13 August 2009

Sir David Tweedie
Chair, International Accounting Standards Board
International Accounting Standard Board
30 Cannon Street
EC4M 6XH
United Kingdom

Re: ED *Income Tax*

Dear Sir David,

The CFA Institute Centre for Financial Market Integrity (CFA Institute Centre),[1] in consultation with its Corporate Disclosure Policy Council (CDPC)[2], appreciates the opportunity to comment on the IASB Exposure Draft *Income Tax.*

CFA Institute, through the Centre, represents the views of its membership, which includes portfolio managers, investment analysts, and advisors, worldwide. Central tenets of the CFA Institute Centre mission are to promote fair and transparent global capital markets, and to advocate for investor protection. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality. The CFA Institute Centre also develops, promulgates, and maintains guidelines encouraging the highest ethical standards for the global investment community through standards such as the CFA Institute Code of Ethics and Standards of Professional Conduct.

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[1] The CFA Institute Centre for Financial Market Integrity is part of CFA Institute. With offices in Charlottesville, VA, New York, Hong Kong, London, and Brussels, CFA Institute is a global, not-for-profit professional association of more than 95,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 131 countries, of whom almost 84,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 136 member societies in 57 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 Council 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 Council provides the practitioners' perspective in the promotion of high quality financial reporting and disclosures that meet the needs of investors.

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Executive Summary

Summary of Exposure Draft

The International Accounting Standards Board (IASB) issued an exposure draft (ED) *Income Tax* containing proposals for an International Financial Reporting Standard (IFRS) to replace the current IAS 12 *Income Taxes* (IAS 12). The IASB undertook the project for two principal reasons: a) to clarify various aspects of IAS 12, and b) to reduce differences between IFRSs and U.S. GAAP.

IAS 12 and Statement No. 109 *Accounting for Income Taxes* share a common approach referred to as the 'temporary difference' approach. The objective of this approach is to recognize the tax that would be payable or receivable if assets and liabilities were recovered or settled at their present carrying amount. However, the two standards include different exceptions to the temporary difference approach; the Boards have decided to remove almost all of the exceptions.

The most significant changes proposed by the ED, compared with the requirements of IAS 12, include:

- A revised calculation methodology for deferred taxes;
- Changes to the allocation of taxes among the various components of the financial statements; and
- New measurement and disclosure requirements for 'uncertain' tax positions.

Key Implications for Investors

Users will be most impacted by those proposals that address the recognition of previously unrecognized uncertain tax positions, allocation of income taxes, valuation allowances, effective tax rates, and disclosures. The Centre's response addresses each of these in further detail. While there are many changes proposed, our response focuses on full and transparent disclosure of the entity's effective tax rate when compared to the statutory tax rate. This focus stresses the importance of disclosures which will help users fully understand the tax consequences of non-recurring transactions, both currently and prospectively, improving their ability to predict future earnings and cash flows.

Summary of CFA Institute Positions

General Comment: We support the efforts of the IASB and the FASB to develop a common set of high-quality global accounting standards and the efforts to eliminate the differences between international and U.S. income tax accounting standards.

Effective Tax Rate: It is extremely important that effective tax rate components be disclosed with full transparency since most users employ valuation models that forecast future income and/or cash flows using the entity's effective tax rate as an input. What matters most to users is to be able to examine an entity's reported effective tax rate, the variations and any trends in that rate, and the rate relative to similar companies.

Valuation Allowances: We agree that recognizing valuation allowances against deferred tax assets is conceptually sound; however in practice it has made reported income more complex, less transparent, and more volatile. We believe that an expected value approach is conceptually superior to either a 'probable' or 'more likely than not' standard.

Uncertain Tax Positions: We believe that all tax positions should be considered for uncertainty and measured at the weighted-average probability of all possible outcomes, We agree with this expected value approach as conceptually superior to either a 'probable' or 'more likely than not' standard.

Allocation of Income Taxes: Reporting income taxes as a single line item would eliminate arbitrary allocations and complexity encountered in other presentation models.

Investments in Subsidiaries and Joint Ventures: Accounting for temporary differences is arbitrary and complex. The uncertainty as to the amount and timing of cash consequences from these reversals affects the estimation of cash flows and firm valuation. We disagree with the view that accounting standards should permit the use of management intent to avoid recording deferred tax liabilities and to control the timing of the reversals.

Disclosures: We believe that transparent qualitative and quantitative disclosure of income tax matters is essential to a user's ability to fully understand the details behind both current and prospective tax payments and accruals. We believe the proposals in the ED are yet another positive step toward providing more detailed disclosures. We especially support the proposal for entities to reconcile the effective tax rate with the entity's domestic statutory tax rate either directly or by reconciling income tax expense.

