improving the Financial Reporting of Income Tax

ICAEW is pleased to respond to your request for comments on the discussion paper *Improving the Financial Reporting of Income Tax*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

John Boulton ACA
Manager, Corporate Reporting
ICAEW Financial Reporting Faculty

T +44 (0) 20 7920 8642
E john.boulton@icaew.com

ICAEW REPRESENTATION

IMPROVING THE FINANCIAL REPORTING OF INCOME TAX

Memorandum of comment submitted in June 2012 by ICAEW, in response to EFRAG discussion paper *Improving the Financial Reporting of Income Tax* published in December 2011.

Contents	**Paragraph**

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the discussion paper *Improving the Financial Reporting of Income Tax* published by EFRAG on 22 December 2011.

WHO WE ARE

2. ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 138,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

3. ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

4. The Financial Reporting Faculty is recognised internationally as a leading authority on financial reporting. The Faculty's Financial Reporting Committee is responsible for formulating ICAEW policy on financial reporting issues, and makes submissions to standard setters and other external bodies. The faculty also provides an extensive range of services to its members, providing practical assistance in dealing with common financial reporting problems.

MAJOR POINTS

We welcome EFRAG's research into methods of accounting for corporate income taxes

5. We welcome the work EFRAG has done in investigating the accounting treatment of corporate income tax. EFRAG's pro-active projects provide a valuable opportunity to explore areas of interest in financial reporting outside the more formal framework of an IASB project. This is a useful way of evaluating different options without committing to a particular course of action and facilitates the early consideration of potential improvements outside the resource constraints of the IASB agenda. We therefore look forward to EFRAG's further consideration of this area as well to the results of its other pro-active projects.

6. We note that there does not appear to be any immediate prospect of the IASB taking this project onto its agenda. In our opinion any new standard or guidance for income tax would certainly have to be issued by the IASB, not a European body. But EFRAG and complementary research bodies such as the UK's Financial Reporting Lab can usefully conduct investigations in this area which the IASB could refer to when in due course the Board seeks to improve IAS12.

Further research is necessary to explore more fully the needs of users

7. We acknowledge and support EFRAG's efforts to base the paper around the needs of users. However, in our view this empirical work is not complete. We acknowledge that anecdotal evidence suggests there is some dissatisfaction with IAS 12, but before any further action is taken it is essential that a full and proper discussion with users is undertaken. Future development of the project can then be based upon a definitive assessment of what users are looking for. Understanding the purpose for which this information will be used is essential, as this then allows an objective to be established against which recognition, measurement and disclosure options can be evaluated. Financial reporting is a practical response to real business demands and therefore it is the usefulness of a particular information set - rather than other more esoteric conceptual considerations - that should be used as the determining factor.

Encouraging more extensive narrative disclosures may be the most effective way of providing the information users need

8. The paper appears to focus on numerical tax disclosures. In considering these it then, correctly, identifies that numerical analyses can be problematic because of the specific conditions relevant to each entity. In our opinion a solution to this would be to focus instead on narrative disclosure. Not only does the greater flexibility and descriptive capacity of narrative mean it may be a better way of explaining relevant factors to users, but it may also be more easily accommodated within the existing framework. Narrative disclosures are already used effectively by some entities to aid user understanding of tax balances and exposures / benefits and therefore it might be productive for the project to focus on promoting best practice in this area, rather than suggesting additional numerical disclosures. This approach has the added advantage that work to improve tax disclosure could commence without having to wait for IASB agenda capacity. The UK Financial Reporting Lab could provide valuable assistance with this endeavour. It will be necessary, however, to be mindful of the push by many to cut the volume of information produced in annual reports, so companies should be encouraged to focus on key messages, avoiding boilerplate or immaterial information.

Further development is necessary before a preferred deferred tax accounting model can be selected

9. Section 2 explores several alternative methodologies for accounting for deferred tax. Given our concerns regarding user needs, we feel that it is not appropriate to select any one of these alternatives at the current time. We did have some discussion about the mechanics of the various alternatives: some members of the working party we formed to respond to the paper felt that flow through should be taken as the default option in the absence of further evidence from users. Others thought it sub-optimal to avoid addressing the tax effect of items already otherwise included in the financial statements; these working party members preferred either an accruals method or the existing IAS 12 approach as the default pending further evidence. Further research is necessary before any conclusions can be drawn regarding which of the alternatives is preferable.

