Liberté • Égalité • Fraternité
RÉPUBLIQUE FRANÇAISE

AUTORITE DES NORMES COMPTABLES
5, place des Vins de France
75573 PARIS CEDEX 12
Phone 33 1 53 44 28 53
Fax 33 1 53 44 20 61
Internet http://www.autoritecomptable.fr
Mel jerome.haas@anc.gouv.fr
Chairman
JH
n° 56

Paris, the 20 JUIL. 2012

Madame Françoise FLORES
EFRAG
35 Square de Meeûs
B-1000 Brussels
Belgium

Re : EFRAG and ASB Discussion Paper « Improving the Financial reporting of Income Tax »

Dear Mrs Flores,

I am writing on behalf of the Autorité des Normes Comptables (ANC) to express our views on the above-mentioned discussion paper. These views result from the ANC's due process, involving all interested stakeholders. More precisely, the due process includes fundamental work by a diversified experts working group, a full fledge discussion of its assessment by a complete Commission for all International standards and then a global and strategic discussion in the collège (Board) before this letter was signed.

The ANC acknowledges that the existing IAS 12 standard is complex to implement for preparers of financial statements and often difficult to understand by users. Therefore, we consider it is useful to undertake research and analysis in this area.

The fundamental question regarding IAS 12 is: "**what is the purpose of income tax related to the objectives assigned to the financial statements and users' needs?**" The ANC considers that this fundamental issue requires preliminary thinking before elaborating any proposals for improvements, and more particularly in the context of the standard's full revision. This preliminary thinking does not appear to have been conducted in the Discussion Paper.

Considering this fact, the ANC can all the more not support the development of a new standard based on different principles from those of the current standard. Having nevertheless examined the approaches proposed if the development of a new standard were to be considered, the ANC considers that only two approaches have merit to be further considered as a basis for new developments: the temporary differences approach and the accruals approach.

The ANC considers that deficiencies in IAS 12 should be addressed through limited amendments to the existing IAS 12 standard. We identify four specific issues where the current requirements are unsatisfactory, and, if addressed, would improve the existing standard:

- An exemption to IAS 12 principles for intragroup transfers of assets,
- A clarification of the scope of the standard,
- A clarification of the tax rate which should be used for single asset entities,
- An analysis regarding deferred tax arising from non depreciable assets acquired trough a business combination.

Regarding possible amendments to IAS 12 addressed in the Discussion Paper, the ANC considers that:

- The possible improvements of presentation and disclosure requirements have to be consistent with the objectives of the "disclosure framework" project;
- About uncertain tax positions, the "more likely than not" recognition criterion and measurement taking into account management's best estimate would better reflect the expected cash flows than using the probability-weighted average of all possible outcomes;
- Discounting of deferred tax assets and liabilities under IAS 12 must still be prohibited.

If you have any questions concerning our comments, we would be pleased to discuss them.

Yours sincerely,

Jérôme HAAS

<u>Copie</u> : Mr Roger Marshall, FRC Accounting Council

Appendix – Questions asked by the EFRAG

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?

The ANC considers that the existing IAS 12 standard is complex to implement for preparers of financial statements and often difficult to understand by users.
Those difficulties are not generally due to deficiencies of the IAS 12 standard itself. Indeed, regulations concerning the taxation of income are complex and very different from one tax jurisdiction to the other. That could be an obstacle to understanding income taxes in the financial statements. However the basis on which the existing standard is defined (the balance sheet approach) does not facilitate the understanding of such effects.

Preliminary thinking is needed prior to identifying proposals for improvements, and more particularly in the context of the full revision of the standard. Main matters to be considered are:

- The purpose of income tax related to the objectives assigned to the financial statements;
- The scope of a standard concerning income tax.

As such process has not been conducted, the ANC cannot, at this stage, support the development of a new standard based on different principles from those of the current standard. The ANC considers that deficiencies in IAS 12 should be addressed through limited amendments to the existing standard IAS 12.

The ANC has identified four specific issues where the current requirements are unsatisfactory, and, if addressed, would improve the existing IAS 12 standard. For the details of these issues, please refer to our comments in question 1.9.

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)

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)

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)

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)

Overall, the ANC considers that:

- The notes to the financial statements should provide factual information which amplifies and explains the primary financial statements, when necessary;
- The notes should explain past transactions; information about the future is provided in other reports;
- Information in the financial statements could be already improved without amendment in the standard. In particular, application guidance could be useful for users of financial statements.

