Testimony of

Susan M. Cosper, Technical Director

Financial Accounting Standards Board

before the

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Permanent Subcommittee on Investigations

Offshore Profit Shifting & the U.S. Tax Code

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Introduction
Chairman Levin, Ranking Minority Member Coburn, and Members of the Subcommittee:
My name is Susan Cosper, and I am the Technical Director of the Financial Accounting Standards Board ("FASB" or "Board"). As Technical Director, I have responsibility for overseeing the staff work associated with the projects on the Board's technical agenda. In addition, I am a Certified Public Accountant in the states of Pennsylvania, New York, and New Jersey. I would like to thank you for this opportunity to participate in today's important hearing.

I have been invited to appear before this Subcommittee to explain U.S. Generally Accepted Accounting Principles ("U.S. GAAP") for deferred U.S. income taxes attributable to unremitted earnings of a foreign subsidiary. I will be pleased to do so.

It is important for the Members of the Subcommittee to keep in mind that my comments relate to the accounting for income taxes in financial statements under U.S. GAAP, not the accounting in tax returns under U.S. law.

First, I would like to give a brief overview of the FASB and its parent organization, the Financial Accounting Foundation ("FAF"), and the manner in which accounting standards are developed and then monitored following issuance.

The role of financial reporting in the economy is to provide information that is useful in making business and economic decisions. Accounting standards are not intended to drive behavior in a particular way; rather, they seek to present financial information so that financial statement users can make informed decisions about how best to deploy their capital. In matters of policy, the FASB defers to Congressional judgments made in the Internal Revenue Code and aligns its accounting standards to reflect those policy decisions.

The FASB
The FASB is an independent, private-sector organization that operates under the oversight of the FAF and the U.S. Securities and Exchange Commission ("SEC" or "Commission"). For nearly 40 years, the FASB has established standards of financial accounting and reporting for nongovernmental entities, including both businesses (public and private) and not-for-profit organizations. Those standards—U.S. GAAP—are recognized as authoritative by the SEC for public companies and by the American Institute of Certified Public Accountants (AICPA) for other nongovernmental entities.

U.S. GAAP is essential to the efficient functioning of the U.S. economy because investors, creditors, donors, and other users of financial reports rely heavily on credible, transparent, comparable, and unbiased financial information. In today's dynamic financial markets, the need for integrity, transparency, and objectivity in financial reporting is increasingly critical to ensure the strength of U.S. capital markets and provide investors with accurate and timely information.

In 2002, Congress enacted the Sarbanes-Oxley Act, which included provisions protecting the integrity of the FASB's accounting standards-setting process. The legislation provided the FASB with an independent, stable source of funding. The legislation established an ongoing source of

funding for the FASB from annual accounting support fees collected from issuers of securities, as those issuers are defined in the Sarbanes-Oxley Act.

It is important to note that although the FASB has the responsibility to set accounting standards, it does not have the authority to enforce them. Officers and directors of a company are responsible for preparing financial reports in accordance with accounting standards. Auditors provide an opinion about whether those officers and directors appropriately applied accounting standards. The Public Company Accounting Oversight Board ("PCAOB") is charged with ensuring that auditors of public companies have performed an audit in accordance with the auditing standards of the PCAOB, which includes an auditor's analysis of whether a public company has complied with appropriate accounting standards. The SEC has the ultimate authority to determine whether public companies have complied with accounting standards.

The Mission of the FASB

The FASB's mission is to establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides useful decision-making information to investors and other users of financial reports. That mission is accomplished through a comprehensive and independent process that encourages broad participation, objectively considers all stakeholders' views, and is subject to oversight by the FAF's Board of Trustees.

We recognize the critical role that reliable financial reporting plays in supporting the efficient functioning of the capital markets: robust financial reporting increases investors' confidence, which in turn leads to better capital allocation decisions and economic growth. Today, as the U.S. economy continues to recover from the financial crisis and recession, the FASB remains committed to ensuring that our nation's financial accounting and reporting standards provide investors with the information they need to confidently invest in the U.S. markets.

To accomplish its mission, the FASB acts to:

1. Improve the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability and on the qualities of comparability and consistency.