In summary we believe that entities should report:

- deferred tax assets gross of any valuation allowance,
- the expected value of any valuation allowance,
- the expected value of uncertain tax positions,
- both the valuation allowance and the uncertain tax positions in detail with roll forwards and robust qualitative disclosures of the changes.

Comments

We support the efforts of the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to develop a common set of high-quality global accounting standards and the IASB's effort to eliminate the differences between international and U.S. income tax accounting standards. We believe that many of the proposals in the ED bridge the gaps between current IAS 12 and Statement No. 109, even though some differences will remain.

The objective of financial reporting is to provide users with information needed to evaluate a firm's financial position, performance, and cash flows. Income taxes have significant financial statement reporting and cash flow consequences for virtually all companies. The analysis of income tax expense and cash flow consequences is often difficult for the user because there are many permanent and temporary timing differences between the accounting that is used for income tax reporting and the accounting that is used for financial reporting. The financial statements and notes to the financial statements provide important information that the user needs to assess financial performance and to compare a company's financial performance with other companies.

The goals of income tax analysis by users of financial statements are to:

1. Understand why the firm's effective tax rate differs (or does not differ) from the statutory rate in its home country.

2. Forecast changes in the effective tax rate, improving forecasts of earnings and cash flows.

3. Review the historical differences between income tax expense and income taxes paid.

4. Forecast the future relationship between income tax expense and income tax payments.

5. Examine deferred tax liabilities and assets, including any valuation allowance, for:

    - Possible effects on future earnings and cash flows
    - Their relevance to firm valuation
    - Their relevance in assessing a firm's capital structure

Our comments on accounting for income taxes are focused on the following six issues in the ED:

1. Effective Tax Rate
2. Valuation Allowances
3. Uncertain Tax Positions

4. Allocation of Income Taxes
5. Investments in Subsidiaries and Joint Ventures
6. Disclosures

<u>Effective Tax Rate</u>

Users employ valuation models that forecast future income and/or cash flows using the entity's effective tax rate as an input. Trends in effective tax rates over time for a firm and the relative effective tax rates for comparable firms within an industry can help assess operating performance. It is for this reason that it is extremely important for the effective tax rate components to be disclosed with full transparency. Given the difference in objectives, taxable income reported to governments may be computed using different accounting methods as well as different assumptions (e.g. asset lives) from those used for financial reporting. A large multinational pays taxes in a number of jurisdictions, adding further complexity to the process. As a result, a large company may have many permanent and temporary differences between financial statement income and taxable income.

Analysts sometimes analyze corporate performance on a pretax basis to avoid the complexity associated with income tax reporting. However, an entity's income tax accounting is too important to ignore, due to significant cash flow and valuation consequences. Therefore it is essential to have a clear picture of the effects of the differences between taxable income and financial statement income, including the impact of significant non-recurring transactions. From a user's perspective, unraveling these effects is a difficult and time consuming task, especially in the absence of transparent disclosures.

To forecast future after-tax cash flows, users calculate the normalized effective tax rate for historic periods. In order to do this, they need to not only understand which income statement items are non-recurring, but also their tax impact. Income tax accounting standards should ensure disclosure of the tax effects of material items, especially if they are unusual or distort the effective tax rates.

What matters most to users is to be able to examine an entity's reported effective tax rate, the variations and any trends in that rate, and the rate relative to similar companies. Variations in these rates are generally the consequence of:

- Different statutory tax rates in different jurisdictions.
- The nature and term of tax holidays and tax credits offered by some countries.
- Permanent differences between financial and taxable income: tax-exempt income, tax credits, and nondeductible expenses.
- The effects of tax rate and other tax law changes.
- The extent to which deferred taxes have been provided on the reinvested earnings of foreign affiliates and unconsolidated domestic affiliates.

- Provisions or reversals of a valuation allowance related to the recoverability of deferred tax assets.

Exhibit 1 contains a selection from Note 8 Taxes from the 2008 Annual Report of Holmen AB, a Swedish forest products company that reports using IFRS.

Holmen's reported effective tax rate (income tax expense/pretax income) declined from 41.7%% in 2007 to 13.2% in 2008. Although profit before tax declined by 71% from 2007 to 2008, profit for the year declined only 57% due to the lower tax rate. The statutory tax rate in Sweden was 28% for both years. An investor studying Holmen would seek answers to the following two questions:

1. Why did Holmen's effective tax rate vary from the statutory rate for both years?
2. What is Holmen's effective tax rate likely to be in the future?

The reconciliation of the effective and statutory tax rates in Exhibit 1 informs these key questions. It indicates that the higher than normal tax rate for 2007 was due to nondeductible losses for which no tax benefit or shield could be recorded. The lower than normal tax rate for 2008 was due to the impact of a change in the statutory rate on the net deferred tax liability, partly offset by a provision for tax disputes. All three of these factors are nonoperating in nature, and are unlikely to recur. Without this reconciliation, the investor would not be able to develop the necessary insight.

