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SEC Comments on Accounting for Income Taxes

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Representatives of the U.S. Securities and Exchange Commission ("SEC") made comments about accounting for income taxes during the 2018 AICPA Conference on Current SEC and PCAOB Developments. This article summarizes certain comments and provides examples of comments related to income taxes recently issued by the SEC to registrants around selected areas of concern that represent trends or areas of focus by the staff.

2018 AICPA Conference on Current SEC and PCAOB Developments

The 2018 AICPA Conference on Current SEC and PCAOB Developments, held December 10-12, 2018, in Washington, D.C., addressed recent developments and initiatives at the SEC, Public Company Accounting Oversight Board ("PCAOB"), Financial Accounting Standards Board ("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 overarching theme at the 2018 conference was that high-quality financial reporting and reliable audits are a shared responsibility among all participants in the financial reporting architecture.

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KPMG LLP's Department of Professional Practice publication *SEC Issues & Trends: AICPA 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.

Non-Generally Accepted Accounting Principles ("GAAP") Financial Measures

During the conference, representatives of the SEC acknowledged that non-GAAP financial measures may play an important role for investors in making investment decisions. However, these disclosures are often developed outside of the financial reporting process and therefore are not subject to the same internal controls or audit procedures. For this reason, the SEC emphasized the need for the same diligence in preparing non-GAAP financial measures as in preparing audited financial statements.

The Division of Corporation Finance ("DCF") staff observed that it can be challenging to differentiate between an acceptable non-GAAP financial measure and an individually tailored accounting principle, which DCF would object to issuers using. To help mitigate the risk of using an individually tailored accounting principle, DCF staff provided the below questions that management and audit committees can ask themselves as they develop non-GAAP financial measures.

- Does the adjustment shift GAAP from an accrual basis of accounting to a cash or modified basis of accounting?
- Does the adjustment add transactions that are also reportable in another company's financial statements?
- Does the adjustment reflect part, but not all, of a transaction?
- Does the adjustment render the measure inconsistent with the economics of a transaction or ignore certain terms of an agreement?

Positive responses to these questions may indicate that a non-GAAP adjustment would be an individually tailored accounting principle to which the staff would object. Included with the question posed related to whether an adjustment reflects part, but not all, of a transaction, was an associated example of adjusting income tax effects for cash taxes paid, but not for temporary or permanent differences. This example demonstrates the potential for income taxes to affect the analysis and disclosure of non-GAAP financial measures.

Preparing for New Accounting Standards

During the conference, it was noted that 2018 marked the beginning of companies implementing three comprehensive accounting standards (revenue recognition, leasing, and current expected credit losses standards); related application and implementation issues were a hot topic of discussion. 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).

Brexit Disclosures

The SEC noted it is closely monitoring disclosures related to the effect of the United Kingdom's exit from the European Union ("Brexit") on business and operations, with specific mention of concerns around the potential adverse effects not being well understood or underestimated. The SEC has observed a wide range of disclosures associated with Brexit and would like to see issuers provide more robust disclosure about how management is considering Brexit and the effect it may have on issuers and their operations. As part of this process, entities may need to consider disclosure of the income taxes consequences of Brexit, including, but not limited to, the potential changes to existing tax treaties between the United Kingdom and other member states.

Examples of Recent SEC Comment Letters

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 for investors to understand a company's income tax environment or when the SEC 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.

Example 1: Tax Reform

The SEC staff may request additional information on why certain provisions of the TCJA (Pub. L. No. 115-97) were not reflected within the financial statements*:*

> We note that you made several TCJA estimated provisions to your financial statements for the year ended December 31, 2017. While we understand that management intends to continue to permanently reinvest any future foreign earnings in Canada, *please tell us what consideration you gave to recognizing a one-time mandatory deemed repatriation tax on certain unrepatriated foreign earnings for the fiscal year ended December 31, 2017 pursuant to the TCJA*.

Example 2: Tax Reform

The SEC staff may request additional information regarding the impacts of tax reform, specifically related to the reason for releasing a valuation allowance as a result of a change in tax law:

> We note your disclosure in the last paragraph on page X that the tax law change allows for the indefinite carryforward of NOLs arising in tax years ending after December 31, 2017. *Please explain to us how this tax law change enabled you to partially release your valuation allowance on deferred tax assets*, as it appears that the deferred tax assets arose prior to December 31, 2017. Also, tell us the amount of the tax benefit for the partial release the valuation allowance. In addition, *explain to us the reason why you recorded $X million of tax benefit, exclusive of the $X million benefit, due to the Tax Act* and the resulting partial release of the Company's valuation allowance.

