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SEC and FASB Comments on Accounting for Income Taxes

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This article summarizes certain comments about accounting for income taxes made by representatives of the U.S. Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) during the 2017 AICPA National Conference on Current SEC and PCAOB Developments. The article also provides examples of comments recently issued by the SEC to registrants around those areas of concern.

The 2017 AICPA National Conference on Current SEC and PCAOB Developments was held December 4-6, 2017, in Washington, D.C. The conference addressed recent developments and initiatives at the SEC, Public Company Accounting Oversight Board (PCAOB), FASB, and International Accounting Standards Board (IASB), as well as other accounting, financial reporting, and auditing topics. Speakers included representatives from regulators, standard setters, preparers, auditors, audit committee members, and financial statement users. The tone of the 2017 conference was different from prior years in many ways and focused more on process as opposed to technical issues.

The KPMG LLP's Department of Professional Practice publication *Issues & Trends: 2017 AICPA National Conference on Current SEC and PCAOB Developments* provides highlights from the entire conference, while this article summarizes certain highlights relevant to accounting for income taxes from the publication.

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Tax Reform

KPMG expects the SEC to focus on tax reform recognition and disclosures during the coming year. At the time of the conference, prior to enactment, it was noted that if tax reform were enacted prior to year-end, companies would have a short time period during which to ensure timely reporting in the year-end financial statements including the measurement of deferred taxes, valuation of deferred tax assets, and the consequences of mandatory repatriation, amongst other factors. In addition, entities may have to determine and disclose the impacts tax reform may have on future profitability.

Preparing for New Accounting Standards

During the conference, a significant amount of time was devoted to implementation issues surrounding several new accounting standards, including “Revenue from Contracts with Customers” and “Leases,” specifically stressing that companies should focus on developing and implementing strong policies, procedures, and internal controls to apply the new accounting standards. Companies should also consider the impact of accounting for income taxes on adoption of the new standards, as well as any impacts on the tax compliance process (for instance, assessing the need for new or changes to existing tax accounting methods).

Transparency in Financial Communications

The Office of the Chief Accountant (OCA) is prioritizing maintaining high quality financial reporting. Similarly, the SEC chairman pointed out that an important aspect of transparency is aligning financial statement disclosures, discussions in other parts of SEC filings (including management’s discussion and analysis (MD&A)), and investor communications made outside of SEC filings (for instance, investor presentations and press releases). In aligning with the SEC priorities, the FASB continues to focus on its disclosure framework project. When complete, the framework should provide guidance on how a company can determine when disclosures are material to financial statements. Additionally, income taxes is one of four project areas in which the FASB is testing its proposed guidance on disclosures. Both projects are still in the re-deliberations stage, with the FASB recently noting the income taxes disclosure project will be reassessed subsequent to tax reform implementation.

Examples of Recent SEC Comment Letters *(Emphasis Added)*

The following selection of SEC comment letters specific to income taxes are provided to illustrate areas in which the SEC staff questioned whether the disclosures provided adequate insight to investors to understand a company’s tax situation or when the SEC staff wanted a better understanding of the basis for management’s judgments. The comments highlight common findings that are representative of the staff’s areas of recent focus associated with income taxes.

Example 1: Effective Tax Rate Reconciliation

The SEC staff may request additional information on significant changes in the effective tax rate reconciliation year over year:

> *We note your effective tax recovery rate has changed from X% to X% from 2015 to 2016, respectively. In your reconciliation from the statutory rate to your income tax recovery in the*

income tax footnote, we note significant changes in certain items that have not been identified or described in management's discussion and analysis (MD&A). For example, we note a significant change in unused tax losses and tax offsets recognized in deferred tax assets and the change in planned distributions of foreign earnings of the company. Please expand your disclosure in MD&A to explain the movements in your income tax expense/recovery for individual items that materially impact your effective tax rates.

Example 2: Effective Tax Rate Reconciliation

The SEC staff may request additional information on changes in the allocation of pretax income between domestic and foreign operations:

We note the discussion of the decrease in your effective tax rate due to a higher proportion of income generated in lower tax jurisdictions each period. We also note the growing impact of non-U.S. income taxed at different rates on your effective tax rate disclosed in [the Notes] to your financial statements. In future filings please revise this section to explain the impact of non-U.S. lower taxed jurisdictions on your effective tax rate, including a discussion of the primary taxing jurisdictions where your foreign earnings are derived, the location of tax holidays and the relevant statutory rates in those jurisdictions. Discuss any uncertainties relating to the income tax rates or benefits you currently receive in those jurisdictions. Refer to Item 303(a)(3) of Regulation S-K.

