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GAAP: In depth

Need to know

Focusing on tax transparency in annual reports and accounts

Income tax disclosures under the spotlight

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Introduction

This edition of Need to know highlights some key issues and challenges for publicly traded companies in the forthcoming reporting season in relation to the transparency of accounting for and disclosure of current and deferred taxes required by IAS 12 Income Taxes in annual reports and accounts. For further guidance on IAS 12, see chapter C13 of Deloitte GAAP 2016.

Why tax disclosures matter

In the light of recent intense media scrutiny of certain large companies, there are growing demands on UK companies to be more transparent in how they approach paying taxes, report on their tax policies and governance, identify significant tax risks and account for and disclose tax in their financial statements.

Tax matters because it is usually a material area of the financial statements and often one for which the accounting requires the exercise of significant judgement or estimation. For multi-national groups in particular, tax is an area where there are frequent changes to complex tax rules, which may raise challenges as to whether those groups can continue to achieve their business model and strategic objectives. For this and other reasons, tax may be an area of principal risk and uncertainty.

Recently, the UK Financial Reporting Council (FRC) carried out a thematic review of the disclosure of tax risks in corporate reports, the results of which are expected to be published this Autumn. The FRC was particularly interested in:

- the transparency of tax reconciliation disclosures and how well the sustainability of the effective tax rate is conveyed; and
- uncertainties relating to tax liabilities (and assets) where the value at risk in the short term is not identified.

The Finance Act 2016 includes legislation on tax transparency which will require certain large businesses to publish their tax strategy in relation to UK taxation on their website from 2017, see our **Governance in brief – Publication of your UK tax strategy**. More generally, there is growing interest in companies' tax strategies and governance and their tax risk appetite.

The IASB is expected to publish its final IFRIC Interpretation on uncertainty over income tax treatments shortly. This is likely to raise users' expectations as to what constitutes clear and transparent accounting and disclosure of uncertain tax positions, see our **Need to know – IASB publishes a draft Interpretation of IAS 12 Income Taxes – Uncertainty over income tax treatments**.

For more information please see the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

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A key challenge for companies in relation to taxes covered by IAS 12 is whether the accounting and disclosures in the financial statements and narrative reporting meet users' information needs, including:

- transparency of disclosures;
- understanding the effective tax rate and changes thereto including expectations as to the future rate; and
- understanding the extent of, and risks relating to, uncertain tax positions and potential future changes to tax laws and regulation.

The central challenge for boards in relation to tax in the annual report and accounts is whether it is possible for users of their annual report and accounts to gain an understanding of why the tax is what it is, what influences it, what the key risks are and whether things might change materially in future.

Tax in narrative reporting

Key questions for Boards in relation to narrative reporting

- Have we discussed the impact of tax on results, cash flows and financial position, highlighting the impact of any significant adjustments to previous estimates or unusual items, and discussed our effective tax rate and how it might change in future?
- Is tax an area of principal risk or uncertainty and, if so, have we described the risk and how we are addressing it?
- Is there consistency between disclosures of principal risks, Audit Committee report, audit report and significant judgements and estimates in relation to tax?
- Have we set out or signposted information on our tax governance, strategy and policies?
- Have we quantified clearly our total tax payments during the year?
- Is tax addressed in a consistent and cohesive way across the entire annual report and accounts?

The impact of tax on results, cash flows and financial position

The Companies Act 2006 (CA 2006) (s414C) requires the strategic report to include a fair, balanced and comprehensive review of the development of the group's business during the year and its financial position at the year end. Discussion of the impact of tax on results, cash flows and financial position will usually be a material component of this review. If there are individually significant tax impacts, such as resolution of a previously uncertain tax position, these should be addressed specifically otherwise the report risks not being fair, balanced and comprehensive. If the cash tax payments in the year differ markedly from tax expense recognised in the accounts, the strategic report should explain this if the reason is not clearly evident from the accounts. They should also discuss significant tax impacts arising from business acquisitions and disposals. Users of the accounts are likely to be interested in the group's effective tax rate (ETR), the reasons for changes to that rate and factors that may affect its sustainability in future. ETR itself may be a key performance indicator.

Principal risks and uncertainties

Depending on a group's circumstances and its complexity, tax may be a source of principal risk and uncertainty, meaning that disclosure as such in the strategic report is required by s414C CA 2006. If so, the principal risk or uncertainty should be described, including how it may affect the group's future prospects such as threats to achieving its business model. Actions being taken to manage or mitigate the risk should be set out. When a group operates in many tax jurisdictions, especially ones where tax laws are unclear or subject to frequent change, tax is more likely to be a principal risk than in straightforward situations where such exposures are lower. For example, the OECD's Base Erosion Profit Shifting (BEPS) project may impact the risk analysis.

