

THOUGHT LEADERSHIP FROM THE BDO NATIONAL ASSURANCE
AND TAX PRACTICES

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FASB



SUBJECT

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

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, *Income taxes*. 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 June 8th, the FASB reviewed and finalized its prior tentative decisions on income tax disclosures reached during five previous meetings on the topic (four previous meetings held throughout 2015 and one meeting held on March 23rd, 2016). Following the June 8th meeting, the Board directed its staff to draft an Exposure Draft of an ASU containing all the final decisions, as summarized below, for a comment period of 60 days, or ending on September 30th, 2016, whichever is longer.

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

DETAILS

Proposed Decisions To Be Included In The Exposure Draft:

Definition Change - Public Business Entities

The current disclosure requirements under ASC Topic 740 are differentiated by public and nonpublic entities, terms which have various definitions for purposes of Topic 740. In December 2013, the FASB amended the Master Glossary to add the definition of a “public business entity,” which uses the same definition for

CONTACT:

PRINCIPAL AUTHORS

YOSEF BARBUT
National Tax/Assurance Partner
ASC 740
(212) 885-8292 / ybarbut@bdo.com

STEPHEN ARBER
Senior Director, International Tax
(212) 885-7355 / sarber@bdo.com

ALICIA MASSI
Associate, International Tax
212-885-8502 / amassi@bdo.com

ADDITIONAL RESOURCES

JOE RUSSO
Partner, ASC 740 National Practice
Leader
(214) 665-0646 / jrusso@bdo.com

WILLIAM CONNOLLY
Tax Senior Director,
National Tax ASC 740
(617) 239-4127 / wconnolly@bdo.com

all applicable Topics. This addition to the Master Glossary did not affect existing requirements, but rather was meant to be used by the Board in specifying the scope and effective date of future financial accounting and reporting guidance and disclosure requirements.¹

During the June 8th meeting, the Board decided to replace the term “public entity” with the term “public business entity” throughout Topic 740 in accordance with ASU 2013-12. As a result, disclosures required under Topic 740 will be applicable based upon whether a company is a public business entity or an entity other than a public business entity (there is no separate definition for a non-public business entity), rather than whether an entity is a public entity or a non-public entity as currently defined in Topic 740.

BDO Observation: This change is not expected to have a significant impact on most entities currently classified as nonpublic entities. Additionally, some entities currently subject to the public requirements will now fall outside of the definition of public business entity. For more details see the definitions provided in Appendix I.

Changes in Tax Law (applicable to all entities)

The Board decided that income tax disclosures should include a qualitative disclosure when a tax law has been enacted in the current period that is probable² 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.

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. The disclosure is to apply to all entities.

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.

Changes in Assertion Related to Undistributed Foreign Earnings (applicable to all entities)

The Board 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.

This includes 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. That is, the disclosure covers changes in assertions in both directions.

¹ See ASU 2013-12. The term “public business entity” was added to the Master Glossary by ASU 2013-12 in order to minimize the complexity of having multiple definitions of “public entity” for varying Topics. Among other differences, the definition of “public business entity” excludes all not-for-profit entities and employee benefit plans, but includes entities required by law, contract, or regulation to prepare U.S. GAAP financial statements and make them publicly available on a periodic basis (e.g. banks required to file annual statements with the FDIC). See Appendix I for the Master Glossary definitions of “public entity” and “public business entity.”

² 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 Board decided to require public business entities and all other entities (i.e., private) to make this disclosure.

BDO Observation: This decision is in response to feedback from users requesting more information on indefinitely reinvested foreign earnings. This proposed disclosure goes beyond existing disclosure requirements in paragraph 740-30-50-2(b) to disclose the cumulative amount of the temporary difference related to investments in foreign subsidiaries. That is, this proposed incremental disclosure focuses on the changes (increases and decrease) in the cumulative temporary difference.

Cash, Cash Equivalents, Marketable Securities (Liquid Assets) Held by Foreign Subsidiaries (applicable to all entities)

The Board also decided to require disclosure of the aggregate of cash, cash equivalents, and marketable securities held by all foreign subsidiaries. It should be noted that loans (inter-company or otherwise) are not included in the list of liquid assets to be disclosed. The term ‘cash equivalents’ refers to short-term, highly liquid investments that have the following characteristics: (a) they are readily convertible to a known amount of cash, and (b) they are nearing maturity and present insignificant risk of changes in value because of changes in interest rates.³ Examples of cash equivalents are Treasury bills, commercial paper, and money market funds with original maturity of generally three months or less.

