

Tax Accounting Services

Income tax disclosure

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Why disclosure

Overview

Users of financial statements continue to emphasize the importance of informative, decision-useful disclosures. This focus often extends to the reporting of income taxes, a material component of most financial statements. Tax laws can be difficult to understand due to their complexity, compounded by the multitude of taxing jurisdictions throughout the world. Connecting the effects of those laws with financial accounting principles adds to the challenge.

Numerous income tax accounting matters require the use of estimates, judgments, and other subjective information that can obscure the presentation in the financial statement accounts. Clarifying disclosures can enable users to gain a better understanding of the reporting entity's income tax environment.

Today's financial reporting users represent a spectrum of stakeholders including investors, lenders, regulators, accounting standard setters, analysts, researchers, and legislative or public policy-making bodies around the world. The business environment and user expectations have evolved such that companies are encouraged to communicate more effectively about their income tax profile.

FASB's focus on disclosure

The Financial Accounting Standards Board (FASB) has a large-scale disclosure framework project in progress. A discussion paper was issued on July 12, 2012 followed by a comment period. The FASB is currently reviewing the feedback, while developing a decision process for establishing disclosure requirements. With the framework project, the FASB hopes to improve the effectiveness of disclosures in the notes to financial statements by clearly communicating

the information that is most important to users. The FASB intends the framework to promote more consistent decisions around disclosure requirements.

Earlier this month, the FASB announced that it will seek further input on certain income tax areas noted in a recently completed Financial Accounting Foundation report as presenting difficulties for users. Specifically, information enabling users to analyze income tax cash flows and the effects of indefinitely reinvested foreign earnings.

IASB's focus on disclosure

The International Accounting Standards Board (IASB) held a discussion forum in London earlier this year and released a paper in May 2013, *Discussion Forum – Financial Reporting Disclosure Feedback Statement*, outlining the initiatives they expect to undertake. The actions include steps to address materiality considerations and the challenges associated with providing effective disclosure.

SEC's focus on disclosure

The Securities and Exchange Commission (SEC) recently announced its plan to hold roundtable discussions with its varying constituents on the subject of disclosure. In October 2013, Mary Jo White, Chair of the SEC, gave a speech to the National Association of Corporate Directors where she expressed the need for continued focus on disclosure requirements to ensure they are providing effective and useful information to users. At the same time, she cautioned against information overload, which can confound users.

The SEC staff continues to focus on disclosures in comment letters issued to registrants. In connection with income taxes, frequent comment areas

include the indefinite reinvestment of foreign earnings, effective tax rate reconciliations, the assessment of deferred tax assets, and uncertain tax positions.

Lawmakers' focus on disclosure

Income tax disclosure continues to be a hot topic with lawmakers around the world. Their focus has similarly been on reported effective tax rates, country-by-country reporting transparency, uncertain tax positions, and reinvested foreign earnings. Included in the *Dodd-Frank Wall Street Reform and Consumer Protection Act* are certain country-by-country tax reporting provisions adopted by the SEC in August 2012. They require SEC-listed companies in the extractive sectors to disclose, on a country-by-country basis, certain payments made to governments. In early 2013, the European Union (EU) enacted *EU Capital Requirements Directive IV*, which includes provisions that will require all banks, other credit institutions, and certain investment firms to publish detailed financial data on a country-by-country basis.

Widespread relevance

Financial reporting disclosures are a key mechanism for communicating with stakeholders. Disclosures go beyond the reporting of numbers in the financial statements, providing an opportunity for a company to tell its story.

While the disclosure requirements are different for non-public entities, effective disclosure can be of equal importance. In addition, entities expecting to become public, as well as regulated filers such as hedge funds, will often consider disclosure from a perspective comparable to that of public companies.

When and where to disclose

When to disclose

The presentation of financial statements in conformity with US generally accepted accounting principles (US GAAP) includes proper disclosure.

