

MINUTES



Financial Accounting
Standards Board

To: Board Members

From: Short-Term Convergence—Income Tax Team (Kispert, Ext. 310)

Subject: Minutes of the December 15, 2004 Board Meeting **Date:** December 30, 2004

cc: Bielstein, Smith, Petrone, Leisenring, FASB Project Team, IASB Project Team, Mahoney, Getz, Vincent, Sutay, Gabriele, Swift, Polley, FASB Intranet (e-mail), Project Team

Topic: Intercompany Transfers and Foreign Currency

Basis for Discussion: Board Memorandum 8 dated December 1, 2004

Length of Discussion: 10:20 p.m. to 11:10 p.m. (EST)

Attendance:

Board members present:	Herz, Trott, Schipper, Batavick, Crooch, Seidman, and Schieneman
Board members absent:	None
Staff in charge of topic:	Gagon
Other staff at Board table:	Thomas, Cassel, Posta, and Kispert
Outside participants:	None

Summary of Decisions Reached:

The Board decided to eliminate the following two exceptions of the exceptions to comprehensive recognition of deferred taxes contained in paragraph 9 of FASB Statement No. 109, *Accounting for Income Taxes*:

1. The exception in paragraph 9(e) of Statement 109 related to intercompany transfers. Eliminating that exception means that entities would be required to recognize deferred tax assets or liabilities for temporary differences created by intercompany transfers of nonmonetary assets between tax jurisdictions.
2. The exception in paragraph 9(f) of Statement 109 related to foreign currency. Eliminating that exception means that entities would be required to recognize deferred tax assets or liabilities for differences related to foreign nonmonetary assets and liabilities that are remeasured from the local currency into the functional currency where the functional currency is also the reporting currency and that result from changes in exchange rates or indexing for tax purposes.

Objective of Meeting:

The objective of today's Board meeting was for the Board to discuss whether Statement 109 should be amended to eliminate two of the exceptions to comprehensive recognition of deferred taxes contained in paragraph 9 of that Statement. Specifically, the Board was asked to decide whether deferred tax assets or liabilities should be recognized for:

- Intercompany transfers of nonmonetary assets between tax jurisdictions
- Differences related to foreign nonmonetary assets and liabilities that are remeasured from the local currency into the functional currency where the functional currency is also the reporting currency and that result from changes in exchange rates or indexing for tax purposes.

Matters Discussed and Decisions Reached:

1. Mr. Gagon began the meeting by stating that the objective of the meeting was for the Board to discuss whether Statement 109 should be amended to eliminate two of the exceptions to comprehensive recognition of deferred taxes contained in paragraph 9 of that Statement. Specifically, he stated that the Board needs to discuss whether deferred taxes should be recognized for:

- Intercompany transfers of nonmonetary assets between tax jurisdictions
 - Differences related to foreign nonmonetary assets and liabilities that are remeasured from the local currency into the functional currency where the functional currency is also the reporting currency and that result from changes in exchange rates or indexing for tax purposes.
2. Mr. Gagon also stated that the International Accounting Standards Board's (IASB) statement on accounting for income taxes, IAS 12, *Income Taxes*, does not contain exceptions for these two items and requires entities to account for the tax effects of both intercompany transfers of nonmonetary assets and changes in foreign currency exchange rates. This difference that exists between U.S. GAAP and IFRS is being considered in this short-term convergence project.

Intercompany Transfers

3. Mr. Gagon stated that intercompany profit from transactions between members of a consolidated group, such as intercompany sales of inventory, is eliminated in the preparation of consolidated financial statements of the group. However, the sale of inventory or other nonmonetary assets between members of a consolidated group located in different tax jurisdictions (or who file separate nonconsolidated returns in the same tax jurisdiction) is an economic event that includes transactions between two third parties and normally results in (1) taxes currently payable by the seller and (2) for the buyer, a tax basis that is higher than the seller's carryover basis for the transferred asset.
4. Mr. Gagon also noted that Statement 109 requires that both the buyer and the seller defer the tax consequences of intercompany transfers until the asset or assets have ultimately been sold to an outside party. Therefore, the seller defers recognizing, for financial statement purposes, any tax expense associated with the transfer of the asset or assets, and the buyer is not allowed to recognize a deferred tax asset for any bases differences.