Reconciliation of the tax paid and current tax expense
The ANC understands that users are interested in obtaining information regarding the payment of tax debt. One solution may be to provide an aged trial balance for the tax liability. Indeed, for the ANC, additional disclosures that would provide a reconciliation of the tax paid and current tax expense will not be useful for users. In addition, were the reconciliation of tax paid to current tax expense considered to be useful, it may follow that such analysis would also be useful for the analysis of all profit and loss accounts. Therefore the question of requesting this type of reconciliation should be addressed in a broader context than that of income taxes.

Disclosures regarding deferred tax assets
The ANC considers that existing disclosures regarding deferred tax assets, especially unused tax losses and unused tax credits, required by the IAS 12 standard are sufficient.

Tax strategies
The ANC disagrees with the proposal that tax strategies should be disclosed in the financial statements. Indeed this information is not in line with the fundamental principles of the notes of financial statements as defined above. The ANC considers that relevant information regarding tax strategies could be provided in the management report, when necessary.

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)

For the ANC, the suggestions made in the paper are helpful by clarifying the explanation about why the tax charge is not equivalent to the amount resulting from the standard rate of tax applied to the accounting profit. The ANC considers that such information could be relevant to users.

In respect of the principles exposed in the answer to the questions 1.1. to 1.5., the ANC recommends that suggestions of tax rate reconciliation should be provided as an application guidance and not as an amendment of the IAS 12 standard.

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)

Without substantial analysis about the purpose of income tax as regards the financial statements, the ANC is not able to suggest how the disclosures in IAS 12 can be improved to provide better information about future cash flows.

However, the ANC recalls that an accounting standard cannot require that information regarding expected cash flows or earnings forecasts be provided in the financial statements. The ANC considers that a schedule of cumulative timing differences at the balance sheet date by the expected year of reversal may provide users with predictive information.

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.

There are relevant arguments in favour of discounting deferred taxes as it allows:

- The recognition of the economic effect of the time value of money in the financial statements, especially as regards the deferred tax liability for which the settlement is considerably uncertain;
- The consistency with current measurement for other assets and liabilities.

However, the ANC considers that the issue of discounting cannot be addressed by an amendment to the existing approach. The ANC therefore concludes that discounting of deferred tax assets and liabilities under IAS 12 must still be prohibited. The ANC's main objections to discounting deferred tax are:

- The segregation of amounts that are already effectively discounted from those that are not. This analysis is necessary in order to avoid discounting assets or liabilities which have already been discounted;
- The complexity and the cost to establish a reliable scheduling of the timing of reversal of the temporary differences;
- The increase in assessments resulting from the inclusion of many assumptions (discount rate and discount period).

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)

(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)

Disclosures

The ANC considers that existing disclosures regarding uncertain tax positions are sufficient and useful for users of financial statements. Indeed, existing standards require that an entity should disclose in its financial statements:

- Within disclosures on accounting policies, the measurement **basis** applied for liabilities (IAS 1.117);
- Information about the assumptions concerning the future and other major sources of estimation uncertainty at the end of the reporting period, when these may have a significant risk of causing material adjustment to the carrying amount of assets or liabilities within the next financial year (IAS 1.125);
- For tax contingent liabilities and contingent assets, a brief description of the nature of these contingent liabilities and an indication of the uncertainties about the amount or timing of outflows (IAS 12.88);
- When changes in tax rates or tax laws are enacted or announced after the reporting period, any significant impact on the entity's tax positions (IAS 12.88).

Recognition and measurement

The ANC considers that the application of the **"more likely than not" recognition** criteria, as in IAS 37 today, would be relevant. The ANC believes a provision should be recognised when it is more likely than not there will be an outflow of resources. This method should be addressed in the IAS 12 standard.

The ANC believes that the **measurement** should be based on the **most likely outcome** and not based on a probability-weighted method.

The ANC considers that tax positions should be measured in accordance with the management's best estimate, as it reflects the more likely expected cash flows and produces decision-useful information. The probability weighted method requires establishing the different possible outcomes and evaluating the probability they are to be realised. Such evaluations are necessarily subjective and may be onerous to provide. The probability weighted average of the different scenarii will not provide estimates of amounts expected to be paid or deducted. The ANC does not think that is relevant information for users because it does not reflect the management's best estimate of expected cash flows.