The Board received feedback from users requesting additional information to better understand the sustainability of an entity’s tax rate and the quality of its 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. In response, the FASB believes that this proposed disclosure would act as one data point which, taken together with other proposed disclosures, would give users of financial statements a better understanding of the timing and amount of future cash flows from accumulated foreign income.

This decision was reached after the Board considered, but ultimately rejected, two disclosure alternatives: (1) disclosure of the disaggregated 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, and (2) disclosure of the amount of liquid assets (cash, cash equivalents, marketable securities, and loans) that represent accumulated foreign earnings that are indefinitely reinvested.

The main concern raised about a country-specific disclosure was that it 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. The proposal to disclose liquid assets in accumulated foreign earnings was deemed to be too costly and complex to disclose such level of details relative to the expected benefit.

BDO Observation: Users have asked for more information about indefinitely reinvested accumulated foreign earnings and the FASB felt it had to propose some improvements. This proposed disclosure will serve to further shine public spotlight on United States multinational corporations’ accumulated foreign income, which is estimated to exceed two trillion dollars. There is currently no footnote disclosure that would allow users to understand the amount of liquid assets as of the balance sheet date that could potentially be used for distribution of accumulated foreign income. This proposal provides users with an additional data point, albeit aggregated as opposed to broken by significant countries.

³ ASC 230-10-20.

Disaggregation of Pretax Income, Income Tax Expense, and Income Taxes Payments (applicable to all entities)

The Board decided to require all entities to disclose:

- ▶ income before taxes disaggregated between domestic and foreign earnings,
- ▶ income tax expense disaggregated between domestic and foreign, and
- ▶ income tax paid by country where taxes paid are significant in relation to total cash taxes paid.⁴

These proposals attempt to address feedback from users indicating a desire for more information about foreign earnings and the tax effect of those earnings. The Board initially decided to require entities to further disaggregate foreign pretax income for any country that is significant to total pretax income. The Board believed country-specific disclosure 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.

However, the Board reversed its initial decision to require disaggregation of foreign pretax income by significant country due to preparers' concerns about costs and complexity.

BDO Observation: The FASB decisions to require disclosure of pretax earnings and income tax expense disaggregated between domestic and foreign effectively codify existing SEC requirements. Therefore, this proposed disclosure would not be new to public entities which already furnish this disclosure in their public filings as required under SEC rules. 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. While the term "significant" is not defined, one threshold that has been used and could be applied is 10 percent or greater of the total income tax paid. 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). This proposal, if it becomes a final accounting standard update, would be the only per-country required information in the income tax footnote. While it might be used as a proxy for gauging per-country earnings, cash tax paid during a particular fiscal year might be disproportionately higher or lower than the associated pretax income due to book-to-tax timing differences.

Revisions to Carryforward Disclosure Requirement (applicable to all entities)

All entities will be required to disclose the amounts of federal, state, and foreign operating loss and tax credit carryforwards on the tax return.

Public business entities will be further required to disaggregate these values by time period of expiration for each of the first five years after the reporting date and aggregate amounts for the remaining years. Public business entities will also be required to disclose the deferred tax asset for carryforwards (tax affected), before valuation allowance, disaggregated by federal, state, and foreign and further disaggregated by time period of expiration for each of the first five years after the reporting date and aggregate amounts for the remaining years. Uncertain tax benefit (UTB) liabilities related to tax attributes carryforward would be aggregated from all jurisdictions and disclosed as a single number.

⁴ The term "cash taxes" means the amount of cash paid during the period to meet tax obligations.

We expect such disclosure for public business entities to look similar to the sample table below. We further expect that the table will include only material amounts and/or jurisdictions.

Year of Expiration	Federal Carryforward	State Carryforward	Foreign Carryforward	Federal DTA	State DTA	Foreign DTA	Less UTB	Net DTA before VA
2016								
2017								
2018								
2019								
2020								
All other								

BDO Observation: Information about income tax carryforwards as reported on tax returns is already a required footnote disclosure (refer to ASC 740-10-50-3(a)), although not in this tabular format. This disclosure format will make it easier for users to understand the magnitude of income tax attributes by the major jurisdictions (i.e., federal, state and foreign) which are commonly used to present income tax information and the potential risk from expiration. It should be noted that on the face of the balance sheet, deferred tax assets for net operating losses and tax credits carryforwards must be reduced by uncertain tax benefit (UTB) liabilities if such tax carryforwards are available to reduce taxable income from future settlement of the uncertain tax liabilities and the entity intends to offset them on the tax return (i.e., balance sheet “net” presentation). Furthermore, an income tax carryforward DTA is presented in the component of deferred taxes disclosure (ASC 740-10-50-2) net of the UTB liability that is required to reduce the income tax carryforward DTA. This is necessary, as the sum of all deferred taxes presented in the component of deferred taxes disclosure should be the same as the total of all deferred taxes presented on the balance sheet. The proposed footnote disclosure would provide “gross” presentation of income tax attributes before any UTB liability (combined for all jurisdictions) and valuation allowance.

