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Recent SEC and FASB Comments on Accounting for Income Taxes

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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 2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments are summarized in this article. This article also provides examples of comments about accounting for income taxes recently issued by the SEC to registrants. Recent comments from regulators and standard setters may help issuers identify areas for improvements in existing income taxes disclosures in order to provide more robust and relevant information to investors.

2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments

The 2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments (the "Conference") was held December 6-8, 2021, in Washington, D.C., and virtually. The speakers and panelists included representatives of the SEC, the FASB, the International Accounting Standards Board ("IASB") and the Public Company Accounting Oversight Board ("PCAOB"), who shared views on various accounting, financial reporting, auditing and regulatory issues. The theme of the Conference was how regulators, standard setters, preparers and auditors can provide investors with high-quality, decision-useful

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financial information. The highlights relevant to accounting for income taxes included a discussion on proposed tax legislation and disaggregation of tax information.

The SEC staff (the "Staff") is actively monitoring developments in the tax legislation proposed in the Build Back Better Act and does not anticipate that any changes that may be enacted will be as significant as the changes that resulted from the 2017 Tax Cuts and Jobs Act ("TCJA"). A representative of the Office of the Chief Accountant noted that the relief provided in Staff Accounting Bulletin ("SAB") No. 118, which allowed entities additional time to analyze and record the tax effects, applies to only the TCJA and would not apply to any new tax legislation. Instead, entities should follow the general requirement of ASC 740, *Income Taxes*, and account for changes in income tax laws in the period that includes the enactment date. Registrants were encouraged to continue to monitor developments in this area.

Additionally, the FASB recently solicited comments through its agenda consultation "invitation to comment" process. The FASB speakers highlighted disaggregating financial information as one of the themes for many comments received in the process, including the disaggregation of income taxes information by jurisdiction or geographies to help investors identify future risks. Investors favor more disaggregation of financial information so they can obtain more meaningful insight into companies, but most preparers do not favor more disaggregation due to the cost and complexity involved in supplying disaggregated information. The FASB will consider these items as it develops its agenda for 2022 and beyond.

Examples of Recent SEC Comment Letters

The following selection of SEC comment letters specific to income taxes is provided to illustrate areas in which the Staff questioned whether the disclosures provided adequate insight for investors to understand a company's income taxes environment or when the Staff wanted a better understanding of the basis for management's judgments. The comments below (emphasis added) highlight common findings that are representative of the Staff's areas of recent focus associated with income taxes.

The examples involve the effective tax rate reconciliation, valuation allowances, unrecognized tax benefits, net operating loss carryforwards, business combinations, critical accounting policies, and non-GAAP measures.

Example 1: Effective Tax Rate Reconciliation

The Staff may request additional detail on the changes to the effective tax rate and significant factors affecting the rate period over period:

> Please expand your disclosures of income tax expense to discuss the changes in the effective tax rate from period to period and correspondingly the significant factors that impacted the rate from period to period. *Please quantify the material factors disclosed as well as whether the material factors impacting the effective tax rate are expected to have a continuing impact. Please specifically disclose whether you are aware of any reasons why the effective tax rate in the historical financial statements may not be indicative of your expected effective tax rate in future periods.*

Example 2: Effective Tax Rate Reconciliation

The Staff may request additional detail on the components of the other line in the effective tax rate reconciliation*:*

> In your income tax rate reconciliation on page F-45, the "other" category in 2019 represents 13.1% of the effective tax. *Please tell us the nature of any individual reconciling item over 5% of your effective tax rate; if there are none, please tell us the nature of the underlying amounts.* Provide us proposed revised disclosure to be included in next year's Form 20-F that separately discloses each item over 5% of the effective tax. See Rule 4-08(h)(2) of Regulation S-X.

Example 3: Valuation Allowances

The Staff may request additional detail on the evidence assessed in supporting the reversal of a valuation allowance:

> *Please expand your disclosures to provide a more comprehensive analysis of the specific positive and negative evidence management evaluated in determining that the valuation allowance on your deferred tax assets should be reversed by $X during 2018.* Your disclosures should include the weighting of the evidence that is commensurate with the extent to which it is objectively verified. Please refer to ASC 740-10-30-16 through 30-25 for guidance.

