Letter of Comment No: 1
File Reference: 1203-UTU

Leon J. Level
Vice President and Chief Financial Officer

November 8, 2004

Ms. Suzanne Bielstein
Director of Major Projects and Technical Activities
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

CCC

RE: Pending Interpretation Regarding Recognition and Measurement of Income Tax Benefits (Including Tax Benefits Relating to Uncertain Positions)

# FILED ELECTRONICALLY (director @fasb.com) and sent via U.S. Mail

#### Dear Ms. Bielstein:

The Financial Accounting Standards Board ("the Board") recently deliberated on proposed guidance regarding recognition and measurement of income tax benefits (including tax benefits relating to uncertain tax positions) at its July meeting. The Board directed the FASB staff to develop an Interpretation of Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" (FAS No. 109) based on the guidance discussed at the meeting. We are gravely concerned with the overall approach under consideration and several of the related implementation issues. This letter summarizes our views and comments regarding the proposed guidance (the "Proposed Approach") discussed at this meeting.

# Recognition and Measurement of Income Taxes Benefits: Binary Approach to Estimating Income Taxes

We do not agree with the proposed binary method of recognition and measurement of income tax benefits. The proposed method would fully recognize tax benefits only where realization is probable, but it would preclude recognition where the likelihood of realization (or partial realization) is ranked anything less than "probable." In our experience, the likelihood of total, all-or-nothing realization of tax benefits most often has been materially less than "probable" if each tax benefit had to be evaluated on the proposed binary basis, i.e., wholly realizable or wholly worthless.

Under FAS No. 109, deferred tax assets are recognized where realization of all or some portion of related tax benefits is more likely than not. Tax contingency accruals or contra assets are recorded to reduce tax benefits recognized to the amount that is probable of realization, based on the weight of available evidence.

Ms. Suzanne Bielstein, Financial Accounting Standards Board November 8, 2004 Page 2 of 7

The likelihood of realization is sometimes based, in part, on the level of assurance provided in the opinion letter furnished by the company's tax counsel. We think this approach provides the most meaningful information for use in estimating required tax accruals. For example, assume Company X has four different "tax advantaged transactions" where the tax benefit arising from each transaction is somewhat uncertain. Further assume each transaction has a probability of 75% and tax benefit value of \$100K. If Company X prevails in three of the four transactions (consistent with the probability) the net benefit realized would be \$300K. Consequently, if Company X had recognized a tax benefit in the amount of \$100K for each of the four transactions and established a tax contingency accrual or contra asset for each of \$25K, the tax benefits realized by Company X of \$300K would be exactly equal to the net tax benefit recognized (aggregate tax benefits of \$400K less related combined tax contingency accruals or contra assets of \$100K).

In some cases the company's position will be upheld, others will be lost and in others, perhaps in the majority of instances, tax benefits will be partially realized. Often the ultimate settlement is more a product of negotiation than, per se, interpretation of tax rules and regulations specifically due to ambiguity inherent in the regulations. In fact, in many foreign jurisdictions tax settlements are frequently the net result of direct negotiations with the tax authority.

We think the Proposed Approach attempts to impose a level of precision and certainty fundamentally inconsistent with inherently ambiguous tax regulations in most global jurisdictions, including complexities such as those under US tax laws. Determining tax accruals based on the likelihood of a successful outcome more nearly approximates the tax which will ultimately be payable. We accomplish this by providing higher tax contingency accruals for "tax advantaged transactions" where tax opinions indicate lower levels of assurance and providing lower accruals where the tax opinion indicates higher levels of assurance. We think this approach is more nearly consistent with the accrual method of accounting. Rather than focusing on whether the tax benefit of any given transaction is probable, we think the focus should be on whether the aggregate tax liabilities or assets represents the probable obligations payable or benefits realizable. Moreover, it is at least as misleading to ignore these tax benefits entirely.

Finally, the Proposed Approach would require the recognition, or de-recognition, of tax benefits whenever the likelihood of realization exceeds, or falls beneath, the probable threshold. We think the "on/off switch" approach to recognition of tax benefits will introduce significant volatility. In fact, we think investors and analysts may even ignore after-tax earnings, and focus on pre-tax EPS, due to the likely volatility this approach would introduce.