Country-by-country reporting could be considered more extensively in the paper

10. Country-by-country reporting is only mentioned in cursory detail in the paper. We find much to support in the campaign to improve governance in resource rich developing countries, but do not believe that the annual report is the most appropriate location for the disclosures sought. However, given the momentum behind these proposals EFRAG should be aware that were IAS 12 disclosures to be re-opened there could be considerable pressure for a country or other specific level of granularity to be specified in the standard, which would be detrimental to materiality-led, investor-focussed financial reporting. We therefore suggest that EFRAG should remain mindful of these issues in its further discussions regarding the scope of tax disclosures.

RESPONSES TO SPECIFIC QUESTIONS/POINTS

Question to constituents - 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?

11. There is certainly a perception that improvements could be made to the income tax reporting model in IAS 12. We therefore welcome EFRAG's research work in this area. A detailed analysis of the ways in which users make use of income tax information, and of the deficiencies they perceive in the currently available information, could provide a useful foundation for any future work to develop a replacement to the current model. Nevertheless, although the current study is a valuable step in that direction, we do not believe the case has yet been made for a replacement of IAS 12. Neither do we believe that piecemeal change through limited amendments can be justified. If sufficient, user-led, evidence can be assembled that points toward an improved new model, then a comprehensive replacement of IAS 12 could be considered. Until such an alternative is put forward, partial revision may only serve to reduce the overall coherence of the standard.

Questions to constituents - Part 1: Possible amendments to IAS 12

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)

12. We agree it would be useful to more clearly understand the relationship between the current tax charge and the amount of tax finally paid. However, there is an inherent issue here; as tax returns are submitted in arrears, and commonly after publication of the accounts, it is not possible to include disclosure of the final amount paid for the current year. The reconciliation would therefore be between the cash flow amount and the prior year tax charge. Although this might provide useful information, it would not address the assessment of the current year tax charge itself.

13. Notwithstanding this limitation, there are a number of other considerations that should also be taken into account. Paragraphs 1.15-1.18 address the current tax expense in the income statement, but the balance sheet current liability, and its relationship to the subsequent year's tax payment, is also relevant for this purpose. Indeed, given that some elements of the current tax charge may not give rise to an immediate tax liability, it may be that the balance sheet position is a more appropriate starting point. It should also be noted that both the current liability and the tax charge may be affected by uncertainties which could result in a difference between the estimate and the final tax paid. In addition, the fact that the cash flow disclosure does not distinguish between discontinued and continuing activities makes it more difficult to reconcile.

14. Ultimately, it is through discussion with users that these limitations can be more extensively explored. With a deeper understanding of the ways in which this information will be used, it may be possible to devise an improved form of disclosure that works within the various limitations outlined above.

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)

15. We agree that providing more extensive information about unused tax losses, credits and other deductible temporary differences could be useful. Although the question specifically refers to deferred tax assets this area also encompasses unrecognised temporary differences, indeed in many businesses *potential* deferred tax assets may exceed those already recognised. Our preference is for disclosure to take account of both recognised and unrecognised timing differences, with the two distinguished as appropriate, and the paragraphs that follow are therefore intended to apply to both categories.

16. The most effective mechanism for enhancing disclosure here may be through the provision of more extensive narrative information. Numerical analysis of for example unused tax losses can provide useful information, and we note that IAS 12 already requires an analysis of unrecognised timing differences by expiry date. But such information is of less value without an explanation of the circumstances under which these balances might be recoverable. There is even a danger that over-analysis may present misleading information, for example a geographical analysis may show a large unused tax loss in a particular region, but there may be specific restrictions on the utilisation of this that may not apply elsewhere. Given the potential complexity of factors determining future recovery a numerical analysis could over-simplify the situation.

