Financial Reporting Council

CORPORATE REPORTING THEMATIC REVIEW

TAX DISCLOSURES

OCTOBER 2016

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The FRC is responsible for promoting high quality corporate governance and reporting to foster investment. We set the UK Corporate Governance and Stewardship Codes as well as UK standards for accounting, auditing and actuarial work. We represent UK interests in international standard-setting. We also monitor and take action to promote the quality of corporate reporting and auditing. We operate independent disciplinary arrangements for accountants and actuaries; and oversee the regulatory activities of the accountancy and actuarial professional bodies.

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Thematic reviews supplement the FRC's Corporate Reporting Review (CRR) function's monitoring of company reports and accounts for compliance with the Companies Act 2006, applicable accounting standards and other reporting requirements. The aim of these reviews is to identify examples of good practice reporting and areas where improvements can be made.

Taxation is an aspect of corporate reporting which gives rise to frequent questions of companies by CRR. Companies' tax arrangements are also subject to considerable public interest currently, prompted by developments in the UK and internationally.

This report shares our detailed findings from the targeted review of certain aspects of companies' tax reporting, against which companies can assess and enhance their own disclosures to ensure they provide high quality information to investors in their annual reports and accounts.

As with individual reviews, the FRC's thematic reviews are based solely on company reports and accounts and do not benefit from detailed knowledge of each company's business or an understanding of the underlying transactions entered into. They are, however, conducted by staff who have an understanding of the relevant legal and accounting framework. The FRC provides no assurance that the reports and accounts subject to this review were correct in all material respects; the FRC's role is not to verify the information provided but to consider compliance with reporting requirements.

1 BACKGROUND

In December 2015, the FRC wrote to 33 FTSE 350 companies informing them that the tax disclosures in their next annual report and accounts would be reviewed by CRR on behalf of the FRC's Conduct Committee. The objective of the review was to encourage more transparent reporting of the relationship between tax charges and accounting profit and the factors that could affect that relationship in the future, in accordance with existing requirements.

2 KEY MESSAGES

Most companies – particularly the FTSE 250 – responded positively to the approach by proactively improving certain aspects of their disclosures. We also observed similar refinements to the quality of tax reporting by other companies outside of the tax thematic review. It was disappointing that no FTSE 100 company subject to the review stood out as a role model in their reporting of tax.

We saw evidence of improvements in the transparency of tax disclosures included in strategic reports. Good practice was identified by those companies who:

- Provided more information on material tax matters likely to be important to investors, including emerging risks arising from the OECD's Base Erosion and Profit Shifting actions.[1]
- Discussed the effective tax rate (ETR) including commentary on variances on prior periods, key influences and the expected future rate.

The improved quality of information provided in companies' ETR reconciliations resulted in greater visibility of the specific factors, including tax structuring, affecting the tax charge and its sustainability. Good reports achieved this by disaggregating and giving detailed descriptions of the reconciling items.

There is, however, scope for companies to articulate better how they account for tax uncertainties by explaining the bases for recognition and measurement. We will continue to challenge companies who do not disclose the amount of uncertain tax provisions when these are subject to risk of material change in the following year. The audit of uncertain tax provisions is an area of particular focus of the FRC's audit monitoring activities for 2016/2017.

Opportunities were identified for companies to improve the usefulness of their disclosure of significant judgements and estimation uncertainties relating to tax. We encourage companies to:

- Consider carefully whether there are significant judgements and estimation uncertainties relating to tax. Where estimation uncertainties are repeated unchanged year on year, we will question whether the disclosure of quantified risk specifically relating to the next year is clear.
- Appraise what specific information about judgements and estimation uncertainties would be most helpful to users of the accounts. In its project "Accounting policies and integration of related financial information"[2] the FRC's Financial Reporting Lab found that investors value an understanding of the judgements made and estimations applied by management, including where that judgement sits within a range of possible or acceptable outcomes.

Of the 33 reports included in its sample, the FRC wrote follow-up letters to three companies where there was a substantive question relating to their tax reporting. Correspondence with these companies is ongoing.