Government Assistance Agreements that are within the Scope of Topic 740 (applicable to all entities)

The FASB decided to require all entities to disclose in the income tax footnote the existence and nature of a government agreement with the entity that has reduced, or may reduce, the entity’s income tax burden. This proposed disclosure focuses on government agreements that provide income tax benefits such as preferential tax rate, reduced tax rate, tax exemption, tax holiday or more. Tax benefits that are available in determining taxable income or that are determined or limited on the basis of income tax liability are not in scope of this proposed disclosure (i.e., tax benefits which can be claimed by the entity without a government agreement, for example a research credit which is available to all entities meeting certain requirements in the tax law and/or regulations). The types of government assistance arrangements contemplated within the scope of this disclosure are entered into between a reporting entity and a governmental body.

BDO Observation: The FASB decided on June 8th to exclude income tax from the scope of its proposed ASU related to disclosure of Government Assistance under a brand new topic (i.e., Topic 832 in the Codification). Many comment letters responding to the FASB’s proposed Topic 832 indicated that all income tax disclosures, including income tax benefits obtained through government agreements, should be kept under Topic 740. Therefore, the FASB added this proposed disclosure under its income tax disclosure project. SEC rules currently require a public entity to disclose the existence of a tax holiday in a foreign jurisdiction including the aggregated benefit and other information such as termination date (SAB Topic 11C). The FASB’s proposed disclosure is broader and encompasses any form of income tax benefit provided to the entity through a government agreement.

Uncertain Tax Benefits (public business entities)

The Board decided to propose the following changes to current disclosures:

- ▶ 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 business entities).
- ▶ Amending the current requirement in ASC 740-10-50-15A(a) regarding disclosure of a tabular reconciliation of the unrecognized tax benefits at the beginning and end of the period to require disclosure of the balance sheet accounts which are affected by UTBs.
- ▶ 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 (this requirement is applicable to all entities).

BDO Observation: The proposal to eliminate the disclosure requirement in ASC 740-10-50-15(d) is significant. This “early warning” type disclosure can be useful information to foreshadow near-term changes in UTB liabilities. However, the FASB decided that this disclosure requires consideration of future events which are not within management’s control, and therefore should be removed.

Rate Reconciliation (public business entities)

The Board decided to modify the current rate reconciliation required for public entities (now referred to as public business entities) and propose the required 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.

BDO Observation: This decision effectively codifies the SEC guidance on rate reconciliation. SEC Rule 4-08(h)(2) in Regulation S-X requires a disaggregation of tax effects which increase or decrease the effective rate by at least 5% of the statutory rate. MD&A disclosure requirements generally include items that cause significant changes in the tax rate year over year. While the FASB initially proposed a rate reconciliation disclosure also for private entities, the FASB reversed course and on March 23 decided not to require private entities to disclose a rate reconciliation disclosure.

Valuation Allowance (public business entities)

ASC 740-10-50-2 currently requires disclosure of the total valuation allowance recognized for deferred tax assets as well as the net change during the year in the total valuation allowance. This current disclosure requirement applies to all entities.

The FASB decided to propose an expansion of this disclosure and require **public** business entities to disclose an explanation of the nature and amounts of the valuation allowance recorded and released during the reporting period. Private entities will not be required to provide this additional information.

BDO INSIGHTS

BDO supports the Board’s intent to improve the effectiveness of financial statements’ income tax footnote disclosures while minimizing costs and complexities. The FASB’s proposed ASU will provide incremental improvements to income tax footnote disclosure. BDO will submit a comment letter when the exposure draft of the proposed ASU is issued and is strongly encouraging all stakeholders to also participate in the FASB’s comment letter process.

APPENDIX I - ASC MASTER GLOSSARY DEFINITIONS

Public Business Entity

A public business entity is a business entity meeting any one of the criteria below.

Neither a not-for-profit entity nor an employee benefit plan is a business entity.

- a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).
- b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC.
- c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.
- d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.
- e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion.

An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.

Public Entity (for purposes of Topic 740)

An entity that meets any of the following criteria:

- a. Its debt or equity securities are traded in a public market, including those traded on a stock exchange or in the over-the-counter market (including securities quoted only locally or
- b. regionally).
- c. It is a conduit bond obligor for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
- d. Its financial statements are filed with a regulatory agency in preparation for the sale of any class of securities.

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