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Comment Letter on the EFRAG Discussion Paper "Improving the Financial Reporting of Income Tax" (December 2011)

Dear Sir/Madam,

Volkswagen welcomes this EFRAG initiative as a matter of principle because disclosures on (current and deferred) income taxes are of considerable relevance in entities' financial reporting and appreciates the opportunity to submit its views.

Our positions on the main proposals in the Discussion Paper are as follows:

(1) Volkswagen does not see a need to stipulate standardised formats for reconciling the actual tax expense reported in the income statement to the charge on accounting profit at the statutory tax rate and to cash paid for taxes in the cash flow statement.

(2) Volkswagen does not believe that discounting of deferred tax items is useful, especially from a cost/benefit perspective.

(3) Volkswagen rejects any attempt to stipulate specific recognition and measurement rules and additional disclosures for uncertain tax positions similar to FIN 48.

(4) Volkswagen does not believe that there is any need for a specific debate on alternative approaches to the concept of temporary differences currently used to account for deferred taxes.

Our detailed comments on selected issues are summarized below.

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?

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The relevance of the issue and the criticism voiced to date by professional constituents justify contemplating amendments to the way deferred taxes are reported. From Volkswagen's perspective, however, any amendment should be well-considered, because the current requirements set out in IAS 12, which have largely been effective since 1998, have generally proved their worth in practice for preparers, auditors and users of financial statements. Additionally, past experience shows that there simply is not a single "right" approach to reporting deferred taxes, and that nobody's interests are served by initiating (or revisiting) protracted, dogmatic debates about theory.

The following should therefore be considered as the bright lines for any revision of the existing IAS 12:

(1) Emphasising the materiality principle so as to spell out in greater detail the fundamental principle – anchored in the IASB Framework – of the relevance and decision-usefulness of accounting information;

(2) Enhancing the transparency and comparability of disclosures on (deferred) taxes;

(3) Optimising the relationship between preparation cost/effort and information benefits (cost/benefit).

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)

No.

At Volkswagen, no questions or comments from users of financial statements have arisen so far in this respect in the context of the presentation of financial reports prepared in accordance with IFRSs. Volkswagen does not therefore share the view that the amounts disclosed for the current tax expense reported in the income statement on the one hand, and for the cash paid for taxes reported in the cash flow statement on the other, which are naturally different, lead to misunderstandings on the part of the users of financial statements. On the contrary: Volkswagen presumes that the users of financial statements are familiar with the conceptual differences between the accrual basis of accounting used for income and expenses in the income statement on the one hand, and the cash basis of accounting used for receipts and expenditures in the cash flow statement on the other. Additionally, we are of the opinion that the information advantages of a reconciliation from current tax expense reported in the income statement to cash paid for taxes reported in the cash flow statement would be very limited, because the reconciliation would not reflect any genuine relationship between the two amounts, but would be a purely artificial reconciliation.

In terms of disclosures on the tax expense related to discontinued operations, we believe that the current classification in IAS 12.81 (h) for notes disclosures is adequate.

For these reasons, Volkswagen takes the view that the existing explanations and classifications of current tax expense (including the disclosure of prior-period income and expense) in the notes in accordance with the current version of IAS 12 are adequate, and does not therefore see a need for amendments.

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)

No.

At Volkswagen, no questions or comments from users of financial statements have arisen so far in this respect in the context of the presentation of financial reports prepared in accordance with IFRSs.

The transactions that underlie deferred tax assets (especially in respect of unused tax losses and tax credits) are often highly specific, and the accounting rules for their recognition are very complex. It may also happen that the utilisation of loss carry-forwards as originally envisaged does not subsequently materialise (e.g. because of changes in the law), but that other losses can unexpectedly be utilised, with the result that the effects offset each other. We therefore believe that excessively detailed disclosures on the background to deferred tax assets would probably be counterproductive in terms of the decision-usefulness of the information provided.

Finally, it should be remembered that deferred tax asset items are normally examined in minute detail by the auditors and the enforcement agencies (in Germany, in particular the Financial Reporting Enforcement Panel). Readers of financial statements can thus count on the condensed, clearly presented disclosures on deferred tax assets giving a true and fair view of the position at the reporting date.

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)

No.