Example 3: Effective Tax Rate Reconciliation

The SEC staff may request additional information about the items that influence the effective tax rate and whether such items are anticipated be recurring:

> We note your discussion and analysis of the changes in your income tax on page 23. *Please expand your disclosures to provide a more robust analysis around the material items impacting your effective tax rate including the underlying facts and circumstances that drove those changes and whether you expect such changes to continue in the future*. With reference to Note 14, please:
>
> - *Explain the material factors impacting the Other line item that positively impacted your effective tax rate by 4.2% in 2017 and only 0.4% in 2016*; and
> - *Explain the 7.2% decrease to your effective tax rate in 2017 compared to the 3.5% decrease to your effective tax rate in 2016 from foreign taxes less than federal statutory rate* in light of the fact that the proportion of income before income taxes for your international operations decreased in 2017 when compared to 2016. *To the extent material factors in your foreign operations including changes in your jurisdictional mix of income impacted your effective tax rate, please explain.*
>
> Please refer to Item 303(a)(3) of Regulation S-K and Sections 501.12.b.3 and 501.12.b.4. of the Financial Reporting Codification for guidance.

Example 4: Effective Tax Rate Reconciliation

The SEC staff may request additional information on significant items within the effective tax rate reconciliation and the nature of the items and why they do not represent the correction of errors in prior periods:

> The "adjustments to prior year taxes" in each year presented are material to your effective tax rate. *Please tell us the nature and amount of the adjustments in each year presented and explain to us why these adjustments are reflected in the period you recorded them and do not represent the correction of errors in your prior period accounting*.

Example 5: Valuation Allowance

The SEC staff may request additional information on the judgment associated with why a valuation allowance does not exist when an entity reflects a cumulative loss in recent years:

> Considering the significant amount of US-based deferred tax assets, the $X billion of US cumulative losses for the three years ended December 31, 2016 on a US GAAP basis, and continued US losses for the nine months ended September 30, 2017, please provide investors with a *comprehensive discussion and analysis of the available sources of future income that meet the more-likely-than-not threshold along with the positive and negative factors affecting the corresponding amounts included in the evaluation. Discuss the degree to which these sources are objectively verifiable* such that you were able to overcome the $X billion of US

> cumulative losses for the three years ended December 31, 2016 on a US GAAP basis. Further, ASC 740-10-30-21 notes that forming a conclusion that a valuation allowance is not needed is difficult when there is significant negative evidence such as cumulative losses in recent years. As such, it *should be very clear from your disclosure why you believe your estimate of future taxable income is sufficiently objectively verifiable to overcome the significant negative evidence of your cumulative losses in recent years.* When disclosing information about your US historical results, please ensure that you also communicate the extent to which these results were impacted by entities that will no longer or are expected to no longer have an impact on your future income. Please disclose the amount of gross US-based deferred tax assets along with the amount of valuation allowances recognized as of the most recent balance sheet date.

Example 6: Valuation Allowance

The SEC staff may request additional information on the reason for having a valuation allowance when an entity does not reflect a cumulative loss in recent years:

> We note that you have a full valuation allowance against net operating loss ("NOL") carryforwards and a partial valuation allowance against other deferred tax assets. *Please explain your basis for the valuation allowances in light of your cumulative income before income tax expense in recent years*. Also, with regard to the decrease in NOL carryforwards in 2016 please clarify how much of the decrease was due to utilization as compared to expiration. Refer to ASC 740-10-30-16 through 24.

Example 7: Indefinite Reinvestment Criteria

The SEC staff may request additional information on the assertion that an entity is indefinitely reinvested while also recognizing a deferred tax liability and question the disclosure that it is not practicable to determine the unrecognized deferred tax liability:

> Disclosure in your Form 10-K indicates that as you consider the majority of undistributed earnings of foreign subsidiaries to be indefinitely reinvested, no United States income tax has been provided on such earnings. However, we note that you recognized a deferred tax liability in 2016 on undistributed earnings that you do not intend to indefinitely reinvest outside the United States. *Tell us about the circumstances that led to the recognition of this deferred tax liability (e.g., you determined that funds that will be repatriated). In addition, tell us how the factors that led to the recognition of this deferred tax liability were considered in your conclusion that the remainder of your undistributed earnings of foreign subsidiaries are indefinitely reinvested pursuant to FASB ASC 740-30-25-17.*
>
> You state that it is not practicable to estimate the additional amount of unrecognized deferred tax liability related to undistributed earnings of foreign subsidiaries permanently reinvested outside the United States. *Explain your basis for this assertion, especially considering the deferred tax liability recognized in 2016 for undistributed foreign earnings that will not be indefinitely reinvested*. Refer to FASB ASC 740-30-50-2.

Example 8: Unrecognized Tax Benefits

The SEC staff may request additional detail on the facts and circumstances that result from additional unrecognized tax benefits reflected and consistency with other disclosures:

> We note you state that you increased your unrecognized tax benefits by $X million in 2015 related to the Settlement payment. It appears this increase was based on a "more likely than not" determination. We further note in the same paragraph that you believe it is "more likely than not" that you will be successful. *Please explain to us why these disclosures are not inherently contradictory.*

In addition to the above examples, the SEC staff may issue comment letters related to omitted disclosures. Some of the most common omitted disclosures include, but are not limited to, domestic and foreign components of income (loss) from continuing operations, amounts and expiration dates of net operating loss carryforwards, unrecognized deferred tax liabilities on indefinitely reinvested earnings or a statement that it is not practicable to determine, unrecognized tax benefit related matters (including the tabular rollforward), and the per share effects of a tax holiday.

Conclusion

In summary, comments delivered at the 2018 AICPA 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.