The following Accounting Standards Codification (ASC) topics provide general guidelines regarding disclosure requirements:

- ASC 205, *Presentation of Financial Statements*, describes the benefits of presenting comparative financial statements instead of single-period financial statements, and addresses how the comparative information and related disclosures should be presented. This includes disclosure of changes due to reclassifications or other reasons that affect the manner of, or basis for, presenting corresponding items for two or more periods
- ASC 235, *Notes to Financial Statements*, sets forth guidelines for the content and format of disclosures of accounting policies
- ASC 275, *Risks and Uncertainties*, requires reporting entities to disclose information about the risks and uncertainties resulting from the nature of their operations, the use of estimates in preparing financial statements, and significant concentrations in certain aspects of the entity's operations
- ASC 855, *Subsequent Events*, prescribes the date of issuance for financial statements and the date

through which management must evaluate subsequent events. Even if a subsequent event is not recognized in the financial statements, it may be necessary to disclose the nature of the event and an estimate of its financial effects, or include a statement that such an estimate cannot be made

- ASC 250, *Accounting Changes and Error Corrections*, requires disclosure of a change in accounting principle (including an explanation of why the newly adopted accounting principle is preferable), the method of applying the change, and any material indirect effects of the change. When financial statements are restated to correct an error, disclosure should include a description of the nature of the error
- ASC 270, *Interim Reporting*, provides guidance on accounting and disclosure issues specific to interim reporting and minimum disclosure requirements for interim financial statements of public companies

In addition to the general guidelines, specific disclosure requirements are prescribed within numerous accounting topical standards. With respect to income taxes, ASC 740, *Income Taxes*, requires certain financial statement footnote disclosures. These are augmented by SEC footnote requirements for public companies. In addition, there are tax-related footnote disclosures required under other standards, such as those relating to

business combinations, stock-based compensation, and foreign currency.

Where to disclose

For US public companies subject to SEC reporting requirements, disclosures may be found in annual and quarterly filings such as the Forms 10-K or 10-Q. A company's annual filing includes the audited financial statements and a narrative containing management's description of the company's performance, activities, and liquidity. If a significant event occurs outside the annual and quarterly filing periods, a Form 8-K filing may be necessary.

Public companies typically also issue press releases and conduct 'earnings calls' to disclose information to users. Companies should be aware of what others in their industry are disclosing and may consider disclosing information through industry-specific publications. Non-authoritative sources may also be useful references for disclosure, including the American Institute of Certified Public Accountants' *US GAAP Financial Statements – Best Practices in Presentation and Disclosure*.

Non-public entities may limit their disclosure considerations to those specified in the authoritative accounting guidance. In some instances, the guidance differs from the requirements for public companies. Non-public entities that anticipate seeking public capital or otherwise wish to report in a more publicly comparable manner may expand their disclosure considerations.

Management's discussion and analysis of financial condition and results of operations

Overview

Our journey through Form 10-K begins with management's discussion and analysis (MD&A). In recent years, this opening section of registrant filings has garnered frequent comments from the SEC staff.

MD&A disclosure is guided by three principal objectives:

- To provide a narrative explanation of a registrant's financial statements that enables investors to see the registrant through the eyes of management
- To enhance the overall financial disclosure and provide the context within which financial information should be analyzed
- To provide information about the quality and potential variability of a registrant's earnings and cash flows, so that investors can ascertain the likelihood that past performance is indicative of future performance

The discussion should be from the perspective of management rather than that of one department, specific employees, or even the corporate board. Obtaining broad organizational input can be instrumental to distilling key considerations and providing clarification that is not otherwise apparent within the filing. In determining whether commentary within MD&A is appropriate, consider the following steps:

- Focus on materiality and relevance, eliminating immaterial information that does not promote an understanding of a company's financial condition, its liquidity and capital resources, or changes in its financial condition and results of operations (both in the context of profit and loss and cash flows)

- Discuss management's key performance indicators, including non-financial performance indicators, that are used to operate the business and that may be relevant to users
- Identify and disclose known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on a company's financial condition or operating performance
- Provide disclosure of information not only responsive to MD&A requirements, but which explains management's view of the implications and significance of that information

It is presumed that reported results will be fairly consistent over the near/mid-term horizon to the best of management's knowledge. To the extent that additional information is known by management that may impact this presumption, discussion within MD&A is encouraged in order to provide appropriate context and timely warning to readers.

Since MD&A should provide clarifying discussions to enhance the usefulness of the financial statements, it should not repeat or contradict content already contained within another part of the filing; it should not be generic in nature; it should not focus on immaterial events or transactions; and it should not dilute the user's understanding. Disclosure is about the quality, not quantity, of information.

Cash flows and liquidity

Registrants should explain significant matters impacting cash flows and capital resources. For example, in the event there are significant cash flows related to windfall tax benefits from stock-based compensation, discussion within MD&A may be appropriate.