5. Mr. Gagon stated that in instances where the buyer and seller's tax rates are different, this deferral of tax recognition results in a difference in differential reporting for financial statements prepared under Statement 109 and IAS 12.
6. Mr. Gagon stated that the IASB discussed this issue at its meetings in April and June 2003. At those meetings, the IASB staff recommended that IAS 12 not be changed to converge with the Statement 109 exception and that the tax consequences of intercompany transfers be accounted for in the consolidated financial statements. The IASB narrowly agreed with the staff's recommendation and has decided to retain the guidance in IAS 12, which requires entities to account for the tax effects of intercompany transfers. The IASB has asked the FASB to consider this issue and to consider amending Statement 109 to converge with IAS 12.
7. Based on the staff's research to date, Mr. Gagon noted that the staff has identified two alternatives for the Board to consider:

Alternative A: (*Retain exception*) Retain the exception in Statement 109 for intercompany transfers of nonmonetary assets and ask the IASB to reconsider its decision made at its April 2003 meeting.

Alternative B: (*Eliminate exception*) Converge with IAS 12 and eliminate the exception in Statement 109 and recognize all tax consequences associated with an intercompany transfer.

Mr. Gagon stated that the staff recommends the Board adopt Alternative B. He then turned the discussion over to the Board.

8. Mr. Batavick stated that since this is a short-term convergence project, his understanding is that the Board is attempting to eliminate differences between the FASB and IASB guidance; however, an important part of doing that is also trying to improve financial reporting. He stated that he does not think Alternative B improves financial reporting and, therefore, supports Alternative A. Mr. Batavick stated that the arguments put forth in the basis for conclusions in Statement 109 are more persuasive than the arguments put forth for eliminating the exception. He stated that he is not convinced that anything has fundamentally changed since Statement 109 was issued that should impact the Board's decision. Mr. Batavick

noted that he believes financial statement recognition of an event should lead to the recognition of related tax consequences. Financial reporting and taxation really do serve two different purposes. Because the intercompany profit itself is eliminated in consolidation, the tax effects also should not be recorded. Mr. Batavick noted that one may argue that there is an economic event when you have two different taxes. However, he stated that he views that as a change in the tax basis. In other words, whatever additional tax cost there would be should be part of the basis of the asset being transferred, and then the total tax effect should not be recognized until it is actually a third-party sale. Mr. Batavick stated he thinks the current accounting is easy to understand, simple, and should continue.

9. Mr. Trott stated that he agrees with the staff's recommendation. He stated that these are economic events that have occurred and to remove them or to have them pushed into the balance sheet rather than being recognized creates complexity as well as less representationally faithful financial reporting. Mr. Trott stated that the data necessary has to be done effectively offline either way, so he does not see how deferral is more simple. In fact, he stated, he believes the deferral creates more complexity in financial reporting and record-keeping. If you do not defer recognizing the tax effects, you can more clearly see the impact in the basic financial records that are being kept by the company.
10. Mr. Schieneman stated he agrees with Mr. Batavick in that eliminating the exception does not advance financial reporting. Referring to the staff's assertion in the Board memo that they had consulted members of the user community to solicit their views, Mr. Scheineman stated that he called three of the four users that the staff spoke with and his understanding after talking to them was that the users were not entirely clear about what the issue is, and it was not a very resounding support for eliminating the exception.
11. Mr. Herz noted that the staff appeared to be perplexed by Mr. Scheineman's statement. Mr. Gagon then stated that on the staff's phone call with the users, there was substantial support from the users. Mr. Gagon also stated that they provided the users with background information and walked the users through an

example. Mr. Schieneman stated that the basic rationale that was given to him by the users for eliminating the exception was that the users compared it to a holding cost. Mr. Schieneman stated that his concern was that income taxes are typically looked at in terms of the effective tax rate, and effective tax rates are a comparison of pretax income and tax expense. Since pretax income is not recognized until the final sale to a third party, the effective rate for the period in which the seller transfers the asset would be distorted.

12. Ms. Schipper stated that in regard to the basis for conclusions in Statement 109, the reasoning behind that basis was predicated on thinking about how ARB No. 51, *Consolidated Financial Statements*, treats intercompany transactions. Ms. Schipper stated that the basis for ARB 51 was based on notions that pertain to the consummation of the earnings process by selling the goods to somebody outside of the consolidated entity and also the matching principle. She stated that she rejects both of those as a basis for thinking through Statement 109 issues because the Board that created that basis for conclusions acknowledged that the excess of the buyer's tax basis over the cost of the transferred asset meets the definition of a temporary difference. Therefore, that Board had to find a reason to say that even though this meets the definition of a temporary difference, they were not going to recognize it. In the interest of eliminating a scope exception, convergence, and representational faithfulness with the principle behind Statement 109, Ms. Schipper stated she supports the staff's recommendation.
13. Ms. Seidman noted that this issue represents a conflict between the principle in Statement 109 and the principle in ARB 51, which states that all intercompany profits and losses should be eliminated in consolidation. That principle is fundamental to GAAP. She stated that it is unclear as to why the Board is letting Statement 109 trump the basic principle set forth in ARB 51. For many of the reasons Mr. Batavick and Mr. Schieneman discussed, Ms. Seidman stated that she supports Alternative A.

