



April 20, 2005

Mr. Robert Herz
Chairman
Financial Accounting Standards Board
401 Merritt 7
P.O. Box 5116
Norwalk, CT 06856-5116

Dear Bob:

The Committees on Corporate Reporting (“CCR”) and Taxation (“COT”) of Financial Executives International (“FEI”) wish to share our views on the Financial Accounting Standards Board’s (“FASB”) project, *Short-Term Income Tax Convergence*. FEI is a leading international organization of 15,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior financial executives. CCR and COT are technical committees of FEI, which review and respond to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and COT and not necessarily those of FEI.

The purpose of this letter is to set forth our concerns regarding the Board’s tentative decisions of December 15, 2004 to amend FAS 109, *Accounting for Income Taxes* (“FAS 109”) to eliminate the exceptions in paragraphs 9(e) and 9(f). As discussed below, we believe that the fundamental conflicts with other authoritative pronouncements that previously resulted in the original decisions to include these exceptions in FAS 109 still exist today and that these conflicts are best addressed by retaining the provisions of paragraphs 9(e) and 9(f). We also believe that the increased complexity and resultant higher costs that would be incurred due to the elimination of these two exceptions far outweighs any benefits that might arise from partially reducing noncomparability between entities applying FAS 109 and those applying IAS 12, *Income Taxes* (“IAS 12”). Accordingly, we respectfully request the Board reconsider and rescind these tentative decisions prior to the issuance of an Exposure Draft.

Intercompany Transfers

A longstanding accounting principle, codified in ARB 51, *Consolidated Financial Statements* (“ARB 51”), is that consolidated financial statements should not include gain or loss on transactions among members of the consolidated group. As discussed in

paragraphs 121 – 124 of FAS 109, the Board recognized the primacy of this fundamental principle in deciding to reject the FAS 96 approach to accounting for the tax effects of intercompany transfers and instead adopting the paragraph 9(e) exception in FAS 109. CCR strongly supported that decision during the due process leading to the issuance of FAS 109 and continues to support it today.

Given the significant differences in income tax rates among tax jurisdictions, and the complex supply chains utilized by global manufacturing companies, we do not believe that recognition of a net tax benefit or expense at the time of transfers within the consolidated group (potentially long before recognition of income from the sale to a third party) would be an improvement to financial reporting. In addition, we believe financial statement users would be concerned that period-to-period tax provisions and earnings were being affected, potentially significantly, by transfers of goods between members of the consolidated group that had supposedly been eliminated from the consolidated financial statements. As financial statement preparers, we are also concerned that the counterintuitive nature of the results obtained under the Board's proposal could be misinterpreted as earnings manipulation even though this is not the case.

At the time that FAS 109 was issued, the Board had on its agenda a project to reconsider the consolidation policies set forth in ARB 51. It was generally understood that the issue of accounting for the tax effects of intercompany transfers would need to be reconsidered if and when a new standard on consolidation policy was issued and that a standard on income tax accounting was probably not the best forum for resolving consolidation policy issues.

We believe that the model discussed with the Board prior to reaching the tentative conclusion to eliminate the paragraph 9(e) exception, and as described in paragraph 121 of FAS 109, is as follows:

“An intercompany transfer of assets such as the sale of inventory or depreciable assets between tax jurisdictions is a taxable event that established a new tax basis for those assets in the buyer's tax jurisdiction. The new tax basis of those assets is deductible on the buyer's tax return when the cost of those assets as reported in the consolidated financial statements is recovered.”

This model fails to recognize the fact that transfer pricing is governed by laws intended to assure that companies pay taxes on the proportion of total profits earned in each taxing jurisdiction. Under the inventory transfer pricing rules of most tax jurisdictions, the new tax basis in the buyer's tax jurisdiction in the above model would not be fully deductible on the buyer's tax return in a transaction that results in recovery of only the carrying value of the inventory and a taxable loss in the buyer's tax jurisdiction. In fact, the situation described in the model, i.e. reporting profits in the shipper's tax jurisdiction and losses in the buyer's tax jurisdiction, is exactly the situation that the transfer pricing rules are designed to prevent.

As a practical matter, if the transferred inventory could only be sold for an amount equal to the shipper's cost, as presumed by FAS 109, the shipper would adjust its intercompany billing to the buyer to equal the amount actually realized. This action is totally within the control of the consolidated enterprise, can be implemented at little or no cost to the enterprise, and would eliminate both the seller's taxable gain and the buyer's non-deductible loss. As such, the actual future tax consequences of recovering the inventory at the amount reported in the financial statements would be the recovery of taxes paid by the seller at time of shipment. In this context, the deferred tax asset related to the increase in tax basis in the buyer's tax jurisdiction is, at best, a contingent asset and taxes paid by the seller represent a prepayment of taxes that are fully recoverable if, upon completion of the earnings process by sale of the inventory to an unrelated party, the intercompany profit invoiced to the buyer cannot be realized. The current accounting under FAS 109 is fully consistent with this reality.

Foreign Currency

Paragraph 15 of FAS 52 defines Foreign Currency Transactions as follows:

“Foreign currency transactions are transactions denominated in a currency other than the entity's functional currency. Foreign currency transactions may produce receivables or payables that are fixed in terms of foreign currency that will be received or paid. A change in exchange rates between the functional currency and the currency in which a transaction is denominated increases or decreases the amount of functional currency cash flows upon settlement of the transaction. That increase or decrease in expected functional currency cash flows is a foreign currency transaction gain or loss.”