17. Again, this is an area in which further research to determine how this information is used is essential before any conclusions are drawn. But it is likely that users will be interested in understanding how a business might develop in the future – for example, expanding in one tax jurisdiction and contracting in another – and what the tax consequences of this could be. Such information is best given as a narrative explanation. Narrative disclosures might also include targeted geographical information, which to be useful would be provided on the same basis as the segmental disclosures of revenues and profit. A key advantage of the narrative approach is that it may be achievable within the current IAS 12 framework. EFRAG might consider working here with the UK's Financial Reporting Lab; within this environment best practice examples of narrative disclosure could be developed, these could then be championed as a mechanism for achieving improvements in practice.

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)

18. The user needs identified appear reasonable, but we believe that further research is essential before conclusions are drawn. In principle each of the disclosures suggested in 1.7 a-g could provide useful information, but our preference is for this to be presented in narrative form. Narrative disclosures can be more easily tailored to reflect the individual circumstances of the business, can provide an explanation to put a particular balance in context, and may be able to be accommodated within the existing framework.

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)

19. Our preference is to include information about tax strategies within management commentary to the extent this is necessary to an understanding of the business. Indeed, where these factors represent a material risk to the business we would expect risk reporting to already comment on them. However, we do not support establishment of a specific requirement to disclose an entity's tax strategy. Most businesses are likely to adopt a similar strategy, eg, to operate as tax efficiently as possible within the relevant legal framework, and therefore it is difficult to see how such a disclosure would be anything other than boiler-plate.

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)

20. We agree that it could be fruitful to investigate ways of improving the informational value of the tax reconciliation. However, before any conclusions can be drawn it is essential that users are consulted to determine the purpose for which they would ideally like to use this information. Part of the issue here is that the purpose of the reconciliation is unclear, specifically whether users look to this disclosure purely to understand better the current tax charge or whether they find predictive value also. This consideration is key, as it may determine whether the reconciliation should be limited to the current tax charge or should also include deferred tax. A theme running through the paper is that the complexity of deferred tax may reduce the utility of tax information to users; if that is the case it should be confirmed through appropriate research as that consideration may inform the decision in this area.

21. Once user needs are defined then a way forward can be devised. It may well be that the information desired can be accommodated within the existing IAS 12 disclosure, indeed we see no reason why the aggregation headings suggested in 2.25-2.33 could not be applied now should a preparer wish to do so. We appreciate that one of the principles guiding EFRAG's suggestions here is to achieve greater standardisation, such that disclosures can be more easily compared between entities, but this may not be an appropriate objective for tax reporting. There are many factors that affect the relationship between consolidated profit and the current tax charge; geographical distribution of operations and profits, distribution and type of capital expenditure, availability of credits and other reliefs, etc. The mix of these factors will vary from entity to entity and an appreciation of how they combine is essential to an understanding of the tax charge in any particular company. Standardisation therefore may not be effective, indeed it may be more appropriate to use narrative information to instead achieve the desired objective.

22. Therefore, through a combination of narrative disclosure and better use of the IAS 12 tax reconciliation the information presented could be enhanced without changing the current framework. A better understanding of the options currently available and of best practice could drive up information quality. If effectively implemented this might enable a better communication of the relationship between consolidated profit and the individual entity profits upon which the tax liability is based. It may also facilitate a more informed choice between the tax charge or the effective tax rate in deciding which reconciliation to present.

23. Paragraph 2.34 suggests individual disclosure of items greater than 5% of pre-tax income multiplied by the statutory tax rate. This requirement would effectively create a differential measure of materiality for this specific note. We are strongly opposed to such an approach. While it may well be desirable to disclose individually material items in the tax reconciliation, establishing an absolute quantitative materiality measure is unnecessary and risks setting an unwelcome precedent. An established system for assessing materiality already exists and there is no reason to create an exception to that here.

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).

24. Users are likely to welcome reliable information about future cash-flows. Unfortunately however, forecasting these amounts with an adequate amount of certainty is difficult. While enhancing disclosure to improve its predictive value is desirable, this should not be at the cost of reliability. Therefore, again we feel that the answer here may be to encourage an enhancement of narrative disclosures rather than attempting to accommodate this information within numerical analysis.

25. These narrative disclosures could focus on factors that can be estimated with some degree of certainty, particularly any items that may give rise to a significant difference between future profits and cash-flows. One example would be planned capital expenditure, particularly where there was a significant acceleration in capital allowances. Other items may be R&D tax credits on budgeted expenditure or tax deductible goodwill.

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.