14. Mr. Crooch stated that he supports Alternative B because it is consistent with Statement 109, there is a temporary difference, and it helps the convergence effort.
15. Mr. Herz noted that the tax that is owed by the seller is short-term as is the stepped-up basis of the asset on the buyer's books. He stated that for the measurement of economic events and short-term cash consequences, respecting the separate tax jurisdictions of the buyer and seller and the effects in those is better accounting. He stated that he may have more sympathy if the asset was more long term, but this is inventory. Mr. Thomas clarified that this exception applies to all nonmonetary assets, not just inventory. Mr. Herz stated that he understood that, but he believes that it principally applies to inventory since pieces of equipment are generally not moved around. He said that he did not understand why analysts would look at the effective tax rate when most U.S. corporations do not pay the effective tax rate. Mr. Herz stated he supports Alternative B not only for convergence purposes but also because he believes it is the better accounting for an economic event.

Foreign Currency

16. Mr. Gagon described the exception contained in paragraph 9(f) of Statement 109 and indicated that it generally applies to highly inflationary economies and for other foreign operations for which the reporting currency is the functional currency. Mr. Gagon pointed out that this issue does not pertain to foreign operations for which a foreign currency is the functional currency—it only applies when the reporting currency is the functional currency.
17. Mr. Gagon stated that if, for example, the U.S. dollar is the functional currency, nonmonetary foreign assets and liabilities are measured in U.S. dollars for financial statement purposes. Assuming that the books and records are kept in the local currency, the foreign currency carrying amounts of assets and liabilities are remeasured into U.S. dollars using historical exchange rates. Thus, when exchange rates change:

- The U.S. dollar historical cost of those assets and liabilities does not change.
 - The foreign currency book basis and the foreign tax basis of those assets and liabilities do not change.
 - The foreign currency equivalent of the U.S. dollar historical cost of those assets and liabilities does change.
18. Mr. Gagon stated that in other words, after a change in exchange rates, more or less foreign currency will be necessary to recover the U.S. dollar historical cost of those nonmonetary assets and liabilities. However, the tax basis of those nonmonetary assets and liabilities has not changed, which results in a difference between the tax basis and the foreign currency equivalent of the U.S. dollar historical cost. Those differences will result in taxable and deductible amounts for foreign tax purposes when the assets are recovered and the liabilities are settled.
19. Mr. Gagon stated that the IASB discussed this issue at its meetings in April and June 2003. At those meetings, the IASB staff recommended that IAS 12 not be changed to converge with the exception in paragraph 9(f) of Statement 109 regarding this issue.
20. Mr. Gagon noted that the IASB Board agreed with the staff's recommendation and has decided to retain the guidance in IAS 12, which requires entities to account for the tax effects of foreign operations when the functional currency is also the reporting currency and exchange rates change or indexing occurs for tax purposes. The IASB has asked the FASB to consider this issue and consider amending Statement 109 to converge with IAS 12.
21. Based on the research done to date and the limitations of a short-term convergence project, Mr. Gagon stated that the staff has identified two alternatives for the Board to consider:

Alternative A: (*Retain exception*) Retain the exception in Statement 109 for foreign operations in which the functional currency is the reporting

currency and ask the IASB to reconsider its decision made at its April 2003 meeting.

Alternative B: (*Eliminate exception*) Eliminate the exception in Statement 109 to converge with IAS 12, and recognize all tax consequences associated with changes in exchange rates or indexing when the functional currency is the reporting currency.

Mr. Gagon stated that the staff recommends the Board adopt Alternative B. He then turned the discussion over to the Board.