Volkswagen believes that the existing requirements governing the reconciliation of the so-called expected tax expense (i.e. accounting profit multiplied by the applicable tax rate) to the tax expense reported in the income statement to be disclosed in the notes in accordance with IAS 12.81 (c) and (d) are adequate. We therefore take the view that the subdivision of the reconciliation proposed in the Discussion Paper (p. 21) into, firstly, effects from current taxes and, secondly, effects from deferred taxes, is not strictly necessary and may actually lead to confusion. Specifically, we are of the opinion that the classification of the tax expense reported in the income statement into current and deferred taxes in accordance with IAS 12.79 f. is adequate.

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)

Volkswagen believes that the separation generally provided for in accounting law makes sense, with the financial statements (including the explanatory disclosures in the notes) relating to past information (reporting date principle), while the management report also contains estimates and assumptions by management about future trends, including future cash flows, for example in the "report on expected developments". In this respect, we are of the opinion that the financial statements may only therefore continue to present information about future cash flows that is also reflected in the carrying amounts reported for balance sheet items. For Volkswagen, the question of the adequate provision of decision-useful information in the annual and consolidated financial statements is thus above all a question of the accurate measurement of balance sheet items.

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.

No.

The question of discounting deferred taxes must distinguish between temporary differences (recognised for tax purposes) between the IFRS carrying amount and the tax base on the one hand, and deferred tax assets in respect of tax losses and tax credits on the other. In the first case, Volkswagen believes that discounting is conceptually questionable, because if the IFRS carrying amounts already represent fair values (discounted if applicable), this must also apply to the resulting temporary difference, ruling out any (further) discounting of the related deferred tax item.

By contrast, the situation with deferred tax assets in respect of tax losses and tax credits is likely to be different, as the main issue here is whether the tax benefits can be realised in the future. Nevertheless, Volkswagen believes that, in these cases as well, no discounting should be required because such a distinction between the measurement rules – which does appear to be arbitrary – would result in the accounting rules for deferred taxes, which are already very complex, being made considerably more complicated. We do not believe that this is something that can be explained to the users of financial statements.

In light of this, from the perspective of Volkswagen, the outcome of any cost/benefit analysis of the proposal to discount deferred taxes is negative. Not least because of this issue, neither German GAAP nor US GAAP discount deferred taxes.

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 positions? 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)

No.

For Volkswagen, current and deferred tax items represent assets or liabilities if they meet the general recognition criteria. Under these criteria, future economic benefits must be expected to flow to the entity from a resource controlled by the entity as a result of past events, or there must be a present obligation of the entity whose settlement is expected to result in an outflow of resources embodying economic benefits. The probability criterion is generally held to mean "more likely than not", i.e. a probability of occurrence > 50%. It must be possible for the reporting entity to provide a reasonable justification for this estimate.

The recognition criteria for tax items thus do not differ from those for other assets and liabilities, i.e. they can be just as certain or uncertain as other balance sheet items are. Consequently, we do not believe that it is necessary to introduce into IFRSs a requirement similar to FIN 48 in US GAAP (especially because experience since the issue of FIN 48 in June 2006 shows that this interpretation of SFAS 109 has tended to cause more problems than it has solved).

The replacement of the most likely outcome method by a probability-weighted average method discussed in this context does not appear to us to be expedient, because forecasting probabilities of occurrence and tax amounts will only lead to misleading degrees of mathematical accuracy that will be paid for by a higher expense and effort needed to calculate them, that will have no benefits for the users of financial statements, and that will no longer be comprehensible if they do materialise.

Volkswagen otherwise welcomes a greater degree of convergence between IFRSs and US GAAP, but it does not believe that this should be allowed to become an end in itself. The question of whether accounting pronouncements are expedient or not must be assessed solely on the basis of the objectives of IFRSs, meaning the provision of decision-useful accounting information for an entity's stakeholders (and considering the cost constraint).

Q2.1-Q2.5
Questions to constituents - Part 2: Alternative approaches to accounting for income tax

Volkswagen does not believe that there is any need for a fundamental debate on alternative approaches to the concept of temporary differences in accounting for deferred taxes. Firstly, the effort and cost of switching to a new regime would probably be very high for both the companies affected and for the users of financial statements. Secondly, past experience shows that there simply is not a single "right" approach to accounting for deferred taxes, and that nobody's interests would be served by initiating (or revisiting) protracted, dogmatic debates about theory.

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We would be pleased to discuss our comments with you at your convenience. If you have any questions, please contact us.

Yours sincerely,

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