

October 25, 2016
Mr. Russell Golden
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-05116

**Re: Proposed Accounting Standards Update, *Income Taxes (Topic 740)* — *Disclosure Framework* —
*Changes to the Disclosure Requirements for Income Taxes***

Dear Mr. Golden,

CFA Institute¹, in consultation with its Corporate Disclosure Policy Council (“CDPC”)² is pleased to provide you with our perspectives on areas for consideration in connection with the Financial Accounting Standards Board’s (FASB’s or Board’s) initiative to improve the disclosures regarding income taxes (hereafter referred to as the “Proposal” or “ED”).

Executive Summary

We strongly support the objectives of enhancing income tax disclosures, as investors depend heavily on these disclosures to understand prior period reported earnings and cash flows and to predict future tax-related cash flows. For example, an investor’s assumption regarding the persistent portion of the effective tax rate is a critical input for the valuation of companies, and investors require meaningful granularity of information within the disclosures to arrive at an accurate, economically relevant adjusted effective tax rate. Furthermore, deferred tax assets/liabilities (DTA/L) can be potentially predictive of future tax cash flows and can also be an indicator of earnings quality. Similarly, unrecognized tax benefits can be potentially predictive of future tax cash flows.

In addition to their key role in determining the value of a business, tax disclosures have become of increasing interest to investors due to the widespread use by companies of aggressive tax strategies. An aggressive tax strategy can create operational, reputational, and legal risks. Investor concerns about tax-related risks have intensified of late due to increased corporate tax

¹ CFA Institute is a global, not-for-profit professional association of more than 137,000 investment analysts, advisers, portfolio managers, and other investment professionals in 157 countries, of more than 131,400 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 147 member societies in 73 countries and territories.

² The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners’ perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

investigations and enforcement actions around the globe, as well as increased cooperation among governments to curb multinational tax abuse.

In short, tax information is a topic of great interest to financial analysts, but current tax disclosures do not always provide sufficient information about a business entity's tax practices, liabilities, and risks. While current disclosures provide some useful analytical information, there is a need to provide better transparency regarding the interplay of taxes and cash flows; the components of the deferred tax valuation allowance; and information regarding repatriation of earnings of foreign subsidiaries, as the ED acknowledges. We would add to these observations that it is generally challenging to reconcile disclosure components to financial statement line items, and there is scope to improve the presentation of tax related information (e.g., via tabular disclosures).

In light of the importance of tax disclosures for investors, and the improvements needed to existing disclosure requirements, we strongly support **most** of the proposed enhancements to the current disclosures – particularly those that have been made regarding increased disaggregation of foreign tax exposures, valuation allowance, carryforwards, indefinitely reinvested foreign earnings, and special government assistance programs that reduce taxes. We believe the changes proposed in the ED will likely result in more effective, decision-useful information about income taxes. We provide a summary of our general comments on the ED, as well as our specific observations on the proposed requirements and our suggestions for additional improvements below.

General Comments

Along with our general support for the proposed changes, we would like to suggest the following areas for further enhancement to the information content of tax information:

- *Material rather than significant:* We agree with the concept of disclosing taxes paid to a foreign country where the amount is significant relative to total taxes paid; however, we propose that FASB should specify a materiality threshold in this context rather than a significance threshold, because “significant” is not a widely understood or agreed upon concept within accounting practice or for investor audiences. We are referring to materiality as it is currently understood, rather than to any intended revision of the materiality concept. That said, we would be supportive of the “significant” threshold if FASB envisions, intends and can clarify that such a threshold will yield more/better disclosure than the “materiality” threshold.
- *Material foreign country tax expense:* If tax paid to a particular foreign country has been disclosed (because it is considered material, as we propose), we propose requiring a corresponding disclosure for tax expense for such countries. We assume that there are minimal constraints to providing material tax expense information for particular foreign countries because preparers are already required to disaggregate tax reporting on a country-by-country basis by the US Treasury and other authorities (e.g., the EU).

We recognize that information provided to tax authorities is different from that required for accounting purposes. Nevertheless, these two sets of information are interrelated. Hence, there ought to be no significant incremental costs incurred if preparers already have country level information that they are providing to other authorities. More importantly, the additional disclosure of tax expense would be beneficial, as it would enable investors to better assess the persistence of effective tax rates and predict future cash flows.