Ms. Suzanne Bielstein, Financial Accounting Standards Board November 8, 2004 Page 3 of 7

#### **Inter-Period Income Tax Allocation**

The Proposed Approach indicates changes in judgments concerning tax benefits should be accounted for on a discrete basis and not spread over future interim periods as required under the integral method. The expressed rationale for this treatment assumes such changes should be accounted for in a manner analogous to the treatment of changes in tax rates and laws and valuation allowances as set forth in paragraph 194. However, FAS No. 109 does not require nor, does it permit, further exclusions from application of the integral method. Therefore, we do not think this treatment should be expanded to analogous situations.

Each year a company will make many judgments about a wide range of assumptions affecting its tax provision, including numerous estimates as to projected earnings and permanent differences. Changes in these judgments will affect the tax provision for the entire year. Accordingly, we do not think changes in judgment regarding realizability of tax benefits should be excluded from the determination of the effective tax rate any more than these other changes in judgment.

The integral method was first adopted pursuant to APB Opinion No. 28, "Interim Financial Reporting". APB Opinion No. 28 excluded only extraordinary items and unusual items (discontinued operations) which are reported separately net of tax from the determination of the estimated annual effective tax rate (paragraph 19):

...At the end of each period the company should make its best estimate of the effective tax rate expected to be applicable for the full fiscal year. The rate so determined should be used in providing for income taxes on a current year-to-date basis. The effective tax rate should reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, in arriving at this effective tax rate no effect should be included for the tax related to significant unusual or extraordinary items that will be separately reported or reported net of their related tax effect in reports for the interim period or for the fiscal year.

FAS No. 109, likewise rejected the discrete approach to interim reporting as indicated in paragraphs 190 and 191 of this Statement:

The accounting requirements of Opinion 28 are based on a view that each interim period is primarily an integral part of the annual period. Tax



Ms. Suzanne Bielstein, Financial Accounting Standards Board November 8, 2004 Page 4 of 7

expense for interim periods is measured using an estimated annual effective tax rate for the annual period. Opinion 28 rejects the discrete approach to interim reporting whereby the results of operations for each interim period would be determined as if the interim period were an annual period. The Board's asset and liability approach to the accounting for income taxes for annual periods, however, is a discrete approach that measures a deferred tax liability or asset at a particular time.

The Board decided not to reopen the subject of interim accounting as part of this project and did not reconsider the general approach in Opinion 28 to accounting for income taxes in interim periods. As a result, most of the requirements of Opinion 28 remain unchanged. The Board concluded, however, that some changes were necessary because of the basic principles encompassed in this Statement.

FAS No. 109 paragraph 194 requires certain limited modifications to APB Opinion No. 28 to recognize tax effects of (1) changes in tax laws or rates or (2) changes in valuation allowances in the interim period in which such changes occur rather than allocating such tax effects to subsequent interim periods.

Measurements of deferred tax liability or asset for annual reporting are subject to change when enacted tax laws or rates change. Likewise, a valuation allowance is subject to change when a change in circumstances causes a change in the judgment about realizability of the related deferred tax asset in future years. For interim reporting, the Board believes that the effects of those changes should be recognized as of the enactment date for a change in tax law or rate or as of the date of a change in circumstances for a change in valuation allowance and should not be allocated to subsequent interim periods by an adjustment of the estimated annual effective tax rate for the remainder of the year. Thus, in effect, there is a catch-up adjustment for the cumulative effect as of the date of the change. The effect of the changes in tax laws or rates and changes in judgment about the need for a valuation allowance on income or losses for future interim periods, however, is reflected by an adjustment of the estimated annual effective tax rate for the remainder of the year.

These limitations, however, were the only exceptions to the continued application of the integral method under FAS No. 109. Accordingly we do not agree with the proposed use of the discrete method for recognition of changes in judgments regarding the realizability of tax benefits.



