point of view

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Accounting for income taxes

It's time for a comprehensive review

Highlights

- Income tax accounting is complex — it requires knowledge of the income tax accounting model, tax laws and regulations in all relevant jurisdictions, and their combined linkage to all other aspects of accounting.
- The evolution of the economic, regulatory, tax legislative, and accounting standard setting environments since the existing accounting was introduced has magnified its shortcomings.
- A comprehensive review is needed to reduce the complexity of income tax accounting while improving the relevance and quality of the reporting.

A fresh look at income tax accounting is needed

- As part of their original convergence agenda, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) had planned to reduce the relatively modest differences between their respective standards on income tax accounting. However, the plan was ultimately abandoned, with the boards indicating that a comprehensive future review would eventually need to be undertaken.
- Some question the conceptual merits of the current model because it does not measure taxes on a discounted or cash flow basis. Many others say the model is too complex and results in accounting that is difficult to understand and costly to produce.
- Investors have shown increasing interest in deriving more relevant decision-useful information from reported income tax amounts and disclosures.
- Once the pending new standards on revenue, leasing, and financial instruments are finalized, we believe a project should be initiated to reassess income tax accounting. The goal should be to improve reporting by reducing complexity and providing more decision-useful information to investors.

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Concerns with the existing model

Changes over time have placed a spotlight on concerns with today's income tax accounting model.

Investors are seeking more decision-useful income tax information from financial statements.

What investors look for

Investors (and other financial statement users) have historically placed importance on the effective tax rate reported under the current standard. In addition, they are interested in understanding companies' tax-related cash flows and expectations. This may include: (1) cash tax rates and risks related to future income tax cash flows, and (2) the economic value of expected income tax obligations or benefits. Today's standard (or "model") does not readily convey this information and often results in detailed disclosures that are not easily understood. This causes investors to ignore much of what is reported or try to draw inferences from surrogate information.

Complexity and cost of reporting

Today's model tracks differences between the book and tax balances of assets and liabilities under the theory that such differences represent future taxable income or deductions. The model then calculates and records the future taxes to be paid (or reduced) because of those differences at the statutory tax rate. Since the model was introduced, changes both in accounting standards and tax laws have made those differences more numerous and complex. In addition, businesses have expanded across more geographic markets and are subject to a wider range of tax laws.

The model also contains many intricate rules, and a patchwork of exceptions that were designed to compensate for unintended consequences or impracticalities.

Personnel with deep knowledge of both income tax laws and financial reporting standards are needed to support income tax accounting. The processes are typically reliant upon spreadsheets that are outside of general ledger systems. Further, companies often turn to outside service providers for help, increasing the cost of financial statement preparation. Yet, accounting errors and control problems persist.

Economic faithfulness

One criticism of the current model is that it may not show an economic measure of income tax costs or benefits. For example, deferred income tax amounts shown on a company's balance sheet are not discounted and are not risk-adjusted to account for the probability of actually realizing a future tax benefit or incurring a future tax cost. As a result, the amounts do not reflect the economic value of expected future cash flows, particularly when future recovery or settlement periods are prolonged. An often cited example is the recognition of a tax loss carry-forward that is expected to reduce taxes in ten years, yet is measured on the balance sheet at the same amount as if it were expected to reduce taxes in the current year.

Some question whether deferred taxes fairly represent an actual future cash inflow or outflow. They suggest, for example, that as long as a company expects to continually reinvest in capital equipment, the related deferred tax liability will replenish thereby deferring cash settlement indefinitely. However, others believe that a deferred tax liability represents a future cash outflow even though future investments may give rise to a similar liability. The model's asymmetric treatment of deferred tax assets and liabilities also gives pause. That is, assets must be supported by the likelihood of having future taxable income whereas liabilities are recorded even when future losses are anticipated.

The treatment of economically equivalent tax law changes can vary depending on how legislation is written. Tax rate changes produce an immediate adjustment to deferred taxes and tax expense, whereas tax credits and certain "special" deductions are not recognized until the tax benefit is claimed. This dichotomy, along with the absence of discounting, has led some lawmakers to design tax legislation to avoid an immediate accounting impact. For example, a tax rate decrease results in an immediate expense for a company with net deferred tax assets. To mitigate the impact of recording that charge, certain jurisdictions have provided offsetting long-dated tax deductions that have minimal economic value.

Analysis

Investors want more decision-useful income tax accounting

Possible reforms range from starting over with a new income tax model to building refinements into today's model.