With respect to deferred taxes, discussion of the expected timing of future tax cash flows may be useful. Disclosure is also expected to indicate potential tax costs that would be incurred if foreign cash or cash equivalents were needed to fund US obligations or contingencies.

Effective tax rate

As discussed later, the effective tax rate (ETR) is based upon the reported amount of income tax expense attributable to continuing operations. Discussion should provide users with an understanding of the key underlying factors reflected in the ETR reconciliation. Registrants should explain the reasons for significant changes in the ETR from year to year. This may include discussion of significant changes that may occur in the future. Additionally, registrants should provide a discussion of unusual and infrequent items impacting the ETR reconciliation.

International operations

Registrants should consider discussion of significant income tax implications relating to international operations and/or foreign income tax rates, which may include:

- Tax holidays and other government tax incentives
- Certain transfer pricing arrangements, particularly where minority investors or other unrelated parties are affected
- Advance pricing agreements
- Restructuring activities or potential business changes that may impact the mix of US and foreign income

Disclosure can provide users with insight into the risks and opportunities relevant to an organization based on how it conducts its cross-border business and which taxing jurisdictions

are of major significance to the organization.

The SEC staff has emphasized the importance of transparency with respect to undistributed foreign earnings. They have been regularly asking companies to disclose the specific factors and plans considered in support of indefinite reinvestment assertions.

Realizability of deferred tax assets

Registrants should consider discussion of the organization's assessment of the realizability of deferred tax assets (DTAs). If there are recent cumulative losses in a jurisdiction with significant DTAs, consider explaining why no valuation allowance was established. If not explained in the footnotes, emphasis should be given in MD&A to the evidence considered by management and the weighting accorded to each component of evidence in reaching its conclusion.

In the event it is not apparent that an organization's existing level of income for a particular jurisdiction is sufficient to realize its DTAs, the following should be discussed:

- The minimum amount of future taxable income needed (e.g., extent of the future increase in profitability needed)
- Management's assumptions in concluding it is more-likely-than-not that the results of future operations will generate sufficient income

The SEC staff has recommended that the historical relationship between pre-tax earnings and taxable income, including the nature and amount of material differences, be disclosed. Likewise, a discussion regarding tax-planning strategies that would be available to generate future taxable income and the timing of the reversal of significant deductible temporary differences should be considered.

Changes in valuation allowances, whether recording or releasing an allowance, should be explained. The SEC staff expects that such changes would not only have been foreshadowed in prior disclosure, but that support for changes in the accounts be discussed in detail.

Contractual obligations table

Liabilities for unrecognized tax benefits should be considered when a registrant prepares the contractual obligations table. There are various formats that these disclosures might follow. However, the ultimate goal of the disclosures is to provide transparent information that enables investors to understand the impact of uncertain tax positions on the company's liquidity.

Critical accounting estimates

Registrants should provide a discussion of critical accounting estimates, assumptions, and uncertainties within MD&A to serve as a supplement to the accounting policy section of the notes to the financial statements. This discussion should not be repetitive or a replacement of the financial statement footnote discussion. It should include a discussion of the process management used to apply decision frameworks

across and between a broad spectrum of models that often require significant judgment.

Specifically, factors to consider for this disclosure include:

- How the company arrived at the estimate/assumption
- How accurate the estimate/assumption has been in the past
- How much the estimate/assumption has changed in the past
- Whether the estimate/assumption is reasonably likely to change in the future

Many organizations include income taxes within this section of MD&A due to the judgmental nature of the accounting estimates and assumptions management must make. Common examples include valuation allowance assessments, indefinite reversal assertions for unremitted earnings of foreign subsidiaries, and tax examination developments.

Forward-looking disclosure

Consideration should be given to tax-related events or uncertainties that could be of a material nature. This may include proposed tax legislation that could significantly impact management's judgments and decisions. Many companies track legislative proposals significant to their organizations and denote significant tax implications that could result if such proposals were enacted. The emphasis would be on the potential effect of such developments on the variability of earnings, financial condition, and liquidity.

Notes to the financial statements

Accounting policies

ASC 235 is a generic disclosure standard that applies to all entities issuing financial statements under US GAAP. This standard addresses the disclosure of the accounting policies judged by management to most fairly present the entity's financial statements.

