May 2016

STAFF PAPER

IASB Meeting

Project	**Income Taxes**
Paper topic	Appendix B: Feedback from Investor Outreach

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Purpose of this paper

1. In order to follow up the work done by other standard setters and better understand how investors obtain and make use of tax information, the staff have conducted some investor outreach (see Appendix C for Investor Survey Questionnaire (Agenda paper 19D)). This survey is independent of the 2015 Agenda Consultation Survey.

2. This paper outlines the result of this investor outreach.

Structure of this paper:

3. This paper contains the following sections:

   (a) Investor outreach conducted (paragraph 4);

   (b) Major comments from investors (paragraphs 5-10); and

   (c) Detailed investor survey result (paragraphs 11-28).

Investor Outreach conducted

4. The staff did the following to understand the needs of financial statements users:

(a) designed an investor survey and used it as the basis for discussion during the 2015 February meeting of the Capital Markets Advisory Committee (CMAC) in London;

(b) launched a global investor survey (see Appendix C (Agenda Paper 19D)) on the usefulness of income tax information. To date, 117 responses have been received;

(c) contacted some respondents to the survey by telephone; and

(d) went through news clips and research papers related to income tax accounting (mainly related to disclosures) under the current framework, some of these papers provided an insight into the current practice for tax disclosures, while others provide suggestions on how the tax disclosures can be improved from the viewpoint of investors.[1]

Major comments from investors

5. As a result of conducting the procedures mentioned above, the following are the major findings on investors' needs on income tax information.

Not much need to change the model for recognition and measurement

6. Most users consider tax information, including deferred tax information, to be useful. Although many users are not very concerned about what type of accounting model the Standard should use, they generally do not support a fundamental change from the existing model because they worry that some data might be lost.

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[1] Multinationals and tax where tax is due: http://economia.icaew.com/opinion/april-2015/multinationals-and-tax-where-tax-is-due ;CR Common Practices Deferred Tax under IFRS: https://www.companyreporting.com/browse/common-practices; International Variations in Tax Disclosures (Erlend Kvaal & Christopher Nobes, 2013); PwC Investor View Improving income tax disclosures: https://www.pwc.com/gx/en/audit-services/corporate-reporting/publications/investor-view/pdf/pwc-improving-income-tax-disclosures.pdf; PwC Tax Transparency: Communicating the tax companies paid: https://www.pwc.co.za/en/assets/pdf/2010-tax-transparency.pdf; 'Corporate Tax Strategy: A sustainability risk for investors: http://yearbook.robecosam.com/corporate-tax-strategy.html; 'It's time to call for more responsibility' Sustainalytics, 2013; KPMG UK: Developing a common framework for disclosing tax information

Need for more transparent tax disclosures

7. Many users think that existing disclosures about income tax information lack transparency. Some users see the recognition and measurement of deferred tax as a mechanism to smooth out earnings and to hide volatility.

8. Users would like more information about an entity's tax strategies, tax risks and tax cash flow. The following are some examples of specific suggestions:

   (a) The tax reconciliation should:

      (i) highlight the key tax strategy employed and the entity's competitive advantage/ disadvantage instead of merely burying these in an aggregated amount of 'Foreign tax rate difference';

      (ii) start from the weighted average tax rate rather than from a tax rate in the parent's jurisdiction, so that the information on key tax strategies would be more clearly highlighted; and

      (iii) provide information about the entity's intercompany debt and about how it contributes to lowering the effective tax rate.

   (b) Entities should provide more information on:

      (i) uncertain tax positions, because this is important for forecasting the entity's future tax risk;

      (ii) special tax incentives that an entity receives, what conditions have to be met to receive those incentives and when the incentives are expected to expire etc;

      (iii) tax loss carryforwards and other items that may affect future tax payments; and

      (iv) details of tax drivers, because this information is considered very important in assessing tax risks and the sustainability of a tax rate.

   (c) A country-by-country analysis is important for examining whether a company had applied an aggressive policy. That analysis should disclose:

      (i) tax policies and approach;

(ii) the purpose of subsidiaries located in tax havens; and

(iii) tax payment and related financial information (sales, revenue etc) in major subsidiaries.

Discounting deferred tax assets (liabilities)

9. Users have different views on whether discounting should be used for deferred tax liabilities and deferred tax assets. Many users think that discounted balances reflect the time value of money, but they are also concerned that the discounted numbers may be more difficult to understand.

Fair value accounting and tax accounting

10. Deferred tax accounting is complex and this may especially be the case when fair value accounting is involved. For example, some users said that they do not understand deferred tax liabilities arising from revaluation of assets, and that they do not understand how it should be treated in their analysis.

Detailed investor survey result

11. The staff developed the investor survey through consultation with the investor liaison team as well as CMAC members. The staff also invited investors to participate in the online survey during 2015. The survey is available at https://www.surveymonkey.com/r/IncomeTax_InvestorSurvey.

Respondent statistics:

12. To date, 117 responses have been received. 30 are invalid because either the respondents are not investors or the surveys are highly incomplete.

13. The remaining 87 valid respondents include 21 private/retail equity investors (24.1 per cent), 16 buy-side equity analysts (18.4 per cent), 11 credit analysts (12.6 per cent), 11 equity portfolio managers (12.6 per cent), 11 sell-side equity analysts (12.6 per cent), 7 creditors/lenders (8.0 per cent), 3 fixed-income portfolio managers (3.4 per cent), 2 private/retail debt investors (2.3 per cent) and 5 other types of investors (5.7 per cent).

