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FASB ASC 740, *Income Taxes*
<u>Disclosure Requirements</u>

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Smart people learn from their mistakes. But the really sharp ones learn from the mistakes of others.

We continue our reporting on Matters for Further Consideration (MFC) in peer review with our look at the MFCs for 2021 peer reviews pertaining to income taxes. Specifically, we noted an above-average number of MFCs related to income tax disclosures. Financial Accounting Standards Board *Accounting Standards Codification* (FASB ASC) 740-10-50, *Income Taxes—Overall—Disclosure*, is the source of guidance on the disclosures related to income taxes in the financial statements of all entities.

> Illustrative disclosures presented in this report are not a substitute for the original authoritative accounting guidance. Accountants and practitioners are urged to refer directly to applicable authoritative pronouncements to help ensure compliance with required disclosure standards. The CPEA is not providing assurance that these illustrative disclosures comply with authoritative pronouncements and are not recommending or endorsing these examples.

Practice Note: In 2016, the FASB issued a proposed Accounting Standards Update (ASU), *Income Taxes (Topic 740): Disclosure Framework—Changes to the Disclosure Requirements for Income Taxes*, that set forth enhanced disclosure requirements for income taxes. After passage of the *Tax Cuts and Jobs Act* (TCJA) in December 2017, the FASB, in 2019, issued a revised proposed ASU. The revised proposed ASU would (1) remove disclosures that no longer are considered cost beneficial or relevant and (2) add disclosure requirements identified as relevant to financial statement users. The FASB continues to work on this project.

Examples of Matters for Further Consideration

Reviewer noted presentation of deferred tax assets and deferred tax liabilities on the face of the financial statements. Notes to the financial statements did not include significant components encompassing deferred tax assets and liabilities. Amounts within each tax jurisdiction were not presented net as one deferred tax asset or deferred tax liability.

Firm did not disclose the valuation allowance related to deferred tax assets.

For the entity engagement selected for review, the financial statement disclosures do not present all the required disclosures related to income taxes, including components of income tax assets and liabilities, the types and nature of reconciling items between GAAP income tax expenses and amounts of income tax expense from applying federal statutory rates.

The accountant's Income Tax note disclosure included components of income tax (benefit) expense and the open tax years; however omitted other disclosures as follows: reconciliation of significant items from applying statutory tax rates, types of temporary differences and carryforwards that cause significant portions of a deferred tax liability or asset; components and classification of deferred tax liabilities or assets; and amounts and expiration dates of operating loss and tax credit carry forwards.

In a compilation with disclosures of a healthcare entity, the statements and notes did not include temporary differences between GAAP and tax basis and also the significant elements of deferred tax liabilities or tax assets.

On the review engagement the disclosure of available tax credit carryforwards did not include their expiration dates.

On the review engagement reviewed, the expiration dates of the net operating losses carryforward were not disclosed.

Income tax disclosures were incomplete in that they omitted certain information including the gross deferred tax assets & liabilities and a description of items that comprise deferred tax balances, a description of items included in temporary differences, the amount of net operating losses available at year end and the amount of net operating losses used during the year, and current and deferred tax expense.

Gross deferred tax assets & liabilities, a description of the types of reconciling items between GAAP tax expense & federal statutory rates & the types of deferred taxes are not disclosed.

Income tax disclosures do not include significant components of income tax expense for current and deferred income tax, expiration dates of operating loss carryforward, the amount of or change in valuation allowance recorded or the amount the deferred tax asset related to the operating loss. The note clearly conveys that a 100% valuation allowance is recorded. This engagement is nonconforming.

Balance Sheet Disclosures

Deferred Taxes

Reporting entities should disclose separately three components of the net deferred tax balance recognized in a balance sheet:

- The total amount of deferred tax liabilities determined according to FASB ASC 740-10-30-5(b)
- The total amount of deferred tax assets determined according to FASB ASC 740-10-30-5(c) and 30-5(d)
- The total amount of valuation allowance on deferred tax assets measured pursuant to FASB ASC 740-10-30-5(e)

A reporting entity also should disclose the net change in the valuation allowance on deferred tax assets during the reporting year. In addition, FASB ASC 740-10-50-8 requires the types of temporary differences that give rise to significant portions of a deferred tax asset or liability to be disclosed. However, it does not prescribe how the differences should be disclosed.

The following is an example of these disclosure requirements.

Note 1—Accounting Policies

Income Taxes

Income taxes are provided for the tax effects of transactions reported in the financial statements and consist of taxes currently due plus deferred taxes. Deferred taxes are recognized for differences between the basis of assets and liabilities for financial statement and income tax purposes. The differences relate primarily to depreciable assets (use of different depreciation methods and lives for financial statement and income tax purposes), allowance for doubtful receivables (deductible for financial statement purposes but not for income tax purposes), and profit on installment sales (deferred for income tax purposes but recognized for financial statement purposes). The deferred tax assets and liabilities represent the future tax return consequences of those differences, which will either be deductible or taxable when the assets and liabilities are recovered or settled. Deferred taxes also are recognized for operating losses and tax credits that are available to offset future taxable income.