It requires that disclosure identify and describe the accounting principles followed by the entity and the methods of applying those principles that materially affect the determination of financial position, cash flows, or results of operations. The disclosure encompasses important judgments as to the appropriateness of accounting principles and methods that involve any of the following:

- A selection from existing acceptable alternatives
- Principles and methods peculiar to the industry in which the entity operates, even if such principles and methods are predominantly followed in that industry
- Unusual or innovative applications of US GAAP

The significant accounting policies disclosure of many companies includes income tax policies. The extent of the disclosure, including the level of depth and specific income tax topics covered, varies among financial statement preparers. Income tax policies often included in this disclosure are:

- Assertions regarding undistributed foreign earnings
- Assertions regarding cross-border intercompany loans and the related foreign currency accounting implications
- Effects of intercompany asset transfers
- Policy election for classification of tax-related interest and penalties

ETR reconciliations

Public entities must disclose a reconciliation (using percentages or dollar amounts) of the reported amount of income tax expense attributable to continuing operations for the year to the amount of income tax expense that would result from applying the domestic federal statutory tax rate to pre-tax income from continuing operations. The statutory tax rate should be the regular tax rate if there are alternative tax systems. The estimated amount and the nature of each significant reconciling item should be disclosed. A non-public entity must disclose the nature of significant reconciling items but may omit a numerical reconciliation.

ASC 740 does not define what constitutes a 'significant' item in the rate reconciliation. However, Rule 4-08(h) of SEC Regulation S-X requires disclosure of individual reconciling items that are more than 5% of the amount computed by multiplying pre-tax income by the statutory tax rate (e.g., for a US-based entity subject to the 35% statutory tax rate, any item that increases or decreases the tax rate by 1.75%). Care should be taken to ensure that items are not disaggregated or aggregated to avoid this requirement, and that reconciling items below this threshold are displayed in appropriate categories. While groupings should generally be consistent from year to year, when a change to a grouping is appropriate an accompanying explanation should be considered.

An area of increasing user interest is the foreign tax rate differential. This reconciling line item should reflect activity resulting from foreign tax rates. The foreign rate differential is not intended to capture all items that may have a related foreign tax consequence.

Other common ETR differentials include:

- Change in valuation allowance
- Change in unrecognized tax benefits from uncertain tax positions
- Dividends-received deduction
- Stock-based compensation shortfalls
- Goodwill impairments or tax amortization
- Permanent differences and tax credits
- Effects of intercompany asset transfers
- Foreign currency translation and transactions

Matters disclosed with the ETR reconciliation may also be relevant to other parts of the filing such as MD&A. Organizations should ensure consistency of such disclosures throughout their filing as well as with all other financial information made available (e.g., earnings calls, information on company websites, and investor presentations).

Dual-rate jurisdictions and hybrid taxes

Certain jurisdictions tax corporate income at different rates, depending on whether (and, in some cases, when) that income is distributed to shareholders. A jurisdiction may have a tax system under which a credit for taxes previously paid is provided when dividends are paid. Conversely, in other jurisdictions the 'distributed' rate exceeds the 'undistributed' rate, and additional taxes are due whenever income is distributed to shareholders.

There should be disclosure of the rate applied in measuring current and deferred taxes. When dividends are declared, any additional tax (or benefit) should be considered for presentation in the ETR reconciliation.

Disclosure should also be considered with respect to other types of hybrid tax systems that similarly require an assessment of the appropriate tax rate. This includes:

- Alternative income-based calculations
- Higher of a tax based on income or a tax based on another measure (such as a gross receipts or capital-based computation)
- Branch profits taxes

Balance sheet disclosures

ASC 740 and SEC regulations require the disclosure of gross DTAs, gross deferred tax liabilities (DTLs), the valuation allowance, and the net change in the valuation allowance. This disclosure requirement would not apply to deferred tax charges related to intercompany transactions and deferred tax credits arising from leveraged leases.

Management may find it prudent to indicate in the financial statements the extent to which realization of DTAs is dependent on projections of future taxable income. In addition, Regulation S-X Rule 5-04 requires that valuation allowance details be provided on Schedule II, as prescribed in Rule 12-09, if it is not otherwise provided in the financial statements or notes.

Public companies must disclose the amounts of significant types of temporary differences. Non-public entities are not required to provide this numeric information but must disclose the nature of significant items. Regulation S-X Rule 4-08(h) does not impose a mechanical hurdle for determining which types of temporary differences are significant. As a practical benchmark, we believe that a particular type of temporary difference should be considered significant if its deferred tax effects equal 5% or more of either total DTAs (i.e., before valuation allowance) or total DTLs, whichever is greater.