The 2008 provision for tax disputes also illustrates the need for better disclosures regarding uncertain tax positions, discussed later in this letter.

Note 8 has no information regarding whether Holmen has provided for deferred taxes on the undistributed earnings of its non-Swedish subsidiaries. As discussed below, this is another important information gap that ought to be filled by required disclosure.

This abbreviated discussion of Holmen's tax disclosures demonstrates the importance of understanding how changes in the effective tax rate can impact the prediction of future cash flows and profitability.

Exhibit 2 presents the effective tax rates for Pfizer and Walmart over the past decade. The data presented further illustrate the importance of effective tax rates in financial analysis. Analysts ultimately need to understand income taxes when doing valuations. In the case of Pfizer, forecasting a normalized tax rate is extremely difficult given the fluctuations (which range from 11.0% to 49.7%) in that rate from year to year. In the case of Walmart, it is easier to forecast, yet the effective rate has steadily declined since 1998. In both cases, analysts need to have an understanding of why these changes are occurring and how persistent they will be when forecasting future tax rates to build into valuations.

Valuation Allowances

Paragraph 23 of the ED states:

> *'An entity shall recognize a valuation allowance against deferred tax assets so that the net amount equals the highest amount that is more likely than not to be realizable against taxable profit'*

While we agree that the valuation allowance is conceptually sound, in practice it has made reported income more complex, less transparent, and more volatile. The "more likely than not" rule under U.S. GAAP is broad enough that the valuation allowance can become an earnings management tool. An additional problem is income volatility as entities set up a valuation allowance when reporting losses, only to remove them after returning to profitability. We are likely to see this pattern continue as firms reporting losses in 2009 decide (or are forced by their auditors) to set up valuation allowances against their deferred tax assets.

We do not believe that the arbitrary nature of the valuation allowance can be avoided. Our preferred measurement would be the probability-weighted expected value, consistent with the use of expected value to measure uncertain tax positions.

Furthermore, we support the requirement to report deferred tax assets gross of any allowance provided. Key information on asset values, changes in expectations, and recoverability are obscured if the individual deferred tax assets are recorded net of any valuation allowance. Investors would also benefit from seeing the valuation allowance disaggregated and disclosed on a line-item basis with specific identification of the amount of the valuation allowance assigned to each specific deferred tax asset.

Regardless of the measurement basis used, it is essential that the Board require transparent and comprehensive disclosures. These disclosures should include a roll forward of the changes with robust qualitative disclosures of the components of the changes. Given the arbitrary nature of the valuation allowance, it is essential to report both the gross deferred tax asset and any valuation allowance applied.

Uncertain Tax Positions

We agree that the new income tax standard should provide guidance with respect to uncertain tax positions. The current guidance under U.S. GAAP is that, for uncertain tax positions having technical merits that meet the 'more likely than not' recognition threshold, the benefit is measured at the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized. The ED would require that all tax positions be considered for uncertainty and measured at the weighted-average probability of all possible outcomes. We agree that this expected value approach is conceptually superior to either a 'probable' or 'more likely than not' standard.

Any measurement model requires significant management judgment and robust and detailed disclosures are needed to make the financial statement effects transparent. U.S. GAAP requires detailed disclosure specific to uncertain tax positions including a roll forward of unrecognized tax benefits. The ED would require uncertainties to be described, assisting users to assess the possible financial statement effects of the uncertainties and related timing; a numeric roll forward is not required.

Although the US GAAP model for uncertain tax positions has not been in effect long enough to determine whether it is an effective measurement approach, the roll forward disclosure has helped users to better evaluate management decisions with respect to the recognition of uncertain tax positions. We strongly believe that a numeric roll forward should be required to adequately reveal the financial impacts of the recorded uncertainties.

Allocation of Income Taxes

Reporting income taxes as a single line item would eliminate arbitrary allocations and complexity encountered in the other presentation models. Users would benefit as it would report the total income tax effects for the entity in the period in a single line item. However, we do believe that separate disclosure of the tax impact of discontinued operations is beneficial to investors. This should be reported on the face of the income statement with amounts for 1) current tax expense, 2) deferred tax expense and 3) total tax expense (sum of 1 and 2). Furthermore, with transparent and robust disclosure of the changes in the effective tax rate, including a reconciliation of the effective tax rate, users will be able to have a full understanding of the tax rate impacts.