2. Keep standards current to reflect changes in methods of doing business and changes in the economic environment.

3. Consider promptly any significant areas of deficiency in financial reporting that might be addressed through the standards-setting process.

4. Improve the common understanding of the nature and purpose of information contained in financial reports.

As it works to develop accounting standards for financial reporting, the FASB is committed to following an open, orderly process that considers the interests of the many who rely on financial information. Because we understand that the actions of the FASB affect so many stakeholders,

we are steadfastly committed to ensuring that the decision-making process is independent, fair, and objective.

The Standards-Setting Process

An independent standards-setting process is paramount to producing high-quality accounting standards because it relies on the collective judgment of experts who are informed by the input of all interested parties through a deliberate process. The FASB sets accounting standards through processes that are thorough and open, accord due process to all interested parties, and allow for extensive input from all stakeholders. Such extensive due process is required by our Rules of Procedure, set by the Board within the parameters of the FAF's bylaws. Our process is similar to the Administrative Procedure Act process used by federal agencies for rulemakings but provides far more opportunities for interaction with all interested parties. In fact, in recent years, we have significantly expanded our ability to engage with stakeholders in a variety of ways.

The FASB's extensive due process involves public Board meetings, public roundtables, field visits or field tests, liaison meetings and presentations to interested parties, and the exposure of our proposed standards for public comment. The FASB videocasts or audiocasts its Board meetings and education sessions on its website so that our stakeholders can more easily observe our decision-making process as well as the process that precedes our decisions. The FASB also creates podcasts and webcasts to provide short, targeted summaries of our proposals and new standards so that stakeholders can quickly assess whether they have an interest and want to weigh in. We also have been proactively reaching out to meet with stakeholders, including a wide range of investors and reporting entities, to discuss our proposals to assess whether the proposals will lead to better information and also to assess the related costs. These proactive, interactive meetings allow the FASB and its staff to ask questions to better understand why a person holds a particular view, which can accelerate the identification of issues and possible solutions in a proposed standard as well as implementation issues with existing standards. Those meetings help us to assess whether U.S. GAAP standards are providing useful information and also to assess the related costs.

In short, the FASB actively seeks input from all of its stakeholders on proposals and processes, and we are listening to them. Wide consultation provides the opportunity for all stakeholders to be heard and considered, the identification of unintended consequences, and, ultimately, broad acceptance of the standards that are adopted. The Board's wide consultation also helps it to assess whether the benefits to users of improved information from proposed changes outweigh the costs of the changes to preparers and others.

The FASB also meets regularly with the staff of the SEC and the PCAOB. Additionally, because banking regulators have a keen interest in U.S. GAAP financial statements as a starting point in assessing the safety and soundness of financial institutions, we meet with them on a quarterly basis and otherwise, as appropriate. We also understand Congress's great interest and regularly brief members and their staffs on accounting developments.

The FASB conducts outreach on a frequent and regular basis with the FASB's various advisory groups. The primary role of advisory group members is to share their views and experience with

the Board on matters related to practice and implementation of new standards, projects on the Board's agenda, possible new agenda items, and strategic and other matters.

In addition to the FASB's various advisory groups, the Emerging Issues Task Force ("EITF") assists the FASB in improving financial reporting through the timely identification, discussion, and resolution of financial accounting issues relating to U.S. GAAP. The EITF also was designed to promulgate implementation guidance for accounting standards to reduce diversity in accounting practice on a timely basis. The EITF assists the FASB in addressing implementation, application, or other emerging issues that can be analyzed within existing U.S. GAAP. Task Force members are drawn from a cross section of the FASB's stakeholders, including auditors, preparers, and users of financial statements. The chief accountant or the deputy chief accountant of the SEC attends Task Force meetings regularly as an observer with the privilege of the floor. The membership of the EITF is designed to include persons who are in a position to project emerging issues before they become widespread and before divergent practices become entrenched.