- *Forward-looking information within disclosures:* In our 2014 CFA Institute report, [*Forward-Looking Information: A Necessary Consideration in the SEC's Review on Disclosure Effectiveness*](#), we provide perspectives on the usefulness of forward-looking information. Specifically, we note that the argument that forward-looking information should not be included in financial statements is inconsistent with the current reality that financial statements already include an extensive amount of forward-looking information. A prohibition against providing this type of forward-looking information also appears to be inconsistent with the FASB's proposed disclosure objectives, i.e., to provide entity-specific information, such as the potential effects on tax liabilities and expenses arising from changes in tax laws and other circumstances, of which a user is not expected to be aware.

We, therefore, disagree with the blanket prohibition of disclosures with forward-looking information, such as disclosing the effects of changes in likely-to-be-enacted tax laws on current year reporting and providing useful information on uncertain tax positions. Furthermore, tax disclosures would be even more useful if they included a discussion of management strategy with regards to tax and tax-planning efforts, including how management foresees tax rates changing over time and how it intends to use net operating losses (NOLs).

- *Improved presentation:* We believe that a fundamental aspect of improving the effectiveness of financial statement disclosures is through enhancing the communication principles underlying them. In this regard, tax disclosures could be enhanced by better integration within and between the financial statements, improved cross-referencing, reconciliation of disclosures to the financial statements, and better use of tables and charts. Improvements such as those suggested below, including requirements to clearly identify the location of the DTA/L on the balance sheet; clearly link the deferred tax provision to the change in the DTA/L; provide a detailed roll-forward of the valuation allowance; and disclose the components of the valuation allowance, so that the components of the net DTA/L can be understood, will result in an increased ability of investors to understand and better use the information provided regarding an entity's taxes.

Specific comments

Our specific comments on the individual changes proposed in the ED, as well as our suggestions for additional improvements, are as follows:

Disclosure objectives

We agree that it is fundamental to set forth the objectives of income tax disclosures, and we support the proposed objectives that are proposed in the ED. We would, however, suggest that disclosure objective b. be modified as follows, so that entities are required to disclose how the various components of income taxes are interrelated in the financial statements (suggested additions are underlined):

b. *Explanation of how income taxes affect financial statement line items, how the various components of income taxes are interrelated in the financial statements, and assumptions that an entity makes in determining those line items.*

We also suggest that item c. be re-worded as follows, in order to capture the impact of income taxes on gross as well as net cash flows:

c. *The various components of income taxes that are measured differently or could affect prospects for ~~net~~ cash flows differently.*

Disaggregation of domestic and foreign components

We support the proposed additional disclosures that disaggregate income from continuing operations between domestic and foreign sources, as they will provide more information regarding the sources and potentially the sustainability of reported income and cash flows. Moreover, this information, in combination with the proposed additional disaggregation of income tax expense, should provide greater transparency into the effective tax rates of domestic versus foreign operations.

Furthermore, while we appreciate that there may be concerns regarding the cost and complexity of further disaggregation of these items on a country-by-country basis, we believe that additional disclosure should be provided for any country whose taxable income is material to the entity's total. The materiality determination should consider both quantitative and qualitative factors. For example, an exceedingly low effective tax rate can be indicative of potential future tax liabilities, as demonstrated in the case of Apple, which is currently facing a \$14 billion tax bill in EU.

We also support disclosures of taxes paid to any country where the amount is material. However, we would prefer the disclosure threshold be based on amounts that are "material" rather than "significant," simply because "significant" is not as a widely understood concept within accounting practice as is the concept of "materiality". That said, we would be supportive of the "significant" threshold, if FASB envisions, intends and can clarify that such a threshold will yield more/better disclosure than the "materiality" threshold.

Disaggregation of income taxes paid by year

We appreciate the concerns regarding the difficulty of disaggregating income taxes paid by the tax years to which they relate. However, we suggest as a compromise a requirement to provide

information regarding taxes paid for the current year versus taxes paid for all prior years, if the latter is material.

We also believe that disclosing cash paid for interest and penalties would provide useful information, especially regarding the success of a company in maintaining its tax positions with the taxing authorities, and do not believe that this information should be unduly burdensome for companies to provide.

Indefinitely reinvested foreign earnings

We support the proposed explanation of changes in the assertions regarding undistributed foreign earnings, as we believe it would improve the understanding of both the liquidity and quality of earnings of the reporting entity.