Range of options

A wide range of approaches to possible income tax accounting reform can be considered. Although each may have advantages and drawbacks, the standard setters should take on this difficult project and consider possible alternatives that may provide investors with more decision-useful information.

Alternatives range from completely scrapping the existing model to modifying it by targeting specific problem areas, with many variations in between.

Starting anew

Among those wishing to start over, some believe that reporting only current tax obligations (and liabilities for risks of additional assessments) would present more relevant information for investors while minimizing complexity. This "as-incurred" approach is already applied to a variety of excise, property, gross receipts, production, duties, value-added, and other non-income based taxes. Proponents of this approach suggest that deferred taxes do not meet the conceptual accounting definitions of assets and liabilities. Although that is debatable, if this approach were taken we would expect that supplemental forward-looking disclosures would be needed to provide investors with information about future expected tax cash flows. Disclosures might include, for example, information about tax loss or credit carry-forwards as well as estimates of future effective tax rates.

Staying the course

Others believe that, generally, the existing deferred tax asset and liability approach should continue. But within that model, where appropriate, deferred tax amounts should be adjusted for the time value of money and the risk of realization. They believe that discounted information more closely reflects the economic value of tax assets and liabilities. If this path is taken, discounting may need to be limited to deferred tax amounts that are not implicitly discounted because they relate to pre-tax balances that are already discounted, such as pension and other employee benefit obligations.

The operational challenges associated with discounting also would need to be considered. With improved tools and more experience, proponents suggest those challenges may not be as difficult to overcome as when income tax accounting was last deliberated. They believe that if discounting of deferred tax amounts is instituted, certain existing exceptions would no longer be needed and other shortcomings of the current model would be diminished. They also believe investors would be provided with more decision-useful information. For example, the impact on net income from recording a one-time adjustment to *discounted* deferred tax amounts for changes in tax laws would more closely reflect the economics.

Middle-of-the-road

A variety of alternatives have been proposed that are between these two broad approaches. One would be to limit deferred taxes solely to profit and loss items that are reported in different periods for book and tax purposes. Another would limit deferred taxes to amounts likely to be settled, for example, in the next three-to-five years. While perhaps not theoretically pure, proponents suggest that such approaches are practical and can be developed in a way to provide investors with relevant near-term tax cash flow and other economic information through additional disclosures.

In conclusion

We believe the key objective of standard setting is to develop high quality standards that do not create unnecessary complexity. To us, high quality accounting standards provide decision-useful information for investors, reflect the economics of transactions, and are sustainable.

The opportunity exists to (1) increase the quality of income tax accounting, (2) improve disclosures, and (3) decrease complexity, all of which would benefit investors and preparers. We believe a comprehensive review of the accounting model for income taxes should be on the standard setting agenda — to begin once the pending major new standards have been finalized.

Questions and answers

Q: You suggest that eliminating exceptions in the income tax model would help reduce complexity and improve the quality of information for investors. Can you provide an example?

A: One example, among many, is recording the benefits of income tax deductions from stock options and similar awards in shareholders' equity instead of income. This results in reported tax expense being higher than the related cash outlay for taxes and makes it difficult for investors to assess the impact of stock options on future tax cash flows. At the same time, it necessitates voluminous recordkeeping in order to determine the timing and measurement of the effects on the shareholder equity accounts.

Q: Can you provide examples of more decision-useful disclosures for investors?

A: Investors want to be able to better understand current and expected income tax cash flows. That would include information relating to risks and the extent to which tax cash flows may be affected by non-recurring items or events. It could also include more information on the expected reversal period and impact of deferred taxes. This might be accomplished, for example, by disclosing the weighted average life of deferred tax assets and liabilities. Investors have also expressed an interest in obtaining better information regarding non-income based taxes as they become more prevalent. At the same time, consideration should be given to simplifying or eliminating certain existing disclosure requirements that do not provide clear, decision-useful information.

Q: What should be the next steps in a comprehensive review of the income tax accounting model?

A: The first step is putting this topic on the standard setting agenda. We would recommend that the project commence following completion of the pending major projects. We also suggest that an early-stage user survey and outreach be conducted. A robust research process should then follow.

Q: Should the FASB and IASB coordinate comprehensive reviews of their accounting for income tax models?

A: The FASB and IASB models for income taxes are quite similar and were introduced around the same time. We believe the concerns and opportunities for improvement largely apply to both standards. Both boards have indicated that a comprehensive review would eventually be undertaken. We encourage the boards to include this on their agendas and coordinate their review processes with the ultimate objective of achieving comparable income tax accounting standards.

Contact Information

To have a deeper discussion about our point of view on accounting for income taxes, please contact:

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