14. Geographical distribution—38 respondents (43.7 per cent) follow the Asia-Oceania market closely, while the remaining valid respondents are distributed among the Americas (15 respondents, 17.2 per cent) Europe, Middle East and Africa (21 respondents, 24.1 per cent) and the global market (13 respondents, 14.9 per cent).

15. Industry distribution—47 respondents are generalist (54.0 per cent), while the rest follow Financial Services (15 respondents, 17.2 per cent), Technology (7 respondents, 8.0 per cent), Industrial (5 respondents, 5.7 per cent), Real estate (4 respondents, 4.6 per cent), Consumer Defensives (2 respondents, 2.3 per cent), Pharmaceuticals (2 respondents, 2.3 per cent) and 1 respondent (1.1 per cent) each for Basic materials, Consumer Cyclicals, Country coverage, Energy and Telecommunication services.

16. Similar responses were observed for all types of investors, regions and industries, for all survey questions.

How tax information is obtained and used currently

Source of tax information

17. Audited financial statements are considered the most important source of tax information, while other information provided by the company (eg management commentary, analyst presentation) and other analysts (eg research reports) is also commonly used.

Use of tax information

18. Tax information is mainly used as inputs in valuation models or is used to assess an entity’s tax strategy and leverage. Some users use it to assess earnings quality, general financial soundness (creditworthiness) and management’s risk appetite, as well as to look for ‘gaming the system’.

19. Of various types of tax rate provided by the company, the effective tax rate (ie tax expense (income) over accounting profit before income taxes) is considered very relevant by many respondents (43.7 per cent), closely followed by the cash tax rate (ie cash tax paid over accounting profit before income taxes) (36.8 per cent) and the company projected rate (eg forecasted tax rate provided by companies

during investor presentations) (32.2 per cent). Some respondents based their valuation model on a single tax rate while taking into consideration other qualitative information available, eg a special tax concession.

Information needs

20. Overall, 35.6 per cent of respondents consider the tax information that is currently disclosed to be unclear, insufficient and difficult to understand; 13.8 per cent consider it clear but insufficient; only 20.7 per cent consider it clear and sufficient. 29.9 per cent express no view on the overall tax disclosure. Investors generally want more information on tax strategy (eg prudence/aggressive tax planning), tax risk (eg drivers for high/low tax rate and the sustainability of the tax rate) and tax cash flow (eg reversal schedule for deferred tax assets).

21. Many investors consider the tax reconciliation important but concluded that the existing reconciliation is not detailed enough to serve its intended purpose. For example:

    (a) foreign tax rate differentials are usually presented as one item that combines information from many jurisdictions with different tax rates and tax arrangements; and

    (b) entities start the tax rate reconciliation with weighted average rates that already include effects of tax planning measures.

22. Some investors suggested that a reconciliation using the average effective rates, weighted by geographical sales, is more relevant than a reconciliation using the parent company's applicable tax rate.

23. Details of tax drivers are usually not disclosed in financial statements, even though users consider this information very important in assessing tax risks and the sustainability of the tax rate. Investors appreciate increased transparency (disclosures in the footnotes) related to special tax incentives and the related investment requirements and expiration dates of related incentives.

24. Many investors are looking for the disclosure of expected patterns of cash flows (reversal schedule) from deferred tax assets/liabilities and if possible, reconciliation between the cash tax rate and the effective tax rate.

Other comments on income taxes

25. 42.5 per cent respondents consider deferred tax liabilities ('DTL') as debt. Others consider it to be a part of an underlying asset/ liability (11.5 per cent), equity (10.3 per cent), nothing more than a fictional number (8.0 per cent), or consider that it depends on the nature of deferred tax liability[2] (5.7 per cent) and income (3.4 per cent). The remaining 18.6 per cent did not express a view on this.

26. The majority consider deferred tax assets ('DTA') as either a financial asset such as prepaid tax (27.6 per cent), or a non-financial asset representing tax loss carryforwards etc (25.3 per cent). Others consider it a part of an underlying asset/ liability (10.3 per cent), nothing more than a fictional number (10.3 per cent), or consider that it depends on the type of deferred tax asset[3] (2.3 per cent), or an expense (1.1 per cent). The remaining 23.1 per cent did not express a view on this.

27. 46 per cent of respondents opposed the discounting of DTA/ DTL either because they believe discounting will make the number even more complicated or because they do not consider DTA/ DTL to be a real asset/ liability. On the other hand, 32.2 per cent support discounting, because they believe discounting better reflects the time value of money. The remaining 21.8 per cent did not express a view on this.

28. Other comments made:

    (a) Deferred tax on revaluations creates complexity.

    (b) Disclosure is not standardised and makes it very difficult to compare entities.

    (c) Deferred tax is too complex and becomes a fictional number. Some suggested that the primary financial statements should include only cash tax number and deferred tax information should be disclosed in the notes.

[2] For example, if the deferred tax arose because of accelerated depreciation for tax purpose, then this deferred tax is seen as equity because it does not bear interest and, as the entity keeps acquiring new assets, the amount of deferred tax liability remains at a similar level. However, for other items such as a deferred tax liability for revaluation gain, some users are not sure what it is.

[3] For example, deferred tax asset for tax loss carryforwards and tax credit are usually seen as assets but other deferred tax assets are not.