The principal findings from the thematic review are set out in section 3.

1 http://www.oecd.org/tax/beps/
2 https://www.frc.org.uk/News-and-Events/FRC-Press/Press/2014/July/FRC-publishes-Lab-report-on-Accounting-Policies-an.aspx

3 PRINCIPAL FINDINGS

Tax in strategic reports

Overall, the FRC evidenced improvements in the transparency of tax disclosures included in companies' strategic reports. Nearly all companies reviewed included some discussion of the ETR in their business reviews. The following examples of good practice were seen:

- **Variance in ETR on prior year**

> *"For 2015, the underlying tax rate was 29.4% (2014: 31.0% including deduction in China of 2.2% for costs incurred in prior periods). The reduction from 2014 was predominantly due to greater profits from territories with lower tax rates, such as the UK where the corporation tax rate has fallen from 21.5% to 20.25%. In addition to the movement in the underlying rate, the effective tax rate in 2015 was impacted by further recognition of US losses and deferred tax on share options which together reduced the rate by 2.4%."*

Michael Page International plc, PageGroup Annual Report and Accounts 2015

- **Key factors influencing the ETR**

> *"The Group's tax rate is sensitive to the geographic mix of profits and reflects a combination of higher rates in certain jurisdictions, such as the US, nil effective rates in the UK due to available tax losses and rates that lie somewhere in between.*

Tate & Lyle PLC, Tate & Lyle Annual Report 2016

- **Expected future ETR**

> *"Over the medium term, our tax rate is likely to increase as the mix of our business changes and we respond to legislative changes arising from the OECD's Base Erosion Profit Shifting ("BEPS") project."*

Senior plc, Senior plc Annual Report and Accounts 2015

There was an increase in the number of companies describing their general approach to tax reporting. Where tax was identified as a principal risk and uncertainty, some companies expanded their description of the risk to include changes to local and international tax laws arising from the OECD's Base Erosion and Profit Shifting actions.

The FRC was pleased to find examples of disclosures where companies focused on material tax matters where detailed information was likely to be important to investors. These examples included:

- discussion of important tax issues arising in the year and the tax impact of exceptional or non-recurring items;
- identification of major tax risks faced by the company;
- explanations of the reassessment of prior year tax estimates where these were significant, for example, changes in assumptions or resolution of open tax enquiries;

- details of large differences between the current tax charge and tax paid where the reason was not clear from the primary statements; and
- the tax impact of acquisitions, for example, the recognition of deferred tax assets relating to the historic losses of an acquiree.

It was unclear how one FTSE 100 company concluded that its strategic report was sufficiently fair, balanced and comprehensive without including details of the nature of re-assessments of prior year estimates which amounted to over 5% of pre-tax profit. Similarly, another FTSE 100 company omitted to explain in its strategic report why tax paid was only 42% of current tax expense (a difference of over 12% of pre-tax profit).

ETR reconciliation disclosures

The ETR reconciliation should enable users of the accounts to understand both the relationship between the tax expense and accounting profit and the significant factors that could affect that relationship in the future. Companies whose reconciliations achieved this objective gave a greater level of disaggregation and detailed descriptions of the reconciling items.

Permanent differences, non-taxable income and disallowable expenses were often found to have the most significant effect on the effective tax rate. Good disclosures explained the nature of these items and why they were not tax deductible or chargeable. The following examples of good practice were seen:

- **Permanent differences**

"The increase in permanent differences from a £2.7m deduction in 2014 to a £7.5m addition in 2015 arises due to an increased level of disallowable expenditure together with a £3.7m reduction in manufacturing tax incentives as a result of the downturn in US activity and a £2.4m increase attributable to movements in non-taxable exchange gains/losses across various jurisdictions."

The Weir Group PLC, The Weir Group PLC Annual Report and Financial Statements 2015

- **Disallowable expenses**

"Expenses not deductible include charges in respect of uncertain tax positions affecting the current year, financing fair value adjustments not allowable for tax purposes and losses on the disposal of businesses which are not subject to tax."