Tax governance, strategy and policies

There is growing stakeholder interest in tax governance, strategy and policies but only a minority of companies address these areas meaningfully in their annual reports or signpost where such information may be found on their websites. Some companies have already taken the opportunity to enhance their narrative reports by demonstrating that they take corporate responsibility seriously in relation to tax, pay their fair share, act ethically whilst ensuring tax efficiency, use legitimate tax reliefs for their intended purpose and do not participate in any aggressive tax planning that may be open to challenge later.

Quantifying total tax payments

Although not a statutory requirement, some companies now include disclosure of the quantification of their total tax cash payments across all taxes, not merely those covered by IAS 12, that they have made in the year in their strategic report or in the section of their directors' remuneration report dealing with the relative importance of spend on pay to demonstrate that they are fulfilling their role as good corporate citizens.

Tax in the financial statements

Income taxes within the scope of IAS 12 are usually material to a company's accounts. Even if not material in strict numerical terms, tax may be qualitatively material, for example because it appears unusually low.

Key questions for Boards in relation to tax in the financial statements

- Are our tax accounting policies relevant, clear, comprehensive and specific?
- Is tax a key source of estimation uncertainty and, if so, have we provided appropriate disclosures?
- Have we disclosed information on any provisions for uncertain tax positions or tax contingencies that are material either individually or in aggregate?
- Does our tax reconciliation enable readers to understand whether the relationship between tax expense and accounting profit is unusual and to understand the significant factors that could affect the relationship in future?
- Have we explained the nature of deferred tax assets and the basis on which we have recognised them, in particular when there is a history of recent losses, or why we have not recognised deferred tax assets in respect of losses or other deductible temporary differences?

Accounting policies

Accounting policies in relation to tax need to be clear, relevant, tailored to the group's circumstances, avoid the use of vague and generic expressions and address all major issues including the recognition and measurement of uncertain tax positions, if relevant. An uncertain tax position arises when there is uncertainty over whether the relevant taxation authority will accept a specific treatment under tax law. A clear accounting policy for uncertain tax positions should explain:

- the recognition threshold, for example that a liability is recognised when it results from a past event and it is more likely than not that a payment will occur;
- the measurement basis, for example, a best estimate approach; and
- how the numbers are arrived at, such as with involvement of internal or external tax experts or based on previous experience with similar issues.

Key judgements and sources of estimation uncertainty

Tax may be a complex area where there is a need for management to exercise significant judgement with regard to assumptions and estimates, in particular when there are uncertain tax positions. Disclosures should be clear, concise and specific and enable readers to understand the key assumptions and judgements management has made and their impact on results and financial position. Management should avoid generic statements without quantification.

IAS 1 Presentation of Financial Statements requires disclosure of information on the assumptions made about the future and other major sources of estimation uncertainty at the end of the reporting period that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year (IAS 1.125). IAS 1 refers specifically to the sources of estimation uncertainty rather than the mere fact that estimates might have been made. The reference in IAS 1 to the next financial year does not limit the disclosure to uncertainties that are expected to be resolved within a year. Rather it applies to any situation where there is a significant risk of a material adjustment in the next year.

IAS 1.129 explains that the nature and extent of the information provided to meet the requirement in IAS 1.125 will vary according to the nature of the assumption and other circumstances. In complex situations, additional disclosures beyond the specific requirements of the standards may be needed to provide the level of transparency and information that users expect regarding the judgements made. Examples given of the types of disclosures that may be needed as a minimum include:

- the nature of the assumption or other estimation uncertainty;
- the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity;
- the expected resolution of an uncertainty and the range of reasonably possible outcomes within the next financial year in respect of the carrying amounts of the assets and liabilities affected; and
- an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

IAS 1.131 notes that sometimes it is impracticable to disclose the extent of the possible effects of an assumption or another source of uncertainty. In all cases, the standard requires disclosure of the nature and carrying amount of the specific asset or liability affected by the assumption.

Quantification of amounts recognised in respect of uncertain tax positions covered by IAS 1.125 and of the risks relating specifically to the next financial year are therefore required. Such disclosure also enhances transparency and enables users to understand the amounts recognised and the related uncertainties.

In many cases, it may be that the tax balances do not include any individually material uncertain amounts. However, companies should nevertheless disclose how much of the total tax amount relates to uncertain amounts and, if relevant, state that within that total there are no individually material amounts. If an individual uncertainty is material, disclosure should be given in relation to that item.

