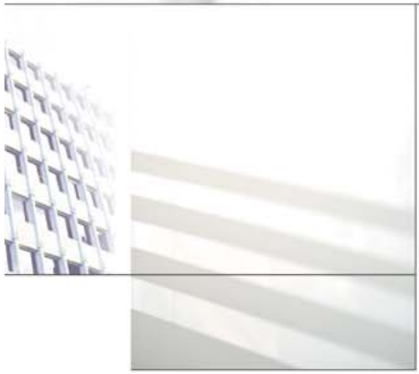

EFRAG

European Financial Reporting Advisory Group

Proactive Work in Europe

Outreach Event, Milan Italy

15 March, 2012

Mario ABELA – EFRAG Research Director

A two part consultation

Objective is to gain input—not to argue for a particular solution

- Part 1—Improving IAS 12
- Part 2—A review of approaches

Part 1: Improving IAS 12
Addressing identified user needs

- Improving presentation and disclosure requirements
  - by enhancing transparency of the tax rate reconciliation
- Improving recognition and measurement
  - by introducing discounting of deferred taxes
  - revisiting uncertain tax position

Part 1: Improving IAS 12
Addressing identified user needs

Outline of improved tax rate reconciliation by introducing a transparent scheme (1)

- Current income tax effects
  - Income exempt from taxation
  - Non deductible expenses
  - Adjustments to current tax of prior years

Part 1: Improving IAS 12
Addressing identified user needs

Outline of improved tax rate reconciliation by introducing a transparent scheme (2)

- Deferred income tax effects
  - Effect of tax losses
  - Effect of foreign tax rates
  - Effect of change in income tax rate
  - Other items

Part 1: Improving IAS 12
Addressing identified user needs

Introducing discounting of deferred taxes (1)

- Support for discounting
  - General requirement of IFRS to discount liabilities if the effect is material
  - To reflect the time value of money e.g. In business combinations

Part 1: Improving IAS 12
Addressing identified user needs

Introducing discounting of deferred taxes (2)

- Objection to discounting
  - Some deferred taxes are already effectively discounted and some are not
  - Discounting requires the scheduling of reversal of 'timing differences' (if not already discounted)

Part 1: Improving IAS 12
Addressing identified user needs

Uncertain tax positions

- Recognition issue: Does an uncertain tax position fulfil the criteria of a liability under the Framework? Is it necessary?
- Measurement issue: Is the weighted-average approach the most suitable?

Part 2: A review of approaches

- Temporary difference (the IAS 12 approach)
- Flow through
- Valuation adjustment
- Partial allocation
- Accruals

What's the problem?

- The tax effects of transactions do not always fall in the same period in which the transactions are reported in the financial statements
  - Accrued interest, taxed on receipt
  - Pension contributions allowed for tax on a cash basis
  - Depreciation of PPE

Example

- Asset purchased for €300
  - Written off over 3 years—€100 each year
  - Deducted for tax over two years, €150 in each year
- Profit before tax €120, tax rate 40%
- Current tax is 40% of €120 + €100 - €150 = 40% of € 70 = €28
- Should we also provide deferred tax of €20 on the difference of €50?
  - Is there a liability greater than €28?

Temporary difference (IAS 12 approach)

- Yes—book value (€200) is greater than tax value (€150)
- Recovery of €200 will incur additional tax liability
  - – part of cost of asset has been deducted for tax, and cannot be deducted twice

Temporary difference (IAS 12 approach)

- Assumes income should not be anticipated
  - But this is not generally how we look at recovery of assets (compare impairment)
  - More than book value may be recoverable, after tax
  - Where is the liability?
- Requires exceptions

Exceptions in IAS 12

- Initial recognition of a non-deductible asset
- Goodwill (but not other assets) on a business combination
- Some ‘outside basis differences’

Flow through

- No deferred tax recognised—tax expense is current tax only
- Requires exceptions
  – Short term differences?
  – Major one off items?
  – Large payments into a pension fund?
  – Long-term contracts?
- Requires disclosures

Valuation adjustment: the rationale

- No liability recognised
- Asset seen as having two components
  - Service potential
  - Tax benefits
- As tax benefits are received, asset is written down

Valuation adjustment: the problems

- Split of value between service potential and tax benefits is arbitrary
- Distinction between pre-tax and post-tax results is difficult to preserve

Partial allocation: the rationale

- In a growing or stable business the effect of old differences will be offset by new ones, perhaps indefinitely
- Provide only to the extent reversal is reasonably foreseeable
- Focus on real impact, not accounting and arithmetic

Partial allocation: the problems

- No clear meaning to reported tax expense
- Continual replacement not a valid criterion for non recognition
  - eg trade creditors

Accruals: the rationale

- Accrue tax effect of taxable transactions
  - Liability arises when taxable income is received
- Allocate tax effects to relevant period
  - Liability arises for tax relief if it will be recaptured in a future year

NB Tax liability depends on the transaction, not how it is accounted for

Accruals: the problems

- Not all temporary differences recognised:
  - – Tax relief obtained on purchased asset deferred
  - – Tax implications of non-deductible asset not recognised

The accruals and timing difference approaches

- Results are similar
- Distinction between current and deferred tax less critical
- Accruals may be less mechanistic