In adopting the paragraph 9(f) exception in SFAS 109, the Board recognized that changes in the functional currency value of future deductions of the foreign currency denominated tax basis of assets remeasured using historical exchange rates arising from changes in exchange rates clearly met the definition of a foreign currency transaction. This can be demonstrated in the following example:

On January 1, a subsidiary where the Functional Currency (FC) is the reporting currency purchases land for 1000 Local Currency (LC). The exchange rate at January 1 is 1 FC = 1 LC. The tax basis of the land is 1000 LC and the local country tax rate is 40%. At December 31, the exchange rate is .9 FC = 1 LC.

	@ January 1	@ December 31
Local Currency Tax Basis	1000 LC	1000 LC
Tax Rate	40%	40%
	-----	-----
Local Currency Value of Future Tax Deduction of Tax Basis	400 LC	400 LC
Functional Currency Value of Future Tax Deduction of Tax Basis	400 FC	360 FC
Functional Currency Book Value of Land	1000 FC	1000 FC

The local currency value of the future tax deduction of the land's tax basis is fixed in terms of the amount of foreign currency that will be received (400 LC). When exchange rates change, the functional currency cash flows that will be realized when the tax basis is deducted also change (a 40 FC reduction from 400 FC to 360 FC in this example). What has not changed is the book basis (1000 FC) or the tax basis (1000 LC) of the asset. Paragraph 6 of FAS 109 states that one objective of the standard "is to recognize deferred tax liabilities and assets for the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns." Since no event has been recognized, no deferred taxes should be recognized.

The 40 FC reduction in future cash flows that will be realized when the tax basis is deducted is the same value calculated using the following methodology:

Functional Currency Book Basis @ December 31	1000 FC
Local Currency Equivalent @ December 31	1111 LC
Local Currency Tax Basis	1000 LC

Difference	111 LC
Tax Rate	40%

Local Currency Liability	44 LC
Functional Currency Liability	40 FC

As noted by the Board in paragraph 119 of FAS 109, while the effect of the change in exchange rates may give the appearance of a being a temporary difference, it is, in

substance, an exchange gain or loss that is not recognized under FAS 52. As a result, the Board decided to include the paragraph 9(f) exception for this item. We urge the current Board to do the same. Eliminating this exception would create unnecessary complexity and can result in extreme volatility in deferred tax accounting that we believe only serves to increase the cost of, and reduce the usefulness of, financial statements.

Indexing for Tax Purposes

Indexing for tax purposes is most commonly found in highly inflationary economies. In deciding to adopt the provision in FAS 52 that requires the financial statements of a foreign entity in a highly inflationary economy to be remeasured as if the functional currency were the reporting currency, the Board considered and rejected a number of alternative methods for restating to a more stable measuring unit. One of the reasons given for rejecting some of these alternative methods was that they involved some aspect of accounting for the effects of inflation in the basic financial statements, which the Board at that time felt was inappropriate (FAS 52, paragraph 105). In deciding to include the exception in paragraph 9(f) for indexing for tax purposes, the Board reaffirmed its position that accounting for some, but not all, of the effects of inflation in the basic financial statements was inappropriate. The Board also noted that were it to permit indexing for tax purposes in these situations, the results obtained would not necessarily be meaningful.

International Accounting Standards (IAS 21, *The Effects of Changes in Foreign Exchange Rates* ("IAS 21") and IAS 29, *Financial Reporting in Hyperinflationary Economies* ("IAS 29")) have taken a different approach to accounting for entities in a highly inflationary economy. These standards specifically reject the reporting-currency-as-functional-currency approach of FAS 52 and instead require purchasing power adjusted financial statements be prepared for entities in highly inflationary economies. We believe that the perceived inconsistency between FAS 109 and IAS 12 relating to the issue of indexing for tax purposes is actually a true reflection of this fundamental conceptual difference in how to account for entities in highly inflationary economies, rather than a technical difference in how the principles underlying these two income tax accounting standards should be applied. We therefore urge the Board to retain the exception in paragraph 9(f) of FAS 109 related to this item.

In discussing its basis for including the exceptions in paragraphs 9(e) and 9(f), the Board noted that inclusion of these exceptions would reduce the complexity, and by inference the cost, of complying with the provisions of SFAS 109. Part of this reduced complexity also derives from the fact that the exceptions in paragraphs 9(e) and 9(f) are consistent with the principles of U.S. tax law. Conversely, eliminating these exceptions will clearly increase the complexity and cost of accounting for income taxes and tax compliance. These increased costs may be significant given the breadth of the changes being proposed and the highly integrated and complex computerized accounting systems that could be affected.

The issuance of FAS 109 was the culmination of a 10-year project on accounting for income taxes. As documented in Appendix C of FAS 109, it was thoroughly deliberated and thoughtfully considered prior to issuance. It is in that spirit that we ask the Board to carefully and fully explore any potential changes to this standard prior to issuing an Exposure Draft. We appreciate the Board's consideration of this important issue. Representatives of CCR and COT will be pleased to meet with the Board and Staff at your convenience to address any remaining questions.

Sincerely,



Frank H. Brod
Chair, Committee on Corporate Reporting
Financial Executives International



Michael Reilly
Chair, Committee on Taxation
Financial Executives International

cc: Sir David Tweedie, Chairman, IASB
Robert Garnett, Member, IASB (CCR Liaison Member)