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

EFRAG

UK ACCOUNTING STANDARD BOARD

OIC – ORGANISMO ITALIANO DI CONTABILITA'

MAZARS

16 APRIL 2012

Table of contents

Panel

- *Mario Abela – EFRAG Research Director*
- *Andrew Lennard – UK ASB Director of Research*
- *Alessandro Sura – OIC Research Director*
- *Steven Brice – Mazars Hosting Partner*
- *Giorgio Alessio Acunzo – EFRAG Project Manager*
- *Leonardo Piombino (Observer) – IASB staff*

Executive summary

Objective

EFRAG's Discussion Papers issued as part of its proactive projects

In October and in December 2011 EFRAG issued two Discussion Papers, 'Accounting for Business Combination 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 accounting for Business Combination under Common Control

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 principally aims to set out the arguments and provide analysis to stimulate discussion and debate and therefore includes a comprehensive analysis of the issues drawing on the relevant IFRS literature. In addition, it notes that there is no 'ideal' approach but draws out three different views of looking at the problem, highlighting some of the strengths and weaknesses of each.

Improving the Financial Reporting of Income Taxes

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 rethink and a new approach has to be pursued. Several commentators argued that IAS 12 is a difficult standard to understand and apply and users do not find the information reported on useful. Income tax represents one of the most significant single costs to most business and the accounting for it remains relevant.

EFRAG together with National

EFRAG and the National Standard Setters involved in these

Standard Setters is engaged in organising outreach events to collect constituents' views on the topics.

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 London on 16 April 2012 arranged in co-operation with Mazars LLP.

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.

Next Steps

EFRAG is expecting to receive comments from constituents on the Discussion Papers. The comment period on accounting for Business Combination Under Common Control closes on 30 April 2012 and Improving the Financial Reporting of Income Taxes on 29 June 2012. Comments should be submitted to:

commentletters@efrag.org

EFRAG has deliberately not taken a position in either Discussion Papers. 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. It will be at that stage that a decision will be taken about what further steps need to be taken before putting forward views to the IASB.

EFRAG proactive activities

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 European level. There are four strategic aims that underpin proactive work:

- 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 and practitioners.

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

EFRAG secretariat prepared this feedback statement for release on EFRAG's web site.

Level of participation

The tables below show the number of participants by nature and by industry:

Nature	Number
Users	9
Preparers	3
National Standard Setters	7
Total	19

Industry	Number
Accountants	9
Banking & Insurance	2
Utilities	1
Others	7
Total	19

Opening and Introduction

The hosting Mazars' Partner welcomed participants to the event and introduced the agenda. He 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. He also expressed his view that the topics dealt within the Discussion Papers had always represented in his experience significant issues both for preparers and users of financial information and therefore he pointed out that having the chance to participate to the European debate set by EFRAG represented something extremely relevant also for UK entities.

Proactive activities

EFRAG intends to influence the international accounting debate through its proactive projects

The EFRAG Research Director welcomed participants at the event and emphasised the importance of gathering views from European constituents and their comment letters in reply 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 of behalf of the European Area. In addition, the EFRAG Research Director 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.

BCUCC

The OIC Research Director provided participants with the background which lead EFRAG and OIC undertaking the project. He underlined that Italy is significantly affected by such transactions given the governance structure of groups. He showed participants at the event a diagram - included in the discussion paper - of a group and he noted that quite often the ultimate parent company is not the listed company and thus business transactions may occur between entities belonging to the same group even if they are not included in the consolidation area of the listed entities.

In addition, the EFRAG Research Director explained the methodology the working team had chosen which was based on the IAS 8 hierarchy and analysed in detail which are the unique features of BCUCC transactions.

One participant questioned whether the Discussion Paper carries across to separate financial statement accounting.

Separate financial statement is currently scoped out

The OIC Research Director emphasised that at this stage the issue related to the representation of such transaction in the separate financial statements had been scoped out. He noted that defining the scope of the project represented the most critical issue of the entire project. Early stage discussions on the scope identified that the separate financial statements issue is not shared around Europe. Many countries still allow or require individual accounts to be prepared under local accounting principles. The EFRAG Research Director informed participants that EFRAG and the Italian Standard Setter were currently involved in a proactive project on the separate financial statements.

Free choice in selecting the accounting treatment should be avoided.

One participant welcomed the Discussion Paper as he referred to further investigate how to apply IFRS 3 or the predecessor basis of accounting instead of leaving the topic at the free choice of the interested parties. Therefore, he supported the debate as it was intended to reduce the use or discretion which had contributed to produce diversity in practice.

View 2 could be further developed as several issues may arise in applying the predecessor basis of accounting

Another participant noted that if different ways of applying view 1 had been identified, there was also a variety of ways of applying view 2 (the predecessor basis of accounting). These included:

- Push down of values from the top level of consolidated accounts top (US GAAP style);
- Values in the books of the transferor;
- Original historical cost (which could be different to the value in the books of the transferor due to intermediate acquisitions).

Country and jurisdiction are distinctive features and the analysis should clearly highlight the geographical picture of the issue

One participant believed that the needs of users needs may significantly vary and therefore wondered whether an analysis had been carried out on a country by country basis.