22. Mr. Trott stated that, similar to the first issue, this issue does not appear to be a data-gathering issue; rather, preparers have all the information they need to prepare financial statements if this exception is eliminated. Thus, he stated he supports the staff's recommendation to eliminate the exception in Statement 109 for convergence.
23. Ms. Seidman stated that there appears to be an inconsistency between the principle in Statement 109 and the principle in FASB Statement No. 52, *Foreign Currency Translation*. In Statement 52, the effect of the remeasurement process should produce the same results as if the entity had maintained its books and records in the functional currency. Thus, you would not be recognizing tax effects if you use the U.S. dollar throughout the whole process. Ms. Seidman stated that she believes that the exception in Statement 109 was included to deal with this conflict between the two standards.
24. Mr. Cassel clarified that even if the asset was accounted for on a U.S. set of books, the facts presented indicate that the asset has a foreign tax basis. That foreign tax basis would change in terms of dollars as the exchange rate changes so you get a temporary difference as defined, even if the assets were kept on the U.S. set of books. Mr. Herz added that you would also get a temporary difference if the assets are indexed locally.
25. Mr. Cassel stated that some people thought that FASB Statement No. 8, *Accounting for the Translation of Foreign Currency Transactions and Foreign Currency Financial Statements*, which preceded Statement 52, was trying to

convey that you should get the same answers if you had done all of your transactions in dollars. However, Mr. Cassel stated that that is not what Statement 8 or Statement 52 requires. It is a remeasurement question in terms of expressing those transactions in dollars or keeping them in the functional currency. The asset is recognized in the foreign jurisdiction and that jurisdiction's tax basis is expressed in the foreign currency. You can carry the asset on any set of books and then the question would be whether a temporary difference is created between the carrying amount and the tax basis as it exists at a specific balance sheet date.

26. Mr. Schieneman stated that he believes the major effect of eliminating the exception would be on fixed assets. The principle impact of what the Board is discussing is the tax consequences of depreciation. Depreciation based on the historical dollar amount is going to be different than depreciation based on the local currency and the Board would be adding another factor to the translation effect. Mr. Schieneman stated that he does not see any benefit and thinks eliminating the exception adds complication.
27. Ms. Seidman stated that the principle she was pursuing relates to the justification for requiring that these nonmonetary items be remeasured at the historical exchange rate rather than a current rate, whereas the monetary items are remeasured using the current rate, giving rise to what is effectively the same effect as a transaction gain or loss. She stated that by the Board removing this exception from Statement 109, entities could report the effect of the change in one of two ways. One would be to report it to the tax expense line, the other would be to account for it basically as a transaction gain or loss, which is contrary to the principle in Statement 52. If you put it in the tax line, Ms. Seidman stated, she would be concerned with the usefulness of the information. Thus, Ms. Seidman does not see the benefit in eliminating the exception other than convergence and does not support eliminating the exception. Ms. Seidman questioned whether the international standards in this area have the same principles for foreign currency transactions. In other words, are they not dealing with the same conflict as the FASB?

28. Mr. Cassel stated he believes the principle in the international standards is similar to Statement 52 considering we are not talking about the unique problems of hyper-inflationary economies.
29. Mr. Batavick stated that he does not see an improvement in financial reporting being made by eliminating the exception and believes that eliminating the exception would introduce some volatility into the income statement, so he does not support eliminating the exception.
30. Ms. Schipper stated she would use Mr. Schieneman's example that tax relief takes the form of depreciation in this case. The value of that tax relief changes when exchange rates change. That is a real change even though it does not take the form of an actual check written, as the first issue on intercompany transfers does. The value of that depreciation moves around as the exchange rates change. It may be volatile, but it is real and consistent with the principle in Statement 109. Ms. Schipper stated she believes that eliminating the exception would be the most representationally faithful way to display this change in value is to adopt Alternative B. It also has the benefits of being convergent and eliminating an exception.
31. Mr. Crooch agrees with Alternative B.
32. Mr. Herz stated that he agrees with Alternative B for the same reasons as Ms. Schipper. Further, if the depreciable asset were indexed in the local tax jurisdiction, it would have a real economic effect on both the depreciation and the basis. Mr. Herz stated he does not believe that effect can be ignored.
33. Ms. Seidman inquired as to whether the staff plans to specify how the change should be recorded. Mr. Thomas stated that the staff will bring that issue to the Board when it discusses the transition method to be used at a future Board meeting. Mr. Cassel stated that the first issue also has disclosure implications, which the staff will also bring back to the Board as part of the disclosure package. Ms. Schipper stated that the staff should also determine whether the IASB has a view on the transition method so as to fully converge. Mr. Thomas stated that a

joint memo on transition and disclosure will be presented to both the IASB and FASB Boards.

Follow-up Items:

None.

General Announcements:

None.