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Dear Sir or Madam,

Invitation to Comment – Discussion Paper: Improving the Financial Reporting of Income Tax

We welcome the opportunity to comment on EFRAG and the UK Accounting Standard Board's Discussion Paper: Improving the Financial Reporting of Income Tax. I am pleased to respond on behalf of BP p.l.c. to the invitation to comment.

Overall, while we believe that the accounting and reporting of income taxes is far from simple, there has been a significant amount invested by preparers and users in understanding the current approach under IAS 12, and we consider the current model to be workable. There are, however, a number of areas where we believe that incremental improvements could be made, including:

- Standardizing the format of the tax rate reconciliation by removing the choice currently allowed: require either a weighted average statutory tax rate or the statutory tax rate in the country of the parent company; require that the reconciliation be presented as a percentage of profit before tax or as a currency amount; and specify the categories of reconciling item to increase comparability between companies.
- Clarify that provisions for uncertain tax positions should be calculated assuming full knowledge by the tax authorities (i.e. should not be adjusted for "detection risk"). No specific methodology should be mandated for measurement of such provisions – while we believe that a best estimate usually better predicts the actual outcome this does depend, to some extent, on the unit of account used.
- The interaction between reporting of income taxes and reporting of post-tax earnings of equity-accounted entities can result in a significant distortion to the effective tax rate. As well as addressing this distortion through improved disclosure in the tax rate reconciliation, this could possibly lead to a review of how equity-accounted entities' taxes are presented as part of a broader review of equity accounting.
- We believe that consideration should be given as to whether it is always appropriate to consider both "inside" basis differences (in respect of the assets and liabilities on the consolidated balance sheet) and "outside" basis differences (arising as a consequence of the structure of the legal entities involved, e.g. taxation related to the sale of shares in a subsidiary) when determining deferred tax. We believe that there are situations where recognizing deferred tax in respect of inside-only or outside-only basis differences based on management's expectations may better align deferred tax



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accounting with economic reality, resulting in fewer deferred tax liabilities which will never crystallize as cash tax payable.

We do believe that disclosures relating to income taxes could be improved, but that such improvements should be pursued with the objective of "better" reporting rather than just "more" reporting. We welcome the work performed to date by EFRAG on a possible disclosure framework, and note the support for a disclosure framework in many of the responses to the IASB's recent agenda consultation. We suggest that any revised disclosures in respect of income taxes be developed in the context of best practice identified as part of the disclosure framework project.

It is also important, in our view, that any future disclosure requirements in respect of income taxes be considered in the context of regulatory developments regarding payments to governments – whether in extractive industries or more broadly – with the objective of ensuring that useful information is provided to investors and creditors in a holistic, non-duplicative and consistent manner.

We do not advocate a wholesale review of accounting for income taxes as we believe that the application issues are not sufficiently important to warrant a completely new approach, and any benefits will be outweighed by the costs of re-education and systems changes, as well as the practical challenges of arriving at an implementable solution within a reasonable timeframe.

Responses to the detailed questions raised in the discussion paper are included in the appendix to this letter. If you would like to discuss any of our comments we would be happy to do so. Please do not hesitate to contact myself or Martin Perrie (martin.perrie@uk.bp.com).

Yours faithfully



Roger Harrington

APPENDIX

Responses to the Invitation to Comment

Question to constituents - 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?

Yes, we believe that there are a number of practical issues in existing IAS 12 that should be addressed. As we set out in our cover letter, we believe that IAS 12 is reasonably well understood by preparers and users, certainly by those who have been applying IFRS for a number of years. We do not believe that it would be helpful to replace in its entirety a standard with which constituents are familiar and for which the application issues are not sufficiently important to warrant a completely new approach. Rather, we believe that IAS 12 could be improved through limited amendments as set out in our cover letter and in our responses to the questions in Part 1 below.

Questions to constituents - 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)

We do not believe that there are significant misunderstandings between the amount of income tax paid presented in the cash flow statement and the current tax expense recognized in the income statement. Other than current tax recognized directly in other comprehensive income or equity, it is not clear to us what reconciling items would be disclosed in such a reconciliation other than "changes in current tax payable/receivable" and "foreign currency translation differences".

A roll-forward of the opening to closing current tax payable/receivable balances which explains more clearly how the current tax expense in the income statement relates to the tax paid in the year and the corresponding balance sheet movements may be a useful way of presenting the information to users.

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)

We believe that there is an asymmetry between the disclosures required for tax losses and tax credits which are recognized on the balance sheet as deferred tax assets, and those which are not recognized. There appears to us to be an imbalance between the greater level of disclosure required for unrecognized tax losses in IAS 12 paragraph 81(e) and the lower level for recognized tax losses in IAS 12 paragraphs 81(g) and 82.