One user questioned whether the EFRAG/UK ASB working group had consulted with the Financial Reporting Lab in the UK.

The EFRAG Research Director noted that the working group had gathered users' views in developing the discussion paper and he appreciated the remark to further enhance the arguments included in the discussion paper.

The hosting partner questioned whether participants were comfortable, in principle, with the recognition of a gain or loss on the occurrence of such transactions.

Experience shows that users do not always welcome the recognition of gain or losses in a BCUCC

A participant noted that experience showed auditors were sometimes less comfortable at recognising gains on disposal in transferors than preparers.

Being a not market driven transaction, fair values could not be reliable to some extent

A user noted that before focusing on the recognition of income and expense by bifurcating the value of the business transferred and the distribution/contribution, preparers would first have to deal with the identification of fair values of assets and liabilities in order to identify the amount actually distributed/contributed ..

The EFRAG Research Director agreed with this remark and noted that in presenting view 1 issues related to the reliability of fair values had been analysed.

Participants agreed that the transactions between owners in terms of distribution and contribution should always be highlighted

Further investigation should be carried out on the relationship between owners' transaction arising from BCUCC and local requirements

Participants at the event generally agreed that complications relating to distributable reserves always arise in BCUCC transactions. They agreed with the analysis carried out in the discussion paper on the potential need to bifurcate transactions and splitting out the elements that are actually distributions/contributions. They believed further investigation is also required in relation to local jurisdiction requirements as they felt that a single accounting model could never encompass all the specificities embedded in several different local regimes.

One participant noted that the concept of contribution and distribution depended on the applicable legislation. In some jurisdictions the price of the combination may be set by law (e.g. Brazil – historical cost, Italy – Fair Value) while in other regimes the price could be nominal.

The EFRAG Research Director agreed and highlighted that the issue was even more significant in jurisdictions where transactions between related parties were required to be at fair value (e.g. Italy).

Participants believed that the BCUCC issue should be dealt with in the wider debate on

Another participant pointed out that BCUCC are a subset of related party transactions, and that he felt they should be included in a general debate on the accounting for those. Another participant noted that in jurisdictions like the UK *related parties' transactions*

transactions may occur at a nominal price of £1. In addition he highlighted that he would welcome a broader scope of the analysis; he expressed his view that on a conceptual basis there would not be differences between buying a company for £1 and in buying a factory for the same price.

One user noted that in some jurisdictions (e.g. the UK) it is difficult to identify who users of sub-consolidated financial statements are. There are few listed entities which are not the ultimate parent company (as in the fact pattern presented in the discussion paper).

The EFRAG Research Director recalled that the issue was frequently seen in Italy. There were several highly concentrated and vertically structured groups where the listed entity usually did not represent the ultimate parent. In addition he noted that in countries where listed companies and certain other entities are required to apply IFRS for their separate financial statements (again the Italian experience) the issue was even more relevant.

The accounting treatment must depict the purposes and the economics of the transaction

A user with an auditing background believed that the reasons for the transactions (e.g. tax, increasing balance sheet values) should be evaluated in order to identify the accounting treatment which best depicts them.

One preparer wondered why entities – already supposed to apply the IAS 8 hierarchy – have come to such different conclusions on the accounting treatment to apply; creating so much diversity in practice. He believed it indicates the existence of problems for preparers in applying IAS 8.

The existence of minorities should significantly influence the accounting choice

One participant appreciated the analysis included in the Discussion Paper on the importance of understanding users' needs and wondered whether the existence of minorities should be considered as a trigger factor in deciding the accounting treatment for BCUCC: in her experience this was an indicator which regulators consider in their enforcement activities.

Does the debate on BCUCC question how control guidance is applied within a large group?

A debate took place amongst participants on changes of control in BCUCC. Some viewed that change of control which triggers the application of IFRS 3 in accounting for Business Combination are not met in a BCUCC transaction as already the transaction occurs within the larger overall group. Others expressed their concern in viewing control from the point of view of anything other than the reporting entity; believing that legal boundaries and applicable requirements count no matter how the ultimate parent company is placed.

View 3 let preparers chose the accounting treatment depending of the transaction purpose

One participant at the event expressed his support for view 3 in the Discussion Paper as he strongly believed in the key importance of understanding why transactions are taking place and therefore would welcome guidance based on that analysis.

A user with an auditing background supported the variant of View 1 where goodwill is ignored because he thought it had significant practical attractions and might help in applying IFRS 3; overcoming conceptual and practical difficulties in the absence of a market driven acquisition price.

Other preparers did not support such view as they believed that if values were available and could be considered reliable they should be properly reflected in the accounts.

Bright lines cannot be drawn in selecting the accounting for BCUCC as the rationale for such transaction could be a myriad

The hosting partner summarised the views expressed so far at this and other outreach events. He noted that participants said they found additional guidance and principles useful, but had presented circumstances and situations which would lead them not to support the definition of bright lines. They thought that the Discussion Paper covered the potential options and that there was no hypothetical view 4 to consider.