Note 16–Income Taxes

The Company's total deferred tax liabilities, deferred tax assets, and deferred tax asset valuation allowances at December 31 were as follows (in thousands):

	2020	2019
Deferred tax assets:		
Total deferred tax assets	46,138	37,164
Less: Valuation allowance	(37,856)	(30,363)
Net deferred tax assets	8,282	6,801
Deferred tax liabilities:		
Total deferred tax liabilities	(8,056)	(6,596)
Net deferred tax assets (liabilities)	$226	$205

As of December 31, 2020, the Company has a valuation allowance of approximately $37,856,000 against all net domestic deferred tax assets, for which realization cannot be considered more likely than not at this time. The net change in the valuation allowance was $7,493,000 for the year ended December 31, 2020. Management assesses the need for the valuation allowance on a quarterly basis. In assessing the need for a valuation allowance, the Company considers all positive and negative evidence, including scheduled reversals of deferred tax liabilities, projected future taxable income, tax planning strategies, and past financial performance.

Operating Losses and Tax Credit Carryforwards

A reporting entity should disclose the following information related to operating losses and tax credit carryforwards:

- The amounts of operating losses and tax credit carryforwards taken on the tax returns and the dates on which these amounts expire
- The amount of any valuation allowance (or portion thereof) on deferred tax assets for which the reporting entity will credit any future recognized tax benefits to shareholders' equity (e.g., a deferred tax asset relating to a net unrealized loss on available-for-sale securities)

The following is an example of a private company financial statement disclosure regarding operating losses and tax carryforwards.

Note 8—Income Taxes

At June 30, 2019 and 2018, the Company has net operating losses of $-0- and $174,000, respectively, available for carryforward to future years. These operating losses begin to expire in June 2030.

Change in Tax Status

If a reporting entity changes its tax status after the end of the reporting year, but prior to the date that the financial statements are available to be issued (i.e., the change qualifies as a subsequent event according to FASB ASC 855, *Subsequent Events*), then two items should be disclosed in the financial statements:

- The change in the tax status that occurred after year-end
- The effect of the change on the financial statements, if material

The following is an example of this disclosure.

> **Note 19—Income Taxes**
>
> On January 2, 2021, the Company filed an election with the Internal Revenue Service, electing to be treated as a taxable corporation for U.S. federal income tax purposes effective January 2, 2021. See Note 21, *Subsequent Events*, for additional disclosures regarding the election.
>
> **Note 21—Subsequent Events**
>
> Tax Election
>
> As discussed in Note 19, *Income Taxes*, on January 2, 2021, the Company filed an election with the Internal Revenue Service, electing to be treated as a taxable corporation for U.S. federal income tax purposes effective January 2, 2021.

Temporary Differences and Tax Carryforwards

All entities should provide additional disclosures about temporary differences and tax carryforwards. However, the required information varies for public and nonpublic entities. A nonpublic entity must identify each category of significant temporary differences and tax carryforwards. However, a nonpublic entity is not required to disclose numerical estimates of the tax effects of each category. An entity can determine individual disclosure items by looking at financial statement captions (e.g., property, plant, and equipment) or by subgroup (e.g., tractors, trailers, and terminals for a trucking company) or individual asset.

Practice Note: The FASB ASC Master Glossary does not define "significant," as used in FASB ASC 740-10-50-6. However, the SEC staff has indicated that, to meet this requirement, public entities should disclose all components that equal or exceed 5 percent of the gross deferred tax asset or deferred tax liability.

Income Statement

Significant Components of Income Tax Expense

Reporting entities should disclose the significant components of tax expense that are related to income from continuing operations for each year that an income statement is provided. These disclosures may be provided in either the income statement or the notes to the financial statements.

The following are examples of components that, if significant, should be disclosed:

- Current tax expense or benefit
- Deferred tax expense or benefit (without the effects of any of the other components listed below)
- Investment tax credits
- Grants from government bodies that have been recognized as a reduction of income tax expense
- Tax benefits of operating loss carryforwards
- Tax expense due to the apportionment of certain tax benefits to contributed capital
- Adjustments of a deferred tax liability or asset for enacted changes in tax laws or rates or a change in the tax status of the entity
- Adjustments of the beginning-of-the-year balance of a valuation allowance because of a change in circumstances that causes a change in judgment about the realizability of the related deferred tax asset in future years

The following is an example of this disclosure from Best Buy Co., Inc.