Experian plc, Experian Annual Report 2016

- **Non-taxable income**

"This was partially offset by the increased benefit of intellectual property incentives from the UK Patent Box and Belgian Patent Income Deduction regimes. Such regimes provide a reduced rate of corporate income tax on profits earned from qualifying patents."

GlaxoSmithKline plc, GSK Annual Report 2015

- **Funding structure**

"Finance arrangements are in place to fund the acquisition of business operations in overseas territories. This finance is provided primarily to US operations through intra group loans which provide a benefit to the Group effective tax rate."

The Weir Group PLC, The Weir Group PLC Annual Report and Financial Statements 2015

Informative reconciliations separately identified the tax impact of non-recurring or exceptional items or provided additional information in footnotes. The following presentations stood out as examples of good practice:

- **Categorisation between recurring and non-recurring items**

	2015	2014
Profit before tax	X	X
UK rate of X%	(X)	(X)
Adjusted for the effects of:		
Recurring items:		
Effect of overseas tax rates	(X)	(X)
Effect of overseas financing deductions	X	X
Non-recurring items:		
Release of tax provisions	X	X

- **Separate presentation of the tax impact of exceptional items**

	Underlying profit/tax	Exceptional items	Total
Profit before tax	X	(X)	X
Tax at weighted average rate of X%	(X)	X	(X)
Adjusted for the effects of:			
Disallowable expenses, impairments, fines etc	(X)	(X)	(X)

- **Additional information provided in the footnotes**

"The Group's tax rate is favourably affected by its internal financing arrangements which involve borrowing by its US operations from the UK, the interest on which has the effect of reducing the amount of tax payable." "This delivered a benefit of £25m in the 2016 financial year (2015 - £24m)."

Tate & Lyle PLC, Tate & Lyle Annual Report 2016

We will raise questions where companies net off reconciling expenses or losses which are non-deductible with income or gains which are not taxable because aggregating fails to demonstrate clearly whether either are significant.

The applicable rate used to reference the ETR should provide the most meaningful information to users of the financial statements. FRC was pleased to see that many companies had not defaulted to the UK Corporation Tax rate when profits were earned across a number of jurisdictions. For example, one FTSE 100 company explained that it had used a weighted average applicable rate for the year, reflecting the applicable rates for the countries in which the group earned profits.

The sustainability of the ETR was conveyed clearly by those companies who described the factors affecting the future tax charge. Common factors included:

- the ability to continue financing arrangements;
- the timing of recognition of tax losses;
- changes to local or international tax laws;
- changes to tax rates;
- the geographic mix of profits;
- new challenges or the resolution of issues by tax authorities; and
- the impact of acquisitions, disposals or restructurings.

The following disclosure illustrated good practice in this area:

> *"The Group receives tax incentives in certain jurisdictions, resulting in a lower tax charge in the income statement. Without these incentives the adjusted effective tax rate would be 26.7% (2014: 27.1%). There is no guarantee that these reduced rates will continue to be applicable in future years."*

Intertek Group plc, Intertek Group plc Annual Report 2015

Uncertainties relating to tax liabilities and assets

Accounting policy

We were pleased to note an increase in the number of companies disclosing a policy for material uncertain tax provisions which is relevant to an understanding of any such amounts presented in the accounts. We observed, however, that descriptions were expressed in general terms, in the absence of any specific requirement setting out how tax uncertainties should be reflected in the accounting for income tax. This is an area where the IASB is shortly expected to clarify the requirements and which will present companies with an opportunity to further improve the quality of their reporting.