We are not convinced that additional meaningful disclosures could be provided for large, complex multinational groups where the recovery of deferred tax assets depends on many factors, including the interaction between deferred tax assets and deferred tax liabilities, particularly where the reversal of existing differences will be replaced by new differences of the same nature. If users are concerned about the extent to which recognized deferred tax assets are recoverable, we believe this is mitigated by the level of challenge provided both

internally through management review and by external auditors – where users are confident that the recognition criteria have been properly applied there should be less need for additional disclosure requirements.

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)

The information needs described in Chapter 1 of Part 1 in general appear reasonable to us. However, we are not convinced that these needs are best met through new mandatory disclosures – we believe that when appropriately complied with the current requirements will, in general, address the user needs identified. In our opinion, many of the perceived weaknesses in current disclosures could be addressed through more thorough application of the existing standards and through outreach and education of user groups to allow them to better appreciate the information already provided in the notes to the financial statements.

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)

We agree that it is not generally appropriate to include forward-looking information such as tax strategies in historical financial statements. However, we are not convinced that meaningful discussion of tax strategies is likely to be provided in management commentary, particularly for large and complex multinational groups, and fear that any such mandated disclosures might be somewhat boilerplate.

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)

We do not agree with the premise that the tax rate reconciliation is inherently complicated – in fact we believe that this is one of the most useful disclosures required by any IFRS standard.

To the extent that there are misunderstandings regarding explanations of why the current tax charge is not equal to a tax rate multiplied by accounting profit, this may be because the required reconciliations are of the **total** income tax expense, including deferred tax. We found the example reconciliation in the discussion paper splitting the effective tax rate reconciliation into current and deferred elements quite helpful in this respect.

We do see that there is some scope for standardization, by removing some of the optionality available in the current standard to enhance consistency and comparability. We believe that there are advantages and disadvantages to each of the options currently available, and so do not express a preference at this stage. We believe there would be advantages in:

- requiring either a weighted average of the statutory tax rates applicable in the countries in which each entity operates or using the statutory rate in the country of domicile of the parent company;
- requiring the reconciliations to be presented as either percentages of pre-tax profit or in currency amounts; and
- establishing standard categories of reconciling items to be used to increase comparability between companies. There may be unusual transactions that do not fit

into the standard categories – these could be shown separately, if material, or otherwise included in an “other” category.

One of the largest reconciling items in our tax rate reconciliation is driven by the profit-before-tax number including a significant amount arising from BP’s share of equity-accounted entities’ post-tax profit, which is not subject to any further group-level tax. An effective tax rate reconciliation which excludes equity-accounted entities, either in the notes to the financial statements or in management commentary, might provide useful information as it would not suffer from this distortion. While there is no real way of avoiding this effect if equity accounting is to remain presented in the form that it currently is required under IAS 28, this could be reviewed as part of a wider review of equity accounting if it causes users of financial statements significant difficulty in understanding tax rate reconciliations.

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)

In our view future tax cash flows are largely a consequence of future pre-tax cash flows, on which there is also, naturally, limited information provided in historical cost financial statements.

We recognize that while the effective tax rate is in general a useful predictor of the future income tax expense (after adjusting for the effects of non-recurring transactions), it is not a particularly good predictor of tax cash flows due to the impact of deferred tax. However, as we mention above in our response to Q1.2, we do not believe it to be practical in a large multinational group to provide information regarding the reversal of temporary differences giving rise to deferred tax, which in any case might not be particularly meaningful as those temporary differences are replaced by new temporary differences (which may relate to transactions which have not yet occurred at the balance sheet date).

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.

We disagree with requiring deferred tax balances to be discounted on both pragmatic and conceptual grounds. From a practical perspective, the projections required of the timing of reversal of temporary differences in order to discount them appropriately would be extremely complex and judgemental, and we question whether the costs would be outweighed by the benefits. On a conceptual level, many deferred tax balances arise as a result of assets being carried at fair value in the financial statements but at historical cost for tax purposes. As those fair values are, in many cases, based on discounted future cash flows, the related deferred tax is already implicitly discounted – it would be double counting to discount again.

Discounting is not the only solution to some of the perceived weaknesses of the current standard. Some of the most undesirable consequences of not discounting deferred tax balances include accounting for deferred tax liabilities which clearly do not represent tax that will be paid in the future, for example those in relation to investment properties in corporate wrappers and acquired indefinite-lived intangibles held in corporate entities. We believe that consideration should be given to amending IAS 12 to not require both “inside” and “outside” basis differences to be taken into account when calculating deferred tax, rather that the deferred tax should reflect management’s expectations of how the asset will be used or sold, including the legal structure used. If a temporary difference is only expected to reverse through the sale of shares of a corporate entity which holds an asset rather than the sale of the asset itself, deferred tax could be accounted for based on the tax consequences of selling the shares and not a hypothetical sale of the asset alone.

