PRI RESPONSE

FINANCIAL ACCOUNTING STANDARDS BOARD: *PROPOSED ACCOUNTING STANDARDS UPDATE*: INCOME TAXES (TOPIC 740), IMPROVEMENTS TO INCOME TAX DISCLOSURES

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ABOUT THE PRI

The Principles for Responsible Investment (PRI) works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The PRI has been working with institutional investors to promote corporate tax responsibility since 2015. We initiated our work with a guide to help investors understand the risks related to tax avoidance and provide a framework for investor-company dialogue on the issue.[1] In 2017, the PRI supplemented this guidance with a set of disclosure recommendations for companies to strengthen corporate income tax disclosure on tax policy, governance and risk management, and reporting areas.[2] Between 2017-19, 36 institutional investors representing US$2.9 trillion in assets under management collaborated to engage large healthcare and information technology companies to enhance corporate tax transparency. The findings of this engagement are published on PRI's website.[3] In 2021, the PRI published a discussion paper to explore the concept of tax fairness and its relevance to investors.[4]

ABOUT THIS CONSULTATION

This consultation responds to the Financial Accounting Standards Board's (FASB) Proposed Accounting Standards Update to address investor requests for improvements to disclosures related to the rate reconciliation and income taxes paid information.[5] The FASB is inviting organizations to comment on all matters in this proposed Update, and particularly on 10 specific questions. The FASB has identified two questions specifically directed to investors (Question 4 and 10).

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[1] Principles for Responsible Investment, *Why and How to Engage on Corporate Tax Responsibility* (March 2016), available at https://www.unpri.org/governance-issues/why-and-how-to-engage-on-corporate-tax-responsibility/585.article
[2] Principles for Responsible Investment, *Investors' Recommendations on Corporate Income Tax Disclosure* (2017), available at https://www.unpri.org/download?ac=1877
[3] Principles for Responsible Investment, *Advancing Tax Transparency: Outcomes from the PRI Collaborative Engagement 2017-2019* (2020), available at https://www.unpri.org/download?ac=10142
[4] Principles for Responsible Investment, *What is Tax Fairness and What Does It Mean for Investors?* (2021), available at https://www.unpri.org/download?ac=15325
[5] Financial Accounting Standards Board, *FASB Exposure Draft: Proposed Accounting Standards Update, Income Taxes (Topic 740), Improvements to Income Tax Disclosure* (15 March 2023), available at https://www.fasb.org/document/blob?fileName=Proposed%20Accounting%20Standards%20Update%E2%80%94Income%20Taxes%20(Topic%20740)%E2%80%94Improvements%20to%20Income%20Tax%20Disclosures.pdf

KEY RECOMMENDATIONS

The PRI welcomes the opportunity to comment on proposed changes to Topic 740 of the FASB Accounting Standards Codification® including updates to disclosures regarding rate reconciliation, income taxes paid and other items. Specifically, the PRI provides comments on questions 4 and 10.

The PRI supports the proposed amendments to Topic 740 addressing rate reconciliation, income taxes paid and related disclosures, and recommends that the FASB implement these proposals in full. We further recommend the FASB considers additional amendments in the future to meet the evolving needs of investors around income tax disclosures.

The PRI's work and engagement with investors has shown that tax risks translate into earnings, reputational and governance risks at the company level as well as contribute to macro-economic and societal risks at the system level[6]. There is increasing recognition that it is in investors' financial interests to better identify tax related factors that could present a downside risk and integrate those risks in valuation and investment decisions, and to assess a company's overall corporate governance profile. Investors are increasingly interested in assessing the evolution of entities' effective tax rates over time and the reasons for differences between effective tax rates and statutory income tax rates. The proposed changes will provide additional information to investors that will allow them to make more informed assessments.

The benefits to investors would be greatly enhanced if these proposed changes were to be accompanied by disclosures on key jurisdiction-level information such as revenues and operating results on a similar level of disaggregation.

The more granular disclosure requirements on income taxes proposed by FASB, when combined with additional jurisdictional information e.g., related to an entity's revenue, taxable income, and income tax expense (or benefit), would enable investors to better assess tax risks and opportunities in their portfolio by allowing them to:

- understand an entity's exposure to potential changes in jurisdictional tax legislation and the ensuing risks and opportunities;
- assess income tax information that affects cash flow forecasts and capital allocation decisions;
- examine the economic scale of operations in different jurisdictions, identify those companies that are best prepared for upcoming regulatory changes and withstand increased scrutiny at the jurisdictional level;
- raise questions with companies where tax structures and strategies might not align with economic value generated and therefore, might lead to higher exposure to risks of challenges by tax authorities;

[6] Principles for Responsible Investment, *Engagement Guidance on Corporate Tax Responsibility* (2015), available at https://www.unpri.org/download?ac=5601

- gain a better understanding of corporates tax practices, overall contributing to a more informed dialogue between corporates and investors.

Greater disclosures on jurisdictional information other than income taxes would significantly enhance the value of FASB's proposed changes to investors. In general, the PRI supports country-by-country reporting (CBCR) which significantly improves investors' ability to assess tax-related risks and gain visibility on higher risk transactions.