FRC understands the difficulty of communicating complex recognition and measurement policies and, in this context, the following examples of better disclosures were identified in the respective areas:

- **When the provision is recognised**

> *"A current tax provision is recognised when the group has a present obligation as a result of a past event, it is probable that the group will be required to settle that obligation…."*

Amec Foster Wheeler plc, Amec Foster Wheeler plc Annual Report and Accounts 2015

> *"Tax liabilities are recognised when it is considered probable that there will be a future outflow of funds to a taxing authority."*

Royal Dutch Shell plc, Royal Dutch Shell plc Annual Report and Form 20-F for the year ended December 31, 2015

- **How the provision is measured**

> *"Uncertainties regarding availability of tax losses, in respect of enquiries raised and additional tax assessments issued, have been measured using the single best estimate of likely outcome approach."*

Acacia Mining plc, Acacia Annual Report and Accounts 2015

- **The factors considered in determining the amount to be provided**

> *"Tax provisions are based on management's interpretation of country specific tax law and the likelihood of settlement...... Management uses in-house tax experts, professional firms and previous experience when assessing tax risks."*

Amec Foster Wheeler plc, Amec Foster Wheeler plc Annual Report and Accounts 2015

Some companies used 'boilerplate' text in their policy descriptions explaining that provisions were established "where appropriate" on the basis of amounts "expected to be paid" to tax authorities. In these cases, the threshold for recognition of the provision and the measurement basis was unclear.

Quantification

29 of the companies sampled identified uncertain tax provisions as involving significant judgements and estimates but only 45% of these quantified the provision. Clarity about significant risk of short-term adjustment to uncertain tax provisions is both valuable to users of the accounts and a requirement of IAS 1[3], paragraph 125.

Justification for non-quantification will continue to be a regulatory focus in future. We found that inconsistency between the identification by the audit committee and/or auditors of significant judgements and estimates in this area and quantification decreases the value of the disclosures.

Contingent liabilities

Some companies disclosed the existence of tax related contingent liabilities but only a handful of those gave an estimate of the financial effect, as required by IAS 37[4], paragraph 86 when more than remote, or disclosed that it was not practicable to do so.

Where uncertain tax provisions and contingent liabilities arise from the same set of circumstances, companies are expected to present their disclosures in a way that shows the link between these two items.

Disclosure of significant judgements and estimation uncertainties

IAS 1 requires companies to disclose information about the assumptions they make about the future and other major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the reported amounts of assets and liabilities within the next financial year.

FRC encourages companies to clearly distinguish IAS 1 disclosures on estimation uncertainty relating to tax, which we believe should forewarn users of reasonably possible changes in the next year, from other valuable information about medium-term tax risks and specific judgements. Where estimation uncertainties are repeated unchanged year on year, we question whether the disclosure of quantified risk specifically relating to the next year is clear.

Some companies identified tax matters as involving significant management judgement or estimation uncertainty but contradicted their own view in the narrative by disclosing that:

3 IAS1 *Presentation of Financial Statements*
4 IAS37 *Provisions Contingent Liabilities and Contingent Asset*

- no material change was anticipated to the amounts already provided; or
- no significant impact was expected on the financial position in the near term.

Descriptions of significant judgements and estimation uncertainties were often bland and not sufficiently specific to the company's circumstances. Better reporters complied with the principle in IAS 1, paragraph 129, by presenting disclosures in a manner that helped users of the financial statements to understand the judgements management had made about the future and about other sources of estimation uncertainty. These disclosures covered, for example, the nature of the assumption or uncertainty, quantified the carrying amount of the asset or liability subject to uncertainty and provided sensitivity analysis or a range of possible outcomes to provide users with a better understanding of the issue. The following good practice example was seen:

> *"The Group's current tax provision of £37.1m relates to management's judgement of the amount of tax payable on open tax computations where the liabilities remain to be agreed with HMRC……. Principally the uncertain tax items for which a provision is made, relate to the interpretation of tax legislation regarding financing arrangements that had been entered into in the ordinary course of business……Due to the uncertainty associated with such tax items, it is possible that at a future date, on conclusion of open tax matters, the final outcome may vary significantly. Whilst a range of outcomes is reasonably possible, the extent of this range is additional liabilities of up to £20m to a reduction in liabilities of up to £52m."*

Pennon Group Plc, Pennon Group Plc Annual Report and Accounts 2016

A few companies recorded that a number of individually immaterial uncertainties together could have a material impact in the next year. Where there is a significant risk of this occurring, good practice would be to explain the circumstances where this could arise and give details of the range of reasonably possible outcomes.

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