Oversight of FASB

The FASB's accountability derives from oversight at two levels. First, the Board is overseen by the independent Board of Trustees of the FAF. Organized in 1972, the FAF is an independent, private-sector, not-for-profit organization. The FAF exercises its authority by having responsibility for oversight, administration, and finances of the FASB and its sister organization the Governmental Accounting Standards Board ("GASB"). The FAF's responsibilities are to:

1. Select the members of the FASB, the GASB, and their respective Advisory Councils.

2. Oversee the FASB's and the GASB's Advisory Councils (including their administration and finances).

3. Oversee the effectiveness of the FASB's and the GASB's standards-setting processes and hold the Boards accountable for those processes.

4. Protect the independence and integrity of the standards-setting process.

5. Educate stakeholders about those standards.

Second, the FASB also is subject to oversight by the SEC with respect to standards setting for public companies. The SEC has the statutory authority to establish financial accounting and reporting standards for public entities. At the time of FASB's formation in 1973, the SEC formally recognized the FASB's pronouncements that establish and amend accounting principles and standards as "authoritative" in the absence of any contrary determination by the Commission. In 2003, the SEC issued a Policy Statement that affirms the FASB's status as a designated, private-sector standards setter.

Additional information about the FASB and the FAF can be found in the 2011 Annual Report of the FAF, which is available on the FAF website (www.accountingfoundation.org).

Summary of U.S. GAAP for Deferred U.S. Income Taxes Attributable to Unremitted Earnings of a Foreign Subsidiary

U.S. GAAP for accounting for income taxes is codified in *FASB Accounting Standards Codification*® ("ASC") Topic 740, Income Taxes. The accounting guidance related to unremitted earnings of a foreign subsidiary commonly is referred to as APB 23. The primary objectives of accounting for income taxes are to recognize the amount of income taxes payable or refundable for current-year operations and to recognize deferred income tax assets and liabilities for the expected future tax consequences of events that currently have been recognized in the financial statements or tax returns.

U.S. GAAP generally requires an entity to recognize current and deferred income taxes attributable to the earnings of a foreign subsidiary. In certain circumstances, the earnings of a foreign subsidiary are taxable in the respective foreign jurisdiction, but the earnings are not taxable in the United States unless the earnings are repatriated to the United States. In this circumstance, U.S. GAAP requires the income taxes payable to the foreign jurisdiction to be recognized in the entity's financial statements in the period the earnings are generated.

It is important to note that there is a presumption in U.S. GAAP that deferred U.S. income taxes should be recognized in the financial statements in the same period in which the earnings are generated because U.S. GAAP presumes that the foreign earnings will be remitted to the U.S.-based parent company in order to distribute the earnings to shareholders. The presumption may be overcome if the entity has sufficient evidence that the foreign entity has invested or will invest the earnings in the foreign jurisdiction or if the earnings will be remitted in a tax-free liquidation, as described below.

> ASC paragraph 740-30-25-3: **It shall be presumed that all undistributed earnings of a subsidiary will be transferred to the parent entity.** Accordingly, the undistributed earnings of a subsidiary included in consolidated income shall be accounted for as a temporary difference unless the tax law provides a means by which the investment in a domestic subsidiary can be recovered tax free. [Emphasis added.]
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> ASC paragraph 740-30-25-17: **The presumption in paragraph 740-30-25-3 that all undistributed earnings will be transferred to the parent entity may be overcome, and no income taxes shall be accrued by the parent entity, for entities and periods identified in the following paragraph if sufficient evidence shows that the subsidiary has invested or will invest the undistributed earnings indefinitely or that the earnings will be remitted in a tax-free liquidation**. A parent entity shall have evidence of specific plans for reinvestment of undistributed earnings of a subsidiary which demonstrate that remittance of the earnings will be postponed indefinitely. These criteria required to overcome the presumption are sometimes referred to as the indefinite reversal criteria. Experience of the entities and definite future programs of operations and remittances are examples of the types of evidence required to substantiate the parent entity's representation of indefinite postponement of remittances from a subsidiary.... [Emphasis added.]

Note that even though an entity may be required to recognize in its financial statements deferred U.S. income taxes in a particular period, such taxes are not payable to the U.S. unless the entity actually repatriates the earnings to the United States. In other words, the recognition of deferred U.S. income taxes in financial statements does not mean U.S. tax law requires the entity to actually pay the income taxes in that period. This treatment reflects a policy decision of when taxes should be payable to the United States and is not a matter of accounting standards.