We also support the disclosure of cash, cash equivalents, and marketable securities held by foreign subsidiaries. While such disclosure would be helpful, it is not sufficient to inform investors about potential tax exposures that could result from the interplay between designated indefinitely reinvested foreign earnings and the repatriation of such earnings. Ultimately, undistributed foreign earnings will be taxed if they are to be used to pay dividends or service debt. Hence, we propose enhancing disclosures by including the following information components within disclosures:

- *Tax Effects*: A qualitative discussion of the tax consequences of remitting the earnings back to the United States and the sustainability of the tax structure. Furthermore, if we assume that the proposed disclosure of undistributed earnings held in cash or cash equivalents is meant to be a proxy for the amount most likely available for repatriation, then there should be a required disclosure of the estimated tax liability associated with these cash and cash-equivalent balances of foreign entities.
- *Roll-Forward*: A tabular roll-forward delineating the increase in undistributed foreign earnings and reduction from repatriation of foreign earnings that had previously been designated as indefinitely invested. Disclosure of this roll-forward over multiple periods can enable investors to identify any interplay between designated indefinitely reinvested foreign earnings and the potential repatriation of such earnings.
- *Country breakdown*: A breakdown by country of material indefinitely reinvested foreign earnings for countries where these earnings are still held in cash³.

Finally, we consider that the change in the deferred tax liability is a component of the tax expense and can potentially⁴ have predictive value in respect of future tax payments. Hence, it is

³ We assume that if the earnings are no longer in cash and were actually re-invested (e.g. on overseas factory, or a foreign subsidiary), then the risk of repatriation is quite low, and therefore any potential tax liability would not be a concern to investors.

⁴ Laux, R.C., 2013. The Association between Deferred Tax Assets and Liabilities and Future Tax Payments, The Accounting Review, Volume 88, No.4, pp1357-1388. This study shows that in certain situations, deferred tax liability expense and balance is predictive of future tax payments.

not clear why the deferred tax liability for undistributed foreign earnings is not considered to be analytically useful.

Rate reconciliation

The tax rate reconciliation is one of the most important tax disclosures for investors. Accordingly, we welcome the incorporation of the SEC guidance that would require separate presentation of individual amounts greater than 5% of the total, as well as an explanation of the changes in the reconciling items from year to year. However, we are concerned that there is a risk that some companies will aggregate too many items under the “other – less than 5%” category. Accordingly, we propose that FASB requires that if the other category becomes unduly large, at a minimum, a qualitative discussion of the nature/sources of the differences in this category must be provided.

Change in entity-specific factors

We support the proposed requirement that an entity should disclose a description of an enacted change in tax law that is probable to have an effect on the reporting entity in the future period, as management is generally aware of these changes and companies routinely adjust their tax planning strategies for such changes.

However, we are not persuaded by the arguments put forward by the Board against requiring disclosure of effects of changes in tax law on the current reporting period. Changes in tax laws distort the relationship between pretax and net income and investors need to know their effects on reported income. We therefore, encourage the FASB to reconsider its decision regarding this particular proposal.

Deferred tax disclosures

Investor challenges with current deferred tax disclosures and presentation requirements

We note that the FASB decided not to require an entity to disclose deferred taxes by statement of financial position line items (as discussed in paragraphs BC75-77). One of the reasons provided was that it expects the disclosure to be less beneficial after entities adopt the amendments in Accounting Standards Update No. 2015-17, *Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes*, whereby all deferred tax assets and liabilities will have to be classified as noncurrent on the statement of financial position. However, we note that investors find it challenging to readily discern the realizability and predictive value of DTA/L on future tax cash flows. An aggregated net DTA/L will further hinder the ability of investors to analyze the DTA/L line item.

As the Financial Accounting Foundation’s Post-Implementation Review on Statement 109 stated “. . . investors have some difficulty understanding income tax information provided in the financial statements and their level of satisfaction with that information varies.” Moreover, the proposed Concepts Statement indicates that the Board should consider requiring disclosure of the relationship between financial statement line items if the relationship otherwise is not apparent. Presently, the level of aggregation and the inability of investors to link events across statements

(balance sheet, income statement, and cash flow statement) limit the ability of disclosures to provide insight into the financial statements.