Example 3: Effective Tax Rate Reconciliation

The SEC staff may request additional information regarding the recurring versus nonrecurring nature of rate reconciling items and their impact on changes in the effective tax rate:

Please expand your discussion related to the provision of income taxes to provide a more robust discussion around the changes that impacted your effective tax rate from period to period. Your disclosures should clearly outline each of the material factors that contributed to your effective tax rate along with the underlying reasons for the changes between periods. To the extent any of those material factors are not expected to be recurring, your discussion should clearly indicate the non-recurring nature of such factors. For example, we note that the amount of permanent differences, net significantly impacted your effective tax rate by approximately $X million or X% in 2016 compared to only $X million or X% in 2015 with seemingly no explanation as to the reasons behind the change or whether the change is considered recurring in nature.

Example 4: Valuation Allowance

The SEC staff may request additional information when a valuation allowance is released including disclosure of the facts and circumstances that resulted in the release and further disclosure of significant assumptions or estimates:

We note that you recorded a reversal of your valuation allowance during the year ended December 31, 2016. And, we note that your reversal of $X million related primarily to U.S. net

> *operating loss carryforwards and other deferred tax assets. Please provide us with a comprehensive analysis of the positive and negative evidence that you considered to determine that this reversal was appropriate. It appears you may have been in a cumulative three-year net loss position at the time of reversal. Further, in future periodic filings please provide a more robust description of the positive and negative evidence you consider when determining whether your deferred tax asset valuation allowance is appropriate.*

Example 5: Valuation Allowance

The SEC staff may request additional information on the judgment associated with a valuation allowance including specific positive and negative evidence assessed:

> *You state that your valuation allowance relates primarily to your ability to realize certain foreign net operating loss (NOL) carryforwards. Please tell us the factors considered when determining that a valuation allowance is necessary in light of your historical pre-tax foreign income, and provide the specific foreign jurisdictions that are impacting your analysis. Also, please explain what contributed to the decrease in the valuation from fiscal 2015 to 2016. To the extent that the decrease relates to the use of NOL carryforwards, please tell us how you determined that it is more likely than not that your NOLs will not be realized. Refer to ASC 740-10-30-17.*

Example 6: Indefinite Reinvestment Criteria

The SEC staff may request additional information on the amount of earnings that are indefinitely reinvested and question the basis for omitted disclosures:

> *Please tell us the amount of undistributed earnings on your foreign subsidiaries for each period presented. Explain to us why the amount of undistributed earnings on your foreign subsidiaries is immaterial in light of the significant amounts of income from foreign subsidiaries in each period as well as the fact that a majority of your cash and cash equivalents are held in bank accounts outside the U.S.*

Example 7: Indefinite Reinvestment Criteria

The SEC staff may request additional information on changes in judgment impacting the indefinite reversal criteria:

> *We note that a deferred tax liability was recognized in 2016 for undistributed foreign earnings as a portion of your cumulative undistributed foreign earnings outside of the United States will no longer be permanently invested. Tell us how the analysis of the financial requirements of your United States companies and foreign subsidiaries and the overall capital structure of your global organization led you to determine that undistributed earnings of certain foreign subsidiaries would no longer be permanently reinvested outside the United States. With your response, provide us with a discussion of the specific plans you have for reinvestment of material components of the undistributed earnings of foreign subsidiaries you intend to permanently reinvest outside the United States. Refer to FASB ASC 740-30-25-17.*

Example 8: Unrecognized Tax Benefits

The SEC staff may request additional information on significant changes in the balance of unrecognized tax benefits:

> *We note in <u>the reconciliation of unrecognized tax benefits that increases based on tax positions in prior years</u> went from $X million at December 31, 2015 to $X million at December 31, 2016. Please <u>explain to us the facts and circumstances associated with the increase</u>.*

Example 9: Recognition of Deferred Tax Assets under IAS 12

The SEC staff may question the judgment associated with the recognition of deferred tax assets when historical losses exist:

> *Please provide <u>further detail regarding your assessment that realization of your deferred tax assets is probable in light of the current low pricing environment, and the fact that you have experienced three consecutive years of losses before taxes</u>. Please tell us how you considered these factors in your assessment and clarify the nature of the convincing evidence that supports your recognition of these deferred assets in accordance with paragraphs 34 through 37 of IAS12.*

Conclusion

In summary, comments delivered at the 2017 AICPA National Conference on Current SEC and PCAOB Developments provide insights into potential future focus areas from the SEC. Further, as demonstrated in recent SEC staff comment letters, accounting for income taxes continues to be an area of focus, and continued improvement is expected to provide relevant and robust disclosures to investors.

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