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)

We believe that information should be provided in relation to material uncertain tax positions in the financial statements, both recognized and unrecognized. We believe that narrative disclosures similar to those required for provisions recognized under IAS 37 would be reasonable and proportionate for material uncertain tax positions, although it is important that any required disclosures do not prejudice any negotiations or proceedings with tax authorities.

We agree that there is currently inconsistent application of recognition and measurement rules in respect of uncertain tax positions, and so further guidance should be provided. In particular we believe that IAS 12 should make it clear that provisions should assume full knowledge of transactions by the tax authorities (i.e. there should be no adjustment for "detection risk").

Measurement based on a most likely outcome will often result in a provision which best reflects the actual tax cash outflows. However, the overall provision for uncertain tax positions across a group will depend to some extent on the unit of account used and how this interacts with the best estimate. For example, where the individual disputed item is the unit of account applying a "best estimate" approach to each of them and summing to reach a total provision may result in an over- or under- estimate in relation to the actual amount that will be paid, which does not take into account an overall view of the total tax that will be paid. In contrast, where the unit of account is the amount of income tax payable in a particular tax jurisdiction, a best estimate will often be a better predictor of the actual amount of tax that will be paid. To that end we believe that the guidance should also discuss the unit of account as well as the measurement basis to ensure that a consistent approach is applied.

While we believe that management's best estimate will often be a better predictor of the actual amounts that will be paid, we would not mandate a particular methodology. However, where the effect is material would expect the criteria used for using a particular measurement methodologies to be disclosed.

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?

We believe that additional guidance could be provided in respect of the scope of IAS 12 as significant judgement is often required in determining whether a new tax is an income tax or not. There is a somewhat circular definition of an income tax whereby paragraph 2 of IAS 12

defines an income tax as a tax based on taxable profits, and paragraph 6 goes on to define taxable profits as being profits upon which income taxes are payable.

Consideration could also be given to how the impact of changes in exchange rates should be recognized in the financial statements where the tax base of assets and liabilities is measured in a different currency to the functional currency of the reporting entity. We are not convinced that recognizing the effect of remeasuring the tax base into the functional currency in the income statement provides useful performance information.

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

We do not, in principle, support exemptions and exceptions in accounting standards, and believe that standards should be principles-based and robust enough to not require exemptions. However, as we discuss above in our response to Q0.1, considering the level of investment in understanding existing IAS 12 we would not support a fundamentally new standard. That being the case we believe that retaining the exemptions in IAS 12 is the least bad option.

Questions to constituents - 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?

As stated in our responses to Part 1 we believe that IAS 12 should be retained with limited improvements, and would not seek to develop a new approach. However, if a new standard is to be developed we believe that the approaches which bear most similarity to IAS 12, i.e. the temporary difference and the accruals approaches, could be considered as they are most likely to be readily understood by preparers and users of financial statements. The partial tax allocation and valuation adjustment approaches appear to be even more complex to apply and understand than IAS 12, and so we would not advocate proceeding with them.

Before embarking on any such project we would suggest that EFRAG, the ASB, and indeed the IASB consider the following fundamental questions:

- Why the scope should be restricted to income taxes, and not include other taxes paid to or collected on behalf of governments? Is it clear what benefits users obtain from the presentation of income taxes separately from other taxes?
- If users of financial statements are essentially interested in predicting future tax cash flows, are any available models for accounting for income taxes capable of providing the information that they would like at a cost which is proportionate?
- To what extent, and in what circumstances, are deferred tax assets and liabilities consistent with the definition of assets and liabilities in the IFRS Conceptual Framework? We are concerned that certain deferred tax liabilities which are not likely to crystallize as current tax payable may not meet the definition of a liability. Consequently, any fundamental review of deferred taxation which is fully reconciled to the Conceptual Framework may, by default, result in something akin to the "flow-through approach" described in the discussion paper, with the ensuing volatility in the income statement that we describe below.
- Are other standard setters such as the US FASB are also considering change? If not, would the perceived advantages of any change outweigh the resulting further divergence in accounting for income taxes that would result?

While we can see the attraction of the flow-through approach from a simplicity perspective regarding the amounts recognized in the financial statements, we believe that the accompanying disclosures required to provide users with an understanding of the future tax consequences of recognized transactions would restore a great deal of the complexity. The flow-through approach would also be likely to result in significant volatility in the income statement charge and effective tax rate, which would be a challenge to explain to investors. We would, therefore, also exclude the flow-through approach from consideration.

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?

We do not foresee any particular difficulties with the limited improvements we suggest to IAS 12.

Q2.3 Are there any approaches that are not discussed in Part 2 that should be considered?

We are not aware of any other approaches 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?

We do not believe that the complexity that would be likely through combining approaches would result in a workable standard.

Q2.5 Do you have any further comments on the discussion of the various approaches in Part 2?

We have no further comments.