Our suggestions on presentation requirements and proposed disclosures

- *Presentation of deferred taxes by statement of financial position line items:* We recommend that FASB should require an entity to disclose deferred taxes by statement of financial position line item as is required under IFRS reporting.
- *Tabular disclosure -conversion of deferred tax liabilities to current liabilities:* Related to the presentation recommendation, we note that investors tend to be concerned about the potential overstatement of DTL in respect of long-lived assets. We believe discounting would be the conceptually correct approach to address this issue, but at the same time, we recognize the difficulties in determining suitable discount rates for these line items. To help minimize the risk of misinterpretation of DTL balances, we recommend a tabular disclosure of when DTL will become current liabilities that can help inform investors regarding the realizability of these liabilities.
- *Roll-forward of DTA/L:* It is not always readily apparent to investors how the deferred tax provision (income statement) relates to the change in the DTA/L on the balance sheet. Hence, we recommend a roll-forward that establishes a clear link between the amounts on the financial statements (income statement expense (benefit) versus changes in DTA/L). We would expect the roll-forward to delineate the nature and amounts of DTA/L amounts that are reversed and utilized.
- *Valuation allowance:* The proposal would require entities to disclose the amounts and explanation of the valuation allowance recognized and/or released during the reporting period. While we support this proposal, it is not clear whether, as worded, this requirement necessitates a detailed roll-forward of the valuation allowance; we recommend this type of approach, as we believe it is a clear way to convey such information. We also support adding a requirement to disclose the components of the valuation allowance on a gross basis, as DTA/L are provided on a gross basis, whereas the valuation allowance is provided on a net basis; as a result, investors currently have no way to gauge what comprises the net DTA/L. We believe this is a significant shortcoming that should be remedied.

Unrecognized tax benefits

We support the proposal to disclose settlements of unrecognized tax benefits using existing deferred tax assets separate from those that have been or will be settled in cash, as this should provide investors with more information regarding the effect of taxes on an entity's cash flows. We also support the proposals to disclose unrecognized tax benefits by statement of financial position line item; and to require a separate disclosure if the unrecognized tax benefits are not disclosed in the statement of financial position. These disclosures are in line with our overall suggestions on improving disclosures through enhanced presentation principles.

However, we disagree with the FASB's decision to eliminate the requirement to disclose the nature of, and an estimated range for, the amount of unrecognized tax positions for which it is reasonably possible that the total amount will significantly change in the next 12 months. As we noted above, the argument that forward-looking information should not be included in financial statements is inconsistent with both the current reality that financial statements already include an extensive amount of forward-looking information. It is also inconsistent with the proposed disclosure objectives of the ED (i.e., to provide entity specific information, and particularly the potential effects from changes in tax laws and other circumstances, of which a user is not expected to be aware). We believe that eliminating this disclosure will reduce the usefulness of tax disclosures by failing to signal to investors on important information regarding future cash flows. Concerns regarding the limitations of such disclosure, due to an entity's inability to make assessments beyond several months in the future, can be clearly addressed by entities through providing a caveat to that effect.

Tax Carryforwards

We support the proposed disclosure of federal, state and foreign carryforwards by time period of expiration for each of the first five years after the reporting date, and a total for any remaining years, as well as the related deferred tax asset amounts before the valuation allowance, similarly disaggregated by time period of expiration. We support these proposed disclosures of carryforwards as they indicate the risk of non-realization and the possible need for corporate actions to avoid expiration without benefit. In addition, we recommend that a clear link should be provided between the two amounts (tax carryforward and deferred tax asset before valuation allowance). Under current reporting, it is not always apparent how these two amounts relate to one another when they are provided in financial statements.

Special government assistance programs that reduce taxes

We support the proposed requirements regarding special government assistance programs that reduce taxes. We believe it is important to provide disclosure regarding these programs as it provides insight into the duration of agreements that reduce an entity's tax burden along with providing information regarding any commitments made by the reporting entity to secure such agreements. In addition, we recommend the disclosure of the following: a) expiry date and any factors that affect the renewal of these programs; and b) material tax credits and the countries that are associated with such credits.

Transition Requirements

We support retrospective disclosures as these enable investors to obtain comparable trend data.

Thank you again for the opportunity to comment on the ED. If you or your staff have questions or seek further elaboration of our views, please contact Vincent Papa, Ph.D., CPA, CFA by phone at +44.207.330.9521, or by e-mail at vincent.papa@cfainstitute.org.

Sincerely,

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