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BDO FLASH REPORT
FASB

SUBJECT

FASB TO ISSUE EXPOSURE DRAFT ON INCOME TAX DISCLOSURES (ASC 740)

SUMMARY

Pursuant to its ongoing Disclosure Framework project, the Financial Accounting Standards Board ("FASB" or "Board") will issue an Exposure Draft this summer (2016) of a proposed Accounting Standards Update (ASU) intended to improve income tax disclosure requirements under ASC 740. The objective of the FASB's Disclosure Framework project is to improve the effectiveness of disclosures in the notes to financial statements by clearly communicating the information that is most important to users. Income Tax disclosures included in ASC 740-10-50 is one of four topics the FASB is currently evaluating for disclosure improvements.

At a meeting held March 23rd, the FASB reviewed its prior tentative decisions on income tax disclosures reached during four previous meetings on the topic (all four previous meetings held throughout 2015). Following these meetings, the Board directed its staff to perform outreach with users, preparers, and other stakeholders to identify issues with the proposed disclosures including costs, complexity, and expected benefits. BDO issued Tax Alerts on tentative decisions reached at three of the four meetings (the first and second meetings covered disclosure aspects related to foreign earnings). Information on the tentative decisions reached at those meetings can be found through the links below:

- **FASB MAKES TENTATIVE DECISIONS WITH RESPECT TO DISCLOSURE OF INCOME TAXES RELATED TO FOREIGN EARNINGS** (March 2015)
- **FASB MAKES TENTATIVE DECISIONS WITH RESPECT TO DISCLOSURE OF UNRECOGNIZED TAX BENEFITS** (September 2015)
- **FASB MAKES TENTATIVE DECISIONS ABOUT INCOME TAX DISCLOSURES** (November 2015)

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The Board made the following decisions at the March 23rd meeting:

The Board decided to reverse its prior decisions and not require all entities to disclose:

1. The line item on the balance sheet in which deferred taxes are presented, and
2. The domestic income tax expense/benefit on foreign-sourced earnings.

The Board also decided to reverse its prior decisions and not require private companies to disclose the following:

1. The rate reconciliation currently required of public companies,
2. An explanation of the nature and amounts of the valuation allowance recorded or released during the reporting period, and
3. The amounts and expiration dates of operating loss and tax credit carryforwards recorded on the tax return basis, the amounts and expiration dates of carryforwards that will give rise to a deferred tax asset (tax effected), and the total amount of the unrecognized tax benefit that offsets the tax-effected carryforwards.

Other Board Decisions:

1. It clarified its prior decision related to disclosure of changes in assertions regarding undistributed foreign earnings and whether they are essentially "permanently" reinvested. The Board decided to require *all* entities to disclose the amount of and an explanation for a change in assertion about the temporary difference for the cumulative amount of investments associated with undistributed earnings (including both those that are no longer indefinitely reinvested and those that are indefinitely reinvested).
2. It affirmed a prior decision to require disclosure of tax law changes that are probable to have an effect on future periods.
3. It affirmed a prior decision to require a disaggregation of pretax income and income taxes paid between domestic and foreign.

The Board additionally decided that all entities would be required to disaggregate:

1. Income tax expense (benefit) between domestic and foreign, and
2. Foreign income tax paid to any country which is significant relative to total income taxes paid.

One significant tentative decision the Board previously made was to require disclosure of the cumulative amount of undistributed foreign earnings that are indefinitely reinvested for any country that represents at least 10% of the total amount of indefinitely reinvested foreign earnings. However, based on feedback from preparers, the staff presented an alternative proposal to the Board at the March 23rd meeting. This alternative would require disclosure of the amount of liquid assets from accumulated foreign earnings that are indefinitely reinvested. The Board directed its staff to perform further outreach on the possibility of requiring disclosure of the aggregate of liquid assets (cash, cash equivalents, marketable securities, and loans) related to the temporary difference for the cumulative amount of investments associated with undistributed earnings that are indefinite in duration. The additional outreach is needed to determine whether disclosure of liquid assets associated with indefinitely reinvested foreign earnings would be operational and feasible.

The FASB also decided to require a *prospective* transition for all proposed changes to income tax disclosures.

DETAILS

Changes in Tax Law

At a previous meeting, the Board tentatively decided that income tax disclosures should include a qualitative disclosure when a tax law has been enacted in the current period that is probable[1] to have an effect on the reporting entity in a future period. The purpose of this disclosure is to assist users in assessing changes in tax laws that would have an effect on future cash flows. During the staff outreach, feedback from stakeholders was mostly positive regarding this new disclosure requirement, however some expressed concern over the potentially large number of disclosures that would be mandated.