It also is important to note that U.S. GAAP requires an entity to disclose in its financial statements circumstances where it has *not* recognized deferred U.S. income taxes attributable to unremitted earnings of a foreign subsidiary. The following excerpts from U.S. GAAP include such disclosure requirements.

> ASC paragraph 740-30-50-2: All of the following information shall be disclosed whenever a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures:
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> > a. A description of the types of temporary differences for which a deferred tax liability has not been recognized and the types of events that would cause those temporary differences to become taxable
> >
> > b. The cumulative amount of each type of temporary difference
> >
> > c. The amount of the unrecognized deferred tax liability for temporary differences related to investments in foreign subsidiaries and foreign corporate joint ventures that are essentially permanent in duration if determination of that liability is practicable or a statement that determination is not practicable. While paragraph 740-30-25-14 prohibits recognition of a tax benefit for tax deductions or favorable tax rates attributable to future dividends of undistributed earnings for which a deferred tax liability has not been recognized, favorable tax treatment would be reflected in measuring that unrecognized deferred tax liability for disclosure purposes.
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> > d. The amount of the deferred tax liability for temporary differences other than those in (c) (that is, undistributed domestic earnings) that is not recognized in accordance with the provisions of paragraph 740-30-25-18.

Judgments Required by Preparers Who Apply U.S. GAAP

In preparing financial statements in accordance with U.S. GAAP, a preparer is commonly required to make judgments to determine the appropriate accounting. As explained above, one area where judgment may be necessary is when U.S. GAAP requires a preparer to evaluate whether or not the foreign entity will invest undistributed foreign earnings indefinitely. Another

area where judgment may be necessary is when the entity is required to have evidence of specific plans for reinvestment of unremitted earnings of a subsidiary that demonstrate remittance of the earnings will be postponed indefinitely. U.S. GAAP does not define the term *indefinitely* and it does not prescribe the specific elements of the reinvestment plan. A preparer must make judgments based on the entity's specific facts and circumstances to determine the appropriate accounting.

Similar to other areas of U.S. GAAP, the accounting for U.S. income taxes associated with unremitted earnings of a foreign subsidiary is principles based, rather than rules based. The FASB has learned from years of outreach with our stakeholders, including users of financial statements and regulators, that principles-based standards sometimes are preferable to rules-based standards. Often, principles-based standards better meet the needs of users because they better reflect the economics of an arrangement and reduce the ability of an entity to achieve a particular accounting outcome by structuring an arrangement to satisfy specific bright-line rules.

Although U.S. GAAP requires a preparer to make judgments when accounting for unremitted earnings, it also requires a preparer to disclose relevant information about these judgments in their financial statements. The disclosure requirements are designed to provide users of financial statements with sufficient information about the accounting so users can make their own judgments about the entity's future cash outflows associated with income taxes. In addition to the specific disclosure requirements for unremitted earnings described earlier, U.S. GAAP includes additional disclosure requirements related to income taxes, such as a reconciliation of the U.S. federal statutory income tax rate to the effective income tax rate in the entity's financial statements.

Historic Treatment of Unremitted Earnings and FASB's Ongoing Monitoring

U.S. GAAP associated with the accounting for unremitted earnings initially was issued in 1972 by the Accounting Principles Board, which was a predecessor standards setter to the FASB. The guidance then was referred to as APB Opinion No. 23, *Accounting for Income Taxes—Special Areas* ("APB 23"). The guidance was issued to eliminate diversity in practice that existed at that time in accounting for U.S. deferred taxes attributable to unremitted earnings of a foreign subsidiary. The approach to recognizing U.S. deferred income taxes in APB 23 is substantially the same as the approach in current U.S. GAAP; however, the FASB has reevaluated this accounting guidance several times as a result of an ongoing dialogue with stakeholders and policymakers, as described below.

In 1987, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 96, *Accounting for Income Taxes* ("Statement 96"). Statement 96 considered and retained the accounting approach in APB 23. The following excerpts from the Basis for Conclusions of Statement 96 include some of the Board's considerations in retaining the accounting approach.