Investments in Subsidiaries and Joint Ventures

Temporary differences generated between pretax financial income and taxable income and the timing of the reversals are generally subject to management influence and control. Accounting for temporary differences is arbitrary and complex. Some differences may never reverse and others may reverse based on management intent, market conditions contrary to those assumed by management in reporting tax positions, and changes in regulations. In our experience, firms actively manage their tax position, responding to changes in tax laws. In recent years, for example, many U.S. based multinational firms remitted earnings from foreign subsidiaries that had been 'permanently invested' in response to temporary tax law incentives. The uncertainty regarding the amount and timing of cash consequences from these reversals affects the estimation of cash flows and firm valuation.

We disagree that accounting standards should permit use of management intent to avoid recording deferred tax liabilities and to control the timing of the reversals. However, if the Board permits the reversals to be based on management's intent, comprehensive qualitative and quantitative disclosures should be required so that users understand the nature of the activity. This will allow users to better understand the cash consequences and its impact on the effective tax rate. *At a minimum, firms should be required to disclose the amount of unremitted earnings and the amount of deferred tax liabilities recognized with respect to those earnings.*

Disclosures

We understand that standard setters frequently hear users asking for more transparency in financial statement disclosures while preparers cite information overload as well as adverse cost-benefit arguments. However, the goal of financial reporting is the delivery of decision useful information. We believe that transparent qualitative and quantitative disclosure of income tax matters is essential to a user's ability to fully understand the details behind both current and prospective income tax matters. We believe that the ED is yet another step toward providing comparable information to users by retaining many of the IAS 12 disclosures while incorporating certain disclosures from Statement No. 109. Furthermore, the proposal requires some new disclosures. We especially support ED paragraph 42 which requires entities to reconcile the effective tax rate with the entity's domestic statutory tax rate either directly or by reconciling income tax expense.

With regard to uncertain tax positions we do not agree with the proposal to exclude the following current U.S. GAAP required disclosures:

- The roll forward of unrecognized tax benefits from the beginning to the end of the period.
- Amount of unrecognized tax benefits that may affect the effective tax rate.
- Significant increases or decreases within the next 12 months that are reasonably possible, including the nature of the uncertainty, the event that would cause the change, and an estimate of the change.

We discussed the need for the roll forward earlier in our letter. Disclosure of the amount of unrecognized tax benefits that may affect the effective tax rate is essential for users to project the impact of the resolution of tax uncertainties. The significant variability in aggressiveness in tax preparation among entities in the same industries and the effects of those individual choices on cash tax rates makes this disclosure key in evaluating the effects of alternative outcomes on liquidity and valuation. The disclosure of the changes in the next 12 months is equally essential to understanding the overhang of past tax positions on current liquidity.

Closing Remarks

In closing we thank the Board for the opportunity to comment on the Exposure Draft and further support efforts by the IASB to develop high quality financial reporting standards.

If you, other Board members, or your staff have questions or seek further elaboration of our views, please contact Matthew M. Waldron, CPA, by phone at +1.434.951.5321, or by e-mail at matthew.waldron@cfainstitute.org.

Sincerely,

/s/Kurt N. Schacht	*/s/ Gerald I. White*
Kurt N. Schacht, CFA Managing Director	Gerald I. White, CFA Chair, Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council

Exhibit 1

Holmen AB [3]

	Group			
	2008		2007	
	MSEK	%	MSEK	%
Stated profit before tax	740		2,852	
Tax at applicable nominal rate	-207	28.0	-723	28.0
Difference tax rate on foreign activities	2	-0.2	-2	0.1
Non-taxable income and non-deductible costs	-2	0.2	23	-0.9
Standard interest on tax allocation reserve	-23	3.0	-19	0.7
Effect of not stated loss allowances and temporary differences[4]	16	-2.1	-384	14.9
Tax attributable to previous periods	-4	0.6	13	-0.5
Change in tax rate on deferred tax/receivable/liability	331	-44.7	-4	0.2
Provision to cover unsettled tax disputes	-225	30.4	0	0
Other	14	-2.0	20	-0.8
Effective Tax rate	**-98**	**13.2**	**-1,077**	**41.7**

[3] *Source:* Holmen Annual 2008 Report selected portion of Note 8 Taxes, page 64.

[4] Note: We are somewhat unclear regarding this explanation since we would not normally expect temporary differences to be a reconciling item to the effective tax rate.

Exhibit 2

Disclosed Effective Tax Rates[5]

Fiscal Year	Pfizer, Inc.	Walmart Stores, Inc.
1998	26.4%	37.0%
1999	28.3%	37.4%
2000	35.4%	36.8%
2001	24.4%	36.5%
2002	22.1%	36.2%
2003	49.7%	35.2%
2004	18.4%	36.1%
2005	29.4%	34.2%
2006	15.3%	33.1%
2007	11.0%	33.5%
2008	17.0%	34.2%
2009		34.2%

5 Source: Company filings.