[1] The Accounting Standards Codification's Master Glossary defines the term probable for GAAP purposes as "likely to occur." That term is typically taken to mean a likelihood of approximately 75% to 80%.

The FASB resolved this concern saying that only those changes in tax law which are probable to have a *material* effect on the entity are required to be disclosed. At the March 23rd meeting, the Board decided to retain this disclosure proposal and include it in the Exposure Draft expected this summer. The disclosure is to apply to both private and public companies.

BDO Observation: This proposal goes beyond the current requirement in ASC 740-10-50-9(g) to disclose, in the financial statements or notes thereto, the significant components of income tax expense related to continuing operations, which might include adjustments to deferred tax liabilities or assets for enacted changes in tax laws. However, this proposed disclosure requirement stops short of requiring quantitative disclosure of the nature and magnitude of the effect on future periods' income taxes.

Deferred Tax Line Items

ASC 740-10-50-2 currently requires entities to disclose the components of total deferred tax liabilities, deferred tax assets and valuation allowances. At a prior meeting, the Board tentatively decided to also require entities to disclose the line item(s) on the balance sheet in which the amount of deferred taxes are presented, if not presented as a separate line item. The Board had decided to require this disclosure based upon feedback that users generally have difficulty understanding the effect of taxes on the financial statements, especially in cases where deferred taxes are presented in multiples lines. The Board decided to reverse this decision at the March 23rd meeting based upon additional feedback from users. Most users said that this disclosure requirement would not add significant value to their analysis. The staff also noted that this disclosure is expected to be less useful when entities adopt ASU 2015-17[2], which requires all deferred tax assets and liabilities to be classified as noncurrent on the balance sheet.

Domestic Tax Expense on Foreign Sourced Earnings

Feedback received from users indicated that more information is needed about the effect of foreign operations on income taxes which led the Board to tentatively decide at a prior meeting that all entities should be required to disclose domestic tax expense on foreign sourced earnings. However, the latest outreach by the staff concluded that most users place little or no utility in this disclosure. Many users felt it would instead be more beneficial to disaggregate income tax expense between domestic and foreign. Based on this feedback, the Board decided to reverse its prior decision and not require all entities to disclose the domestic income tax expense (benefit) on foreign sourced earnings. Instead, the Board decided to require disclosure of disaggregated income tax expense and income taxes paid between domestic and foreign.

Assertion Related to Undistributed Foreign Earnings

At a prior meeting, the Board tentatively decided that entities should be required to disclose the amount of, and an explanation for, any change in assertion about the temporary difference for the cumulative amount of investments associated with undistributed foreign earnings that are no longer asserted to be essentially permanent in duration. At that meeting, the Board also decided to further require separate disclosures for any individual country that is significant to the disclosed amount (see following section for more details). These decisions were made based upon feedback from users requesting more information on indefinitely reinvested foreign earnings. They would apply to both public and private companies.

The Board's prior decisions, however, did not include corresponding disclosure requirements regarding changes in the other direction – i.e., that investments associated with undistributed foreign earnings for which a deferred tax liability is recognized are now asserted to be essentially permanent in duration which leads to the de-recognition of the outside basis deferred tax liability. At the March 23rd meeting, the Board clarified that their prior disclosure decisions include changes in assertion in both directions.

[2] The FASB issued on November 20, 2015 ASU No. 2015-17, "Balance Sheet Classification of Deferred Taxes". ASU No. 2015-17 is effective for annual periods beginning after December 15, 2016 for public entities and after December 15, 2017 for other entities.

Disaggregation of the Temporary Difference on Investments Associated with Undistributed Foreign Earnings

ASC 740-30-50-2(c) requires disclosure of 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. Most companies chose to issue a statement under ASC 740-30-50-2(c) that such disclosure is not practicable.

Based upon feedback from users requesting additional information to better understand the sustainability of an entity's tax rate and the quality of its earnings, the Board decided at a prior meeting to require entities to disaggregate the temporary difference for the cumulative amount of investments associated with undistributed foreign earnings that are essentially permanent in duration for any country that represents at least 10 percent of the disclosed amount.

The Board decided to require this disclosure by country in order to help users assess likely amounts of future cash flows, and to understand the timing and uncertainty of cash flows related to the indefinitely reinvested foreign earnings. However, during outreach, concerns were raised by stakeholders about the benefits of this disclosure, the cost and complexity of requiring companies to disclose such level of detail. The main concern raised was that this disclosure would not be representational of where the earnings originated since the assertion could be made in a different foreign country than where the earnings originated such as in a holding company structure. Certain preparers also felt that this disaggregation could be used by taxing authorities as a "roadmap" in international tax examinations.