The different legal requirements and regimes existing together with multiple reasons for carrying out BCUCC transactions imply it is impossible to identify a single preferred accounting treatment. Overall, participants supported view 3 as they perceived it to be the best one in providing useful guidance in accounting for transactions which in practice (even if all labelled as BCUCC) could be very different. Finally, the majority of participants at the event had found it useful to widen the analysis broadly to transactions made between related parties believing that the substance and the economics of such operations do not change if it is an asset being transferred as opposed to be a business.

Income tax

The UK ASB Director of Research introduced the Discussion Paper and provided guidance on how the working group had led the analysis. He pointed out that within the Discussion Paper two different approaches had been suggested, namely:

1. IAS 12 *Income Tax* is a standard which should be 'repaired' in order to remove the perceived

inconsistencies and, accordingly, some suggestions were presented on major topics (Disclose the reconciliation of tax rate, introducing discounting in deferred taxes, dealing with uncertain tax positions);

2. IAS 12 *Income Tax* which is based on the temporary difference approach is fatally flawed and thus it should be re thought. Several conceptual alternatives are presented together their pro and cons.

Both approaches considered what had been identified as users' needs, namely the wish to identify the entity's specific sustainable tax rate and the risks related to the tax area also in terms of expected and unexpected cash outflows.

One participant believed that users' needs should drive the accounting for income taxes and thus supported these outreach events and enhanced reporting; in addition he believed that the IASB should react to users' request.

Participants at the event supported IAS 12 as it is

One participant stated that he believed users were satisfied with IAS 12 as it currently is. He believed that the implied effective tax rate on the face of the income statement can be easily used to generate an effective tax rate going forwards.

Users need to understand in a multi-jurisdiction group the implication of different tax regimes apply and the impact on the group tax rate

A user with an auditing background remarked that the existence of several tax jurisdictions was one of the reasons why differences existed in practice. In addition he believed that in multinational groups the issue was even more perceived as at consolidated level preparers had to summarise heterogeneous information for consolidated reporting.

A user believed it would be beneficial for the development of the debate to consult with the Financial Reporting Lab in the UK.

US requirements are considered burdensome and not effective

The hosting partner expressed his view on uncertain tax positions and expressed his support in avoiding US style disclosures (included in FIN48) given their complexity and high costs.

The working group should investigate the definition of income tax

One participant wondered why the definition of income tax was not included in the scope of proposed changes. He believed that, especially in the Oil and Gas industry, it represented a significant issue – as shown by the requests submitted to the IFRS Interpretations Committee. He would welcome the inclusion of this in the scope of the discussion paper. He also noted that the UK government was pressuring companies to include tax credit above the line.

The EFRAG Research Director noted that one of the objectives of the Discussion Paper was to gather views on the necessity of completely rethinking the accounting for corporate taxes and accordingly part 2 of the paper started from the assumption that a balance sheet approach would need to be pursued to resolve all the issues perceived by both preparers and users.

Narrative reporting could be properly used to remove perceived inconsistencies

A user with an auditing background expressed her view that narratives may help users in understanding an entity's tax position and resolve all the other issues discussed within part 1 of the paper.

Taxes recognised within the OCI should be included in the proposed tax reconciliation

With reference to the tentative tax reconciliation proposed in the paper, one participant wondered how taxes recognised directly within the equity through the statement of comprehensive income would be disclosed.

Discounting is not perceived to be an improvement in accounting for income taxes

Participants were unanimous in not expressing a desire for the inclusion of discounting in deferred tax accounting, noting that historically it was only used by utilities companies or others with long-lived assets (in the UK context of allowing, but not requiring, discounting).

Guidance on how to account for new classes of transaction should be developed

A user with an auditing background believed that in exploring different applicable approaches a set of guidance should be defined to help identify the proper accounting treatment when new types of transactions occur or when new taxes are levied.

Best estimate is the preferred method in accounting for uncertain tax liabilities

With reference to the recognition and measurement criteria for uncertain tax positions participants unanimously supported the use of the best estimate approach.

Exceptions increase complexity and difference in practice, consequently they should be removed

Some argued that in the past a lack of comparability had been caused by the initial scope exemption in circumstances when legislation changed and therefore IAS 12 had to be followed, even though they would not if the legislation had been brought in before the transition to IFRS. The paradox was that the transition date would influence the reported figures as an entity adopting IFRS after the change in legislation would still be allowed to use the initial exception and therefore no liability would be recognised.

Other participants agreed with the UK ASB Research Director that the existing inconsistency in the intra-group transactions should be removed as it resulted in figures which did not fairly depict the substance of the operation.

One participant also questioned whether the issue related to classification of currency differences has been analysed in circumstances when there is a difference between the tax functional currency and accounting functional currency; he noted that diversity in practice could arise in circumstances where some entities classified such difference as an exchange difference while others classified it within the tax line.

Enhanced disclosure in income tax should also be included in interim financial statements

One participant also welcomed the inclusion of the tax reconciliation in interim financial statements. In addition he would have welcomed some disclosure in order to provide narrative supporting the main reason for changes in numbers.

Closing

The Hosting Partner, after having asked participants at the event for additional comments closed the event.