Note 11–Income Taxes

Earnings before income tax expense by jurisdiction were as follows ($ in millions):

	2021	2020	2019
United States	$2,203	$1,704	$1,574
Foreign	174	289	314
Earnings before income tax	$2,377	$1,993	$1,888

Income tax expense (benefit) was comprised of the following ($ in millions):

	2021	2020	2019
Current:			
Federal	$447	$261	$275
State	117	73	75
Foreign	51	48	64
	615	382	414
Deferred:			
Federal	(25)	56	4
State	(16)	8	-
Foreign	5	6	6
	(36)	70	10
Income tax expense	$579	$452	$424

Practice Note: Disclosure by jurisdiction, as presented above, is not required for non-public entities.

Rate Reconciliation

All entities should provide disclosures about the difference between income tax expense recognized in the financial statements and the amount expected if tax expense were calculated by applying the statutory income tax rates to net income before taxes. However, the required information varies for public and nonpublic entities.

All entities should provide information about the nature and effect of any significant item that makes it difficult to compare the amount of income tax expense recognized in the financial statements across all the periods presented. A nonpublic entity must disclose the nature of each significant reconciling item but is not required to present a numerical reconciliation. Further, nonpublic entities should provide information about the main reconciling items between:

- The amount of income tax expense recognized in its income statement that is related to income from continuing operations; and
- The amount of income tax expense calculated as follows:

Pretax income from continuing operations

X

Domestic federal statutory income tax rates

The following is an excerpt of a typical private company financial statement disclosure for a reconciliation of the company's statutory rate to its effective tax rate.

Note 6—Income Taxes

The following is a reconciliation of the statutory federal income tax rate applied to pretax accounting income with the income tax provision attributable to continuing operations in the statements of income:

	Year Ended December 31	
	2014	2013
Income Tax Expense at the Statutory Rate		
(22.08% / 15.00%)	$25,433	$4,055
Increase (Decrease) Resulting from:		
State Income Taxes,		
Net of Federal Income Tax Benefit	(2,140)	(308)
Temporary Differences	(2,145)	411
Permanent differences	621	414
Deferred Income Tax Adjustment	2,429	(685)
Provision for Federal Income Tax	$24,198	$3,887

Unrecognized Tax Benefits

All reporting entities should provide the following information regarding unrecognized tax benefits at the end of each annual reporting period presented:

- Amount of interest and penalties recognized in the income statement and balance sheet, respectively
- The following items specific to those tax positions for which it is reasonable to expect that the amount of unrecognized tax benefits may change significantly either positively or negatively within 12 months of the reporting date:
  - The reason why the position is uncertain

- The type of event that could lead to a change in the amount within 12 months
- The approximate range of the change deemed reasonably possible, or a statement that such an estimate is indeterminable
- A statement describing the tax years still open for audit by major tax authorities (See the CPEA's report, titled, *Controversy Over the Applicability of the Disclosure Requirement of Open Tax Years: Unintended Consequences and Lessons for All*, about this requirement. We feel that this disclosure is necessary only if an entity has unrecognized tax benefits.)

The following is an example of this disclosure.

Note 13–Income Taxes

Uncertain Tax Positions

The Company has approximately $1.9 million and $1.1 million accrued for interest and penalties as of December 31, 2020 and December 31, 2019, respectively, in the Consolidated Balance Sheets and recorded $0.8 million and $0.6 million in interest and penalties during 2020 and 2019, respectively in the Consolidated Statements of Income. Interest and penalties related to unrecognized tax benefits are recorded in "Provision for income taxes" on the Consolidated Statements of Income.

Unrecognized tax benefits are not expected to significantly change within the next 12 months.

Generally, a number of years may elapse before a tax reporting year is audited and finally resolved. With few exceptions, the Company is no longer subject to U.S. federal, state, or local examinations by tax authorities before 2015. While it is often difficult to predict the final outcome or the timing of or resolution of a particular tax matter, the Company does not anticipate any adjustments resulting from U.S. federal, state, or foreign tax audits that would result in a material change to the financial condition or results of operations. Adequate amounts are established for any adjustments that may result from examinations for tax years after 2015. However, an unfavorable settlement of a particular issue would require use of the Company's cash and cash equivalents.

Other Disclosures

Consolidated Tax Return

If an entity is a member of a tax group that files a consolidated tax return and issues separate financial statements, then the entity must provide the following information in its separate financial statements:

- The aggregate current and deferred income tax expense for each income statement presented
- The amounts owed to or by affiliated entities for taxes as of the date of each balance sheet presented

The principal provisions of the method by which the consolidated amount of current and deferred tax expense is allocated to members of the group and the nature and effect of any changes in that method (and in determining related balances to or from affiliates) during the years for which the above disclosures are presented. The following is an example of this disclosure.