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?

The ANC has identified four subjects which, if addressed, would improve the existing IAS 12 standard.

Intragroup transfers of assets
According to the current requirements of IAS 12, the differed tax is quantified at the tax rate of the buyer. Indeed, intragoup transfers of assets create a temporary difference between the carrying amount of the asset transferred and its taxe base. The asset transferred is stated at cost to the group but it has a tax base corresponding to the transfer price. In accordance with the temporary difference approach, the temporary difference is quantified by the buyer who recognises the asset transferred.
That rule leads to unfair presentation of the income tax expense. Indeed, at the time of the asset transfer, the tax on the profit transfer is computed at the seller tax rate. Afterwards, no further additional income tax will be due at the time of the asset's use or sale.

The ANC thinks that the application of the tax rate of the seller is more appropriate and better reflects cash flows. An exemption to IAS 12 principles, applicable to intragroup transfers of assets, would lead to better presentation of the financial statements.

Scope
The ANC is concerned that the scope as defined in the existing standard is vague and has to be better framed.

Single asset entity
Regarding single asset entities, the ANC believes that a clarification is necessary as to which tax rate has to be used, i.e. asset or entity tax rate.

Non depreciable assets
The ANC considers that the subject of deferred tax arising from non depreciable assets and especially intangible assets, acquired trough a business combination should be addressed.

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

The ANC considers that the exemptions that currently exist in IAS 12 correspond to identified needs and lead to better presentation of financial statements. Therefore, the ANC is not in favour of removing any of these exemptions.

Part 2: Alternative approaches to accounting for income tax

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?

Notwithstanding being convinced that more work needs to be done on the objectives of accounting for income taxes in the financial statements prior to considering a fundamental rethink of the current standard, the ANC has examined the five proposed approaches in the Discussion Paper.

In this regard, the ANC considers that three approaches should not be considered as a basis for further development for a new standard for income taxes:

- **Flow-through approach**. The tax expense reported for a period is the tax assessed on the income of that period as the tax expense. Although simple, this approach does not provide relevant information.
- **Partial tax allocation approach**. The effect of timing differences is recognised only to the extent to which they are expected to lead to future cash flows. This approach responds to a criticism of the existing IAS 12 standard which may result in the recognition of deferred tax liabilities, although the prospect of any future payment seems to be remote. However this approach involves reliance on subjective estimates and an important cost of preparing financial statements.
- **Valuation adjustment approach**. Timing differences do not give rise to deferred tax assets and liabilities, but affect the amount of assets and liabilities which should be adjusted accordingly. This approach is complex and does not provide relevant information in terms of 'direct-reading' as regards deferred tax.

To summarise, these three approaches provide less useful information than the existing IAS 12 standard.

The ANC considers that two approaches should be considered as a basis for further development for a new standard for income tax:

- The temporary differences approach
- The accruals approach

The **temporary differences approach** corresponds to the balance sheet approach for deferred tax. Under the temporary differences approach, the effect of all differences between the carrying amount for financial reporting purposes of an asset or liability and its tax basis is recognised. This approach is the one that underlies the existing IAS 12 standard. Under this approach, the tax effects of all temporary differences are recognised in the financial statements. This rule leads to results that are considered difficult to justify and which should be addressed by exceptions. If exceptions are retained, this approach will be very close to the existing IAS 12 standard but it will require amendments as described in the answer to question 1.9.

The **accruals approach** corresponds to the profit and loss approach for deferred tax. Under the accruals approach, the reported tax expense reflects the tax effect of all transactions and events that are reported in the period. That includes taxes without base (tax adjustments, tax relief, prior period adjustments...). No formal distinction between current and deferred tax is made.

This approach seems to be relevant. Indeed the accruals approach fairly reflects tax consequences of income and expenses that are recognised in the period. However, this approach should be reviewed

- To recognise current tax expense and deferred tax expense separately;
- To recompute the amount on the balance sheet every time there is a change in the tax laws or tax rates.

These two approaches are based on different concepts of deferred tax.

Therefore, before further work on a possible revision of the standard, the ANC considers that thorough work be done regarding the purpose of income tax related to the objectives assigned to the financial statements (see answer to question 0.1).

Combination of approaches

Finally, the ANC considers that devising an approach based on principles consistent with the purpose of financial statements is preferable to devising a system that uses a combination of approaches.