Example 4: Valuation Allowances

The Staff may request additional detail on the evidence assessed in supporting the reversal of a valuation allowance:

> Please provide us with your analysis supporting the release of your Italian valuation allowance including the positive and negative evidence considered and how you weighted such evidence. Refer to ASC 740-10-30-17 through 30-25. We note from disclosure in the Form 6-K furnished on November 12, 2019 that the planned spin-off of your operation was considered as part of your analysis. *As the spin-off is subject to shareholder approval, please tell us how you considered management's ability to control the planned transaction in your analysis.* Refer to ASC 740-10-30-19. Further, in future filings, please revise your Operating and Financial Review Prospects disclosure to discuss the specific circumstances that led to the release and the circumstances that could reasonably cause you to adjust your valuation allowance in the future. Refer to Section III.B.3 of SEC Release No. 33-8350.

Example 5: Valuation Allowances

The Staff may request additional detail on the reconciliation of the change in the valuation allowance as reflected in the table of deferred taxes to the amount disclosed in the effective tax rate reconciliation:

> We note the valuation allowance of $X million at December 31, 2019 increased by $X million to $X million at December 31, 2020. However, the increase to the valuation allowance is $X million in the table reconciling the expected statutory federal income tax expense (benefit) to the income tax provision. *Please explain the difference in these amounts.*

Example 6: Unrecognized Tax Benefits

The Staff may request additional detail on the amount of unrecognized tax benefits compared to the assessed value:

> We note your disclosure on pages 65-66 and F-61 regarding the draft notice of proposed adjustment from the IRS that could increase the company's federal tax expense by $1.65 billion, which is $1 billion beyond the company's current reserves. *Please expand your disclosure in this section [Risk Factors] to further describe the potential tax liability and how it may impact your business, revenue or results of operations. Please quantify the potential impact, to the extent practicable, and disclose the potential liability and impact on your financial condition in your Summary.*

Example 7: Net Operating Loss Carryforwards

The Staff may request revisions to address omitted disclosures related to net operating loss carryforwards:

> *Please revise your disclosure to disclose the amounts and expiration dates of your net operating loss carryforwards for tax purposes.* Reference is made to ASC 740-10-50-3a.

Example 8: Business combinations

The Staff may request additional detail on whether an acquisition resulted in limitations on the utilization of attributes:

> We note your statement that it is likely that the Business Combination would result in an ownership change and if an ownership change is deemed to have occurred, [Company's] carryforwards may be limited. *Please revise to explain how the limitation on the use of carryforwards is determined if there is an ownership change*.

Example 9: Critical Accounting Policies

The Staff may request additional detail on the determination of the realizability of deferred tax assets as it relates to critical accounting policies:

> We note that you have not recorded a valuation allowance against your significant US jurisdiction deferred tax assets, other than the US interest limitation. In light of the objective and verifiable negative evidence in the form of cumulative losses over the three years ended December 31, 2019, *please tell us your consideration of providing more robust critical accounting policy disclosures regarding the various judgments and assumptions made in determining the deferred tax assets are realizable, including a discussion of the degree of uncertainty associated with key assumptions*. Such discussion would desirably provide specifics (e.g., projected future taxable income assumes revenue and margin growth rates of X% and positive net income by what year) as well as a description of potential events and/or changes in circumstances that could reasonably be expected to negatively affect the key assumptions . Please refer to Item 303(a)(3)(ii) of Regulation S-K and SEC Release No. 34-48960.

Example 10: Non-GAAP Measures

The Staff may request additional detail to understand why the impact of discrete tax items was excluded from the effective tax rate:

> *We note that you present in this note an effective tax rate excluding the impact of discrete tax items, which appears to be a non-GAAP measure.* Please refer to the guidance in Item 10(e)(1)(ii)(C) of Regulation S-K which prohibits you from presenting non-GAAP measures on the face of or in the notes to your financial statements, and revise future filings to comply. Also, revise your similar disclosures on page 27 in MD&A to provide all disclosures required by Item 10(e) of Regulation S-K.

Conclusion

In summary, as demonstrated in recent SEC staff comment letters, accounting for income taxes continues to be an area of focus for the SEC. Consequently, financial statement preparers may decide to consider the recent comments from regulators and standard setters to identify areas for improvements in existing disclosures related to income taxes.

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