26. We recognise that in circumstances where settlement of a deferred tax balance will not occur for an extended time period, and where discount rates and settlement timings can be determined reliably, discounting a deferred tax liability might better model future cash-flows. We also acknowledge that at present deferred tax could be calculated on already-discounted amounts and therefore that some balances could be a hybrid of un-discounted and partially discounted components. However, applying discounting in practice would be complex, both in terms of the underlying accounting and the resultant disclosures. The assumptions applied could be rather subjective. Given that one of the underlying objectives of the paper is to improve the understandability of tax disclosure for users, and presuming that the IASB is not likely to reopen IAS 12 in the near future, we question the value of considering a new approach to discounting at present.

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.

27. We agree that disclosure of uncertain tax positions may be useful and would be an area for the IASB to consider when it next puts IAS 12 onto its agenda. Indeed, without a change to IAS 12 there is little scope for a change in the accounting for uncertain tax positions. Conceptually, potential tax assets or liabilities are no different from other contingent assets or liabilities and therefore if a new approach was to be considered it would be reasonable to apply a similar methodology to IAS 37, including the relevant disclosures. Of the two options, we would prefer something along the lines of alternative 2, reflecting IAS 37's disclosure requirements; if information about a particular balance is necessary for the accounts to show a true and fair view, it needs to be included within the financial statements, not as management commentary.

(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?

28. We feel that the recognition and measurement of uncertain tax positions should be consistent with the general measurement principles of IAS 12 and with IAS 37. We were strongly opposed to the proposed revision of IAS 37 to move to a weighted average model and accordingly we are opposed to the use of this method for tax balances. Weighted average can be appropriate for large and heterogeneous populations, but this is unlikely to be the case in instances of tax uncertainty. In smaller populations it is likely to produce a value quite different to the final outcome. It is better to use most likely outcome instead, this at least has the virtue of predicting an outcome that could actually occur. Further, IAS 12 is a 'most likely outcome' standard and it would be inconsistent with this were the IASB to introduce a probability weighted method of measuring uncertain tax positions.

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?

29. We have not identified any additional issues. We suggest that EFRAG conduct further user research to determine whether any further conclusions on IAS 12 can be drawn.

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

30. The exemptions currently within IAS 12 are not particularly cohesive and it is not clear why there are differences of treatment in some areas between otherwise similar items; for example, deferred tax is provided on intangibles identified in an acquisition, but not on the residual goodwill balance. However, we do question how easy it would be to improve the situation. Further research and deliberation would be necessary to devise a better alternative.

Questions to constituents - Part 2: Alternative approaches to accounting for income tax

31. We do not believe that a conclusion can be drawn at this stage regarding the most appropriate method for accounting for income tax. In evaluating the different models, the most important consideration is the use that will be made of the resulting information. Once the purpose for which the information is required is clearly established, the alternative methods can be assessed to determine which is best in meeting this objective. As part of that evaluation, benefits should be weighed against costs in terms of complexity and ease of application / understanding. Financial reporting is a practical response to real situations; certain tax accounting models may have claims to greater conceptual merit than others, but it is their utility in meeting user needs that is most important here. Consequently an answer can only be reached by further empirical investigation.

32. Within the working party we formed to consider this paper we had some discussion about the potential merit of the different models. Although no conclusions were reached, three alternative models, flow through, maintaining the IAS 12 model and accruals received some support. Some working party members felt that the complexity of deferred tax detracted from its usefulness and therefore that, unless user research suggested a better alternative, flow through should be the default starting point. Other working party members were concerned that flow through was deficient, in that in some cases a liability (or asset) clearly existed and that unless this was recognised the financial statements could be incomplete. However, these comments were the result of initial discussion only, and without further research we would not wish to rule out any of the potential alternatives, including the existing IAS 12 model.

E john.boulton@icaew.com

Copyright © ICAEW 2012
All rights reserved.

This document may be reproduced without specific permission, in whole or part, free of charge and in any format or medium, subject to the conditions that:

- it is appropriately attributed, replicated accurately and is not used in a misleading context;
- the source of the extract or document is acknowledged and the title and ICAEW reference number are quoted.

Where third-party copyright material has been identified application for permission must be made to the copyright holder.

icaew.com