Stakeholders instead suggested that disclosing how much of the balance of undistributed foreign earnings that are indefinitely reinvested is considered "liquid assets" would be more beneficial to assessing the timing and availability of foreign earnings and the uncertainty related to future repatriation of those earnings.

The Board deferred a decision on this disclosure and instead directed staff to perform further outreach on whether disclosure of the aggregate of "liquid assets" (i.e. cash, cash equivalents, marketable securities, and loans) associated with the temporary difference for the cumulative amount of investments associated with undistributed foreign earnings that are essentially permanent in duration would be operative.

Disaggregation of Pretax Income, Income Tax Expense, and Income Taxes Payments

Due to feedback from users indicating a desire for more information about foreign earnings and the tax effect of those earnings, at a prior meeting, the Board tentatively decided to require entities to disaggregate pretax income between domestic and foreign and to further disaggregate foreign pretax income for any country that is significant to total pretax income. The Board believed this would give users sufficient information to analyze tax exposures to foreign countries and better understanding of the sustainability of an entity's tax rate and quality of the entity's earnings.

As a result of preparers' concerns about costs and complexity, the Board reversed its prior decision to require disaggregation of foreign pretax income by significant country and decided to only require income before taxes disaggregated between domestic and foreign earnings.[3] This disclosure will apply to both public and private companies. However, this would not be a new disclosure to public entities which already furnish this disclosure in their public filings as required under SEC rules.

However, to provide further insight to users, the FASB decided to require disaggregation of both income tax expense and income taxes paid by domestic and foreign and to further require disaggregation of income taxes paid by country where taxes paid are significant in relation to total cash taxes paid. This requirement applies to both public and private companies.

[3] Preparers also expressed concerns about the potential use by taxing authorities of the country-specific disclosure for pretax income.

BDO Observation: The term "cash taxes" means the amount of cash paid during the period to meet tax obligations. While the term "significant" is not defined, one threshold that has been used and could be applied is 10 percent or greater. Under this proposed disclosure, cash taxes paid in any one country that is significant relative to total cash taxes paid in any given period should be disclosed. This disclosure proposal would be an expansion of income tax paid during the reporting period presented as a separate class of operating cash flow in the statement of cash flows (refer to ASC 230-10-45-25(f)) or disclosed under the "indirect method" (refer to ASC 230-10-50-2).

Disaggregation of Income Taxes Paid by Time Period

At a prior Board meeting, the staff recommended the disaggregation of income taxes paid by current tax year, prior tax year, subsequent tax year, other income tax years, and refunds received or applied. The Board had previously decided against this disclosure because it was unsure of the benefit of this information and it determined that proposed disclosures combined with existing disclosures would provide sufficient information for users. The staff recommended this disclosure again at the March 23rd meeting based on additional outreach with users who indicated this information continues to be beneficial. However, the Board decided against it at the March 23rd meeting, arguing this disclosure would be too complex to prepare and would only be useful in a limited number of situations.

Previous Tentative Decisions That Remain in Effect

The Board did not redeliberate previous tentative decisions on income tax disclosure requirements in ASC 740 specific to uncertain tax benefits ("UTB") and certain other income tax disclosures reached at previous meetings. These decisions therefore remain in effect and will be included in the Exposure Draft of the proposed ASU.

The Board's tentative disclosure decisions specific to UTBs included:

- Amending the current requirement in ASC 740-10-50-15A(a)(3) regarding settlements with taxing authorities to require disaggregation of cash settlements and non-cash settlements (Note: a tabular reconciliation disclosure of beginning and ending gross UTBs is only required of public entities).
- Requiring the balance sheet accounts which are affected by UTBs to be disclosed.
- Eliminating the current requirement in ASC 740-10-50-15(d) to disclose significant changes in UTBs that are anticipated to occur within 12 months of the reporting date (Note: this requirement is applicable to public and non-public entities).

Other FASB tentative decisions which remain in effect include:

- Modifying the current rate reconciliation required for public companies to include disclosure of:
  - An individual reconciling item that is more than 5 percent of the amount computed by multiplying the income before tax by the applicable statutory federal income tax rate, and
  - A qualitative description of those items that have caused a significant movement in the rate year over year.
- Requiring public companies to disclose the amounts and expiration dates of the carryforwards recorded on the tax return and the carryforwards that will give rise to a deferred tax asset, and also the total amount of the unrecognized tax benefit that offsets the tax-effected carryforwards.
- Requiring public companies to disclose an explanation of the nature and amounts of the valuation allowance recorded and released during the reporting period.

BDO INSIGHTS

BDO supports the Board's intent to improve the effectiveness of financial statements' income tax footnote disclosures while minimizing costs and complexities. We will continue to monitor the Board's activities in this area and will release an alert update when the Board has issued its Exposure Draft on the proposed ASU.