> Paragraph 96: Individual Board members support that decision [to continue the APB 23 accounting approach] to various degrees and for various reasons that include the following:

a. The complexity of measuring the deferred tax liability for foreign unremitted earnings and the reliability of the results

b. The need for Board members to compromise in order to improve other aspects of accounting for income taxes

c. The omission of discounting which, if concluded to be appropriate, would significantly reduce the magnitude of the deferred tax liability for those temporary differences.

Although Statement 96 did not change the accounting approach for unremitted earnings from APB 23, it added to U.S. GAAP a requirement to disclose information about the accounting for unremitted earnings in an entity's financial statements.

In 1992, the FASB issued SFAS No. 109, *Accounting for Income Taxes* ("Statement 109"). Statement 109 also considered and retained the accounting approach in APB 23. The following excerpts from the Basis for Conclusions of Statement 109 include some of the Board's considerations in retaining the accounting approach.

> Paragraph 173: Complexity was one reason Statement 96 did not require recognition of a deferred tax liability for Opinion 23.... Information received from constituents has convinced the Board that calculation of a deferred tax liability for undistributed foreign earnings that are or will be invested in a foreign entity indefinitely may sometimes be extremely complex. The hypothetical nature of those calculations introduces significant implementation issues and other complexities that occur less frequently in calculations of a deferred tax liability for an *expected* remittance of earnings from a foreign entity. For that reason, the Exposure Draft proposed to not require recognition of a deferred tax liability for undistributed earnings that are or will be invested in a foreign entity indefinitely. Based on respondents' concerns about complexity, however, the Board decided to extend that exception for foreign undistributed earnings to include the entire amount of a temporary difference between the book and tax basis of an investment in a foreign subsidiary or foreign corporate joint venture that is essentially permanent in duration regardless of the underlying reason(s) for that temporary difference.

Statement 109 also retained the disclosure requirements in Statement 96.

In 2004, the FASB again evaluated U.S. GAAP for accounting for income taxes, including the accounting for U.S. deferred income taxes attributable to unremitted earnings of a foreign subsidiary, in connection with a short-term convergence project with the International Accounting Standards Board. As part of this project, the FASB performed extensive outreach with stakeholders (including financial statement users, preparers, and auditors) and some of our advisory groups (Financial Accounting Standards Advisory Council and User Advisory Council) to better understand the costs and complexities to develop the estimates for a deferred tax liability, as well as to understand whether there were benefits to users from having the information.

Overall, users of financial statements informed the FASB that the current reporting better reflected economic reality than requiring recognition of deferred U.S. income taxes regardless of whether or not the earnings would be repatriated. Many users even suggested that if recognition of the liability were required under all circumstances, then they would back out the related liability and expense recognized in an entity's financial statements because they perceive it to be theoretical and not representative of future cash outflows. They also were concerned that the complexities involved with applying U.S. tax law to a set of facts and circumstances that have not occurred could cause noncomparability among deferred tax liabilities recognized in entities' financial statements. Users informed the FASB that the information they required to perform their analyses is included in the existing disclosure requirements.

The FASB continues to monitor tax law changes and update its accounting standards accordingly. For example, when U.S. income tax laws were changed by the American Jobs Creation Act of 2004, the FASB issued timely guidance that was designed to address practice issues that arose associated with accounting in financial statements for the change in U.S. income tax laws. The guidance, which was issued in 2004, was FASB Staff Position (FSP) No. FAS 109-1, "Application of FASB Statement No. 109 to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004," and FSP FAS 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004." As the designated standard setter of accounting standards, the FASB is continually updating its accounting standards to reflect Congressional legislative intent.

In addition, the FASB has several mechanisms to receive input about U.S. GAAP from our stakeholders (including regulators, users, preparers, auditors, academics, foreign standards setters and regulators) and our advisory groups. The FASB continues to regularly monitor the accounting for income taxes as well as other areas of accounting.

Conclusion

Thank you for the opportunity to provide a brief overview of the FASB's role and standards-setting process and the U.S. GAAP for deferred U.S. income taxes attributable to unremitted earnings of a foreign subsidiary. I will attempt to answer your questions on this topic.