Note 9—Income Taxes

The Company is a member of a tax group that files a consolidated tax return and uses the separate return method to allocate the consolidated amount of current and deferred tax expense among the group members. Under the separate return method, the Company is assumed to file a separate return with the taxing authority, thereby reporting its taxable income or loss and paying the applicable tax to or receiving the appropriate refund from the parent. Thus, it is possible that the Company could recognize a loss or credit carryforward, even though there is no carryforward on a consolidated basis. Additionally, when the tax law in the jurisdiction provides for the carryback of losses, the Company could reflect the carryback of a current-year loss against prior taxable income even though the consolidated group had losses. Allocated income tax expense (benefit) was comprised of the following ($ in millions):

	2021	2020	2019
Current:	615	382	414
Deferred:	(36)	70	10
Income tax expense	$579	$452	$424

The following amounts are owed to or (by) the Company for taxes as of December 31 ($ in millions):

2019	$ 15
2020	$(89)
2021	$ 13

Practice Note: A reporting entity does not have to allocate consolidated amounts of current and deferred tax expense to a legal entity that is not subject to tax and that is disregarded by the taxing authority, but it may elect to do so on an entity-by-entity basis.

If an entity that is not subject to tax and that also is disregarded by the taxing authority makes the election under FASB ASC 740-10-30-27A to include allocated amounts of current and deferred tax expense in its separately issued financial statements, it must disclose this fact. In addition, the entity must provide the disclosures described above.

Income Tax Accounting Policies

A reporting entity is sometimes allowed a choice between several available tax accounting policies. The policies elected and applied by the entity should be disclosed. These choices generally relate to:

- The classification of interest and penalties
- The method of recognition of investment tax credits

Interest and Penalties

A reporting entity may elect to present the amount of interest it recognizes pursuant to FASB ASC 740-10-25-56 related to an underpayment of income taxes in its income statement as either income tax expense or interest expense.

CPEA Observation: Most public reporting entities include interest and penalties in income tax expense (i.e., provision for income taxes). Some entities disclose their policy in the Summary of Significant Accounting Policies note; other entities disclose their policy in the Income Taxes note for context on the amount of interest, penalties, and other income tax-related amounts recognized in the financial statements.

The following is an example of this disclosure from Seachange International, Inc.

> **Note 2—Summary of Significant Accounting Policies**
>
> Our policy is to classify interest and penalties related to unrecognized tax benefits, if and when required, as a component of income tax provision (benefit), in our consolidated statements of operations and comprehensive loss. We have made a policy election to treat the Global intangible low-taxed income (GILTI) tax as a period expense.

Investment Tax Credits

For tax purposes, an investment tax credit can be used to reduce the current taxes payable by an entity, or it can be carried back or forward. As described in FASB ASC 740-10-25-46, a reporting entity may elect one of two methods to recognize the tax benefits from investment tax credits in its financial statements. The two acceptable approaches are the deferral method and the flow-through method. Under the deferral method, an entity recognizes the cost savings gradually from the tax credit. More specifically, the investment tax credit is accounted for as a reduction to the acquired asset that gave rise to the credit. Then, the credit is amortized over the useful life of the asset. The amortization is a reduction to income tax expense. A temporary difference arises when a company elects to use the deferral method for investment tax credits. Under the flow-through method, an entity immediately recognizes the cost savings from the tax credit. The entire investment tax credit is accounted for as a reduction in income tax expense in the year the asset is acquired. The treatment of the tax credit using the flow-through method is similar to the treatment of the tax credit for tax purposes. Therefore, a temporary difference does not exist when an entity elects to use the flow-through method. As noted in FASB ASC 740-10-25-46, the deferral method is the preferable approach for financial reporting purposes.

The following examples illustrate this disclosure requirement:

> The Company uses the flow-through method to account for investment tax credits. Under this method, the investment tax credits are recognized as a reduction to income tax expense.
>
> *or*
>
> Investment tax credits are accounted for under the cost reduction method whereby they are netted against the expense or property and equipment to which they relate. Investment tax credits are recorded when the qualifying expenditures have been incurred and if it is more likely than not that the tax credits will be realized.

Risks and Uncertainties

FASB ASC 275, *Risks and Uncertainties*, provides disclosure guidance incremental to that provided in FASB ASC 740, specific to estimates that satisfy certain conditions. The following is an illustration of this disclosure.

> The entity has recorded a deferred tax asset of $4.8 million reflecting the benefit of $12 million in loss carryforwards, which expire in varying amounts between 20X5 and 20X7. Realization is dependent on generating sufficient taxable income prior to expiration of the loss carryforwards. Although realization is not assured, management believes it is more likely than not that all of the deferred tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income during the carryforward period are reduced.

<u>Conclusion</u>

We hope this report is helpful in understanding the disclosure requirements related to income taxes. And, as always, the CPEA is available to answer our members' questions.

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