When the risk of a material adjustment in the next year is not significant, the specific IAS 1.125 disclosure requirement does not apply and the disclosures should not describe the area in question as a key source of estimation uncertainty. Nevertheless, companies should make disclosures relating to estimates made in respect of uncertain tax positions where there is a significant risk of a material adjustment beyond the next financial year as this is transparent and informative to users. Such disclosures may, for example, be provided as part of the tax note.

Disclosure of tax contingencies and post-year end tax changes

Uncertain tax positions give rise to contingent liabilities and contingent assets to the extent that amounts in respect of such positions are not recognised in the financial statements. Provision may be made for part of an uncertain tax position, with the remainder disclosed as a contingent liability. In such cases, disclosures should identify clearly that the two components are related to one another. IAS 12.88 requires disclosure of any tax-related contingent liabilities and contingent assets in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent assets. The standard notes that contingent assets and liabilities may arise, for example, from unresolved tax disputes with the taxation authorities.

When changes in tax rates or tax law are enacted or announced after the reporting period, the accounts should disclose any significant effect of those changes on the company's current and deferred tax assets and liabilities.

Tax reconciliation and effective tax rate

IAS 12.81(c) requires an explanation of the relationship between tax expense/income and accounting profit in either or both of the following forms:

- a numerical reconciliation between tax expense/income and the product of accounting profit multiplied by the applicable tax rate or rates, disclosing also the basis on which the applicable tax rate is computed; or

- a numerical reconciliation between the average effective tax rate and the applicable tax rate, disclosing also the basis on which the applicable tax rate is computed.

IAS 12.84 explains that these disclosures enable users of financial statements to understand whether the relationship between tax expense and accounting profit is unusual and to understand the significant factors that could affect the relationship in future.

IAS 12.85 notes that, in explaining the relationship between tax expense or income and accounting profit, an entity uses an applicable tax rate that provides the most meaningful information to the users of its financial statements. It further notes that, often, the most meaningful rate is the domestic rate of tax in the country in which the entity is domiciled, aggregating the tax rate applied for national taxes with the rates applied for any local taxes which are computed on a substantially similar level of taxable profit/tax loss. However, for an entity operating in several jurisdictions, IAS 12 notes that it may be more meaningful to aggregate separate reconciliations prepared using the domestic rate in each individual jurisdiction.

Therefore, where a group has operations in many tax jurisdictions, a key issue to consider is whether using the domestic tax rate, such as the UK Corporation Tax rate, provides the most meaningful disclosure. Often, a weighted average approach will be more appropriate in such cases, for example where using the UK Corporation Tax rate gives rise to significant adjustments due to differing tax rates in other jurisdictions.

Disclosure of reconciling items should be sufficient for the reader to understand their nature and why they have arisen. For example, descriptions of reconciling items should be clear and specific and, as a minimum, the following categories of reconciling item should normally be identified separately if material:

- effect of differing tax rates;
- expenses not deductible for tax;
- income not subject to tax;
- change in unrecognised deferred tax assets;
- adjustments relating to previous periods; and
- utilisation of past losses.

Reconciling items should not be offset and presented net when the individual components are material, such as non-deductible expenses and non-taxable income.

When there are material adjustments relating to previous years, this may raise challenges as to whether those adjustments indicate past undisclosed uncertain tax positions and whether further such adjustments might arise in future, so clear explanation is important. Distinguishing significant one-off items from those that are expected to recur increases the predictive value of the disclosure and helps users assess the sustainability of the ETR.

When exceptional or similar items are disclosed, their tax effect should also be disclosed where material as this will help readers to understand their impact on the ETR. In some cases, tax charges or credits may themselves warrant separate disclosure on materiality grounds, for example when the outcome of a tax dispute goes against what the company had been expecting or where a decision in a tax case not itself involving the company gives rise to a material change in the estimate of tax payable.

Companies can enhance the disclosure still further by providing explanatory narrative for significant reconciling items and discussing future expected ETR and the factors that may affect it or why it is not practicable to provide such information.

Deferred tax assets

Recognition of deferred tax assets may pose significant challenges, especially when there is a track record of recent losses, and may be a source of significant estimation uncertainty. Disclosures should enable readers to understand the assumptions made in estimating the amounts recognised, how sensitive those amounts are to changes in assumptions, over what period the entity has been able to forecast probable suitable taxable profits (the 'look-out' period) and whether assumptions for those periods are consistent with those made in other areas, for example impairment testing. In addition, where there are losses or other deductible temporary differences in respect of which no deferred tax assets have been recognised, disclosures should enable the reader to understand why no asset is recognised and what may change that assessment in future.

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