Ms. Suzanne Bielstein, Financial Accounting Standards Board November 8, 2004 Page 5 of 7

We understand there have been recent discussions among the FASB, SEC and others regarding accounting for inter-period income tax allocation for interim reporting. We also understand the SEC has begun to challenge companies where tax adjustments of prior period tax liabilities have been incorporated in the determination of the effective tax rate for the current fiscal year rather than recognizing the full impact of such changes immediately in the current quarter.

CSC

Contrary to the positions expressed by these groups and statements in the Board's Proposed Approach, the integral method of inter-period income tax allocation is the long-established, prevalent method of accounting for income taxes in interim statements. Furthermore, we think the integral method of accounting for interperiod income tax allocation continues to be the most appropriate and meaningful method of determining the tax provision in interim financial statements for a number of reasons.

- The inherent inability to determine the actual tax liability for interim periods undermines the conceptual validity of the discrete approach. The discrete approach is fundamentally impracticable. For example, this would effectively require the calculation of the net tax liability for all global tax jurisdictions on a quarterly basis, an undertaking which would be nearly impossible for most large multinational corporations. In fiscal 2004 alone, CSC filed over 12,500 tax returns in 140 countries. The vast majority of which were filed on an annual basis.
- Accounting for certain elements on a discrete basis and others on an
  integral basis is not meaningful. Piecemeal application of the discrete
  approach to only certain of the elements involved in the tax provision fails
  to provide a sufficiently comprehensive framework for meaningful
  representation of a company's tax expense and liabilities at any interim
  period within the year.
- The integral method provides an appropriate matching of income tax expense with earnings throughout the fiscal year. Even changes to estimates of prior year tax provisions are, in fact, part of the current year's provision, unless a change represents correction of an error sufficiently material to require treatment as a prior period adjustment. Income taxes for substantially all jurisdictions are based on annual tax periods. The tax rate for each year must take into account the uncertain and changing nature and status of events and transactions which will give rise to tax liabilities and benefits throughout the year. The integral method enables the company to incorporate the full range of issues which will ultimately affect the company's tax provision for the entire taxable period. As a

Ms. Suzanne Bielstein, Financial Accounting Standards Board November 8, 2004 Page 6 of 7

result, the integral method provides more meaningful, predictive information as to the operating results and outlook of for-profit companies.

### Classification as to Current vs. Non-Current Liability

We do not agree with the Proposed Approach to report any tax accrual in excess of the "as filed" tax return as a current liability where such payments are not expected to be made within the company's next operating cycle. Classification of such liabilities as current would be fundamentally misleading. This treatment would not fairly reflect the company's expected cash flows and financial condition and would distort a number of important financial measures and ratios closely monitored by the investor community (current liabilities, working capital, current ratio, etc.). This is wholly inconsistent with the recent emphasis on the importance of reporting and disclosure of cash flows and increased disclosure requirements for debt maturities and other obligations. Furthermore, we do not think comparison of company tax obligations with demand notes is even remotely meaningful. The intrinsic character of these obligations is entirely different.

## Recognition and Measurement: Evidence

One Board member suggested that a "should" opinion of company counsel would be necessary to support the conclusion realization of a tax benefit is probable. Another indicated that such guidance should be provided by the PCAOB. We do not agree and think guidance concerning registrant accounting requirements should be provided by the Board. Furthermore, we do not think legal opinions would be necessary to support the treatment of every transaction. Where the company has entered into similar transactions in the past the assessment of likely tax benefits may be based on such experience and no legal opinion should be required.

#### Transition\_

The initial proposed effective date under the Proposed Approach is March 15, 2005. Given the complexity, wide range of issues and pervasive impact, any substantial change in recognition and measurement or disclosure requirements in this area would require a substantially longer transition period. We think a period of not less than 1 year would be the minimum period necessary for implementation.



Ms. Suzanne Bielstein, Financial Accounting Standards Board November 8, 2004 Page 7 of 7

Thank you for your consideration of our views. I would be glad to meet with you or your staff to discuss this matter further at your convenience and may be reached at (310) 615-1728.

Sincerely,

CSC

Leon J. Level

Chief Financial Officer

cc: M

Mr. Robert H. Herz, Chairman and

Members of the Financial Accounting Standards Board

FILED ELECTRONICALLY and sent via U.S. Mail