The PRI does not fully agree with the FASB's conclusion that CBCR *"is beyond the objective of general purpose financial reporting, which is to provide financial information about the reporting entity that is useful to existing and potential investors in making decisions about providing resources to the entity".* CBCR is relevant and decision-useful financial information for investors seeking to understand the tax implications of entities with operations spanning multiple jurisdictions.

The FASB concluded that the costs of incorporating OECD-aligned country-by-country reporting in financial statements would be too significant because OECD-aligned CBCR data is not necessarily based on GAAP amounts. We appreciate the significance of alignment costs for preparers, but would stress that said alignment costs should be balanced with the needs of investors. Likewise, the PRI notes that there is growing regulatory appetite on the introduction of mandatory public CBCR with requirements being effective in the European Union[7] and proposed in Australia[8] with implications for large US companies.

DETAILED RESPONSE

Question 4: For investors, would the proposed amendments to the rate reconciliation disclosure result in more transparent and decision-useful information? If so, how would that information help assess income tax risks and opportunities and how would it influence investment and capital allocation decisions? If not, what additional information about rate reconciliation should the Board require?

The PRI supports the improved disclosures to the rate reconciliation, as this would help investors gain deeper insights into a company's income tax position. As the FASB highlighted, the rate reconciliation is one of the most useful tax related disclosures for investors seeking to understand an entity's income taxes, and income tax risks and opportunities. However, current income tax rate disclosures often provide only high-level information on the company's income tax rate reconciliation, making it difficult for investors to understand the consequences of different foreign tax rates and factors such as research and development credits and other tax advantages that impact the tax rate. A clear tax reconciliation would allow investors to have some understanding of the

[7] European Union, *Official Journal of the European Union: Directive (EU) 2021/2101 of the European Parliament and of the Council* (24 November 2021), available at https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021L2101
[8] Australian Government, The Treasury, *Exposure Draft: Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Multinational tax transparency – Tax changes* (5 April 2023), available at https://treasury.gov.au/consultation/c2023-383896

material incentives, arrangements, or items that influence the company's tax rate and enable better assessment of the durability and sustainability of a company's future earnings[9].

The PRI supports the 5 percent threshold "whereby reconciling items have to be disclosed when the absolute value of the effect of a reconciling item is equal to or greater than the absolute value of 5 percent of the amount computed by multiplying the income [or loss] from continuing operations before tax by the applicable statutory income tax rate". The PRI notes that the FASB could consider introducing an absolute threshold that is independent of the headline tax rate to avoid variations to the underlying reconciling items from changes to the headline rate.

Furthermore, the PRI supports the introduction of the proposed eight specific categories. These categories will also enhance investors' ability to analyse and compare companies' tax reconciliations. For example, this information will allow investors to better forecast future cash flows or income after tax and gauge the level of certainty associated with future tax cash flows and income.

The PRI supports FASB's amendments to require separate disclosure of reconciling items by nature and by jurisdiction, on the basis of a quantitative threshold of 5 percent, within the foreign tax effect category. Currently, entities report an aggregate figure when accounting for the impact of differential foreign tax rates on their income tax reconciliation which provides investors with limited insights on the effects of foreign tax rates.

The PRI supports amendments for business entities to provide an explanation of reconciling items impacting the rate reconciliation. Currently, the accompanying footnotes often lack decision-useful information, providing vague, or incomplete information. The proposed amendment will assist investors in gaining a better understanding on e.g., the nature of the effect, the year over year changes of these material reconciling items, etc. Improved qualitative disclosures can more clearly and meaningfully explain and contextualise the reconciliation table.

Question 10: For investors, would the proposed amendments to the income taxes paid disclosure result in more transparent and decision-useful information? If so, how would that information help assess income tax risks and opportunities and how would it influence investment and capital allocation decisions? If not, what additional information about income taxes paid should the Board require?

The PRI supports the proposed amendments on income taxes paid on a jurisdictional basis. These changes will result in more transparent and decision-useful information for investors. The current level of disclosure requirements is insufficient to help investors understand the tax profile of an entity operating across jurisdictions. The aggregate information provided by entities on foreign income taxes paid offers an extremely limited explanation of companies' foreign tax rates and related adjustments. For those companies where foreign operations make up a significant part of their

[9] Principles for Responsible Investment, *Evaluating and Engaging on Corporate Tax Transparency: An Investor Guide* (2018), available at https://www.unpri.org/Uploads/t/r/l/PRI_Evaluating-and-engaging-on-corporate-tax-transparency_Investor-guide.pdf

revenues and incomes before tax, the lack of information on income taxes paid on a jurisdictional basis is even more detrimental to investors.

The FASB is proposing further disaggregation to the income taxes paid on an annual basis by individual jurisdictions in which income taxes paid (net of refunds received) is equal to or greater than 5 percent of total income taxes paid (net of refunds received). Such disclosures will provide investors with some level of much-needed transparency.

However, in the future, the FASB should consider disclosures of income taxes paid in all countries of operation. This information is practical for companies to disclose and represents the most appropriate level of granularity to investors. In addition, disclosures of additional jurisdictional information related to an entity's revenue, taxable income and income tax expense (or benefit) with a similar level of granularity would greatly enhance the benefits of these proposed changes for investors. With jurisdictional-level information, investors would be able to cross-reference income taxes paid on a jurisdictional level with information on revenues and operating results to properly assess tax-related risks and opportunities to future cash flows and tax rates.