Other required disclosures relating to deferred tax balance sheet accounts include:

- The nature and effect of any significant matters affecting comparability of information for all periods presented (unless otherwise evident from other disclosures)
- Any portion of the valuation allowance for DTAs for which subsequently recognized tax benefits will be credited directly to contributed capital

Tax carryforwards

Companies are required to disclose the amounts and expiration dates of loss and tax credit carryforwards. This would include the nature and potential effects of any tax law provision that might limit the availability or utilization of those carryforward amounts (e.g., limitations caused by change in ownership).

The disclosure of such tax attributes should also reflect unrecognized tax benefits that would reduce the amounts claimed or reported in the tax returns. Companies may wish to disclose the claimed tax return amounts as well as the amount that excludes the effects of unrecognized tax benefits.

When a stock compensation award is settled, but a company cannot recognize the tax benefit of a windfall deduction because it did not reduce income taxes payable, the carryforwards for which a DTA is recorded may differ from the amount available to the company. The carryforwards related to windfall tax benefits will need to be tracked separately, but will be included with the other available carryforwards disclosed in the footnotes. The amount of carryforwards for which a benefit would be recorded in equity when realized should be disclosed.

Income statement disclosures

ASC 740 and SEC regulations require the disclosure of the amount of income tax expense or benefit allocated to continuing operations and the amounts

separately allocated to items that are included in other categories, such as discontinued operations, other comprehensive income, and extraordinary items.

The amount of income tax expense or benefit allocated to continuing operations would ordinarily be shown on the face of the income statement. The significant components of income tax expense attributable to continuing operations for each year presented are to be disclosed in the financial statements or footnotes. Those components may include:

- Current tax expense or benefit
- Deferred tax expense or benefit (exclusive of the effects of other components listed below)
- Unrecognized tax benefits from uncertain tax positions
- Research and investment tax credits
- Government grants (to the extent recognized as a reduction of income tax expense)
- Benefits of loss or other tax carryforwards
- Tax expense that results from allocating certain tax benefits directly to contributed capital
- Adjustments to valuation allowances
- Adjustments to deferred taxes for changes in tax laws or tax status

Foreign earnings

In situations where a DTL has not been recognized because of the exception for indefinite reinvestment, the following information should be disclosed:

- A description of the types of temporary differences and the types of events that would cause those differences to become taxable in the parent's home country jurisdiction
- The cumulative amount of each type of temporary difference; for example, the amount of unremitted earnings and amount of cumulative currency translation

- The estimated amount of unrecognized DTL or a statement that the determination of such an estimate is not practicable

For companies that do not disclose an estimate of the unrecorded liability, the SEC staff has been requesting an explanation as to why determination of an estimate is not practicable. Some companies that had historically concluded that an estimate was not practicable have more recently begun disclosing an estimate.

If it is reasonably possible that within one year there will be a change in an indefinite reversal assertion (or in the expected method of recovery of an investment in a domestic subsidiary), disclosure under ASC 275 may be required. If a foreign non-controlled investee becomes a subsidiary, disclosure should be considered with respect to the treatment of previously recorded deferred taxes.

Disclosure should also be considered in relation to earnings that are not eligible for home country tax deferral. For US companies, that can include so-called 'subpart F' earnings of foreign subsidiaries as well as foreign branch earnings. The income tax accounting model in each of these contexts can in certain cases present policy choices that should be considered for disclosure.

Risks and uncertainties

ASC 275 requires disclosures in financial statements of risks and uncertainties (e.g., use of estimates) that can help users in predicting future cash flows and results of operations. This guidance is often relevant to income taxes in relation to areas such as valuation allowances and indefinite reversal assertions for unremitted

earnings of foreign subsidiaries. Disclosure may include assumptions that management uses to estimate its balance sheet and income statement tax accounts. When it is reasonably possible that a material adjustment will occur in the near term (generally considered approximately one year), the financial statements should disclose this uncertainty along with a range of potential changes to its recorded amounts. The premise of this disclosure requirement is that significant one-time charges or benefits, such as a change in the assessment of the need for a valuation allowance, should not surprise users.

Other tax disclosures

ASC 740 requires public entities that are not subject to income taxes, because their income is taxed directly to their owners, to disclose that fact. In addition, there should be disclosure of the net difference between the tax bases and the reported amounts of assets and liabilities.

Consistent with ASC 235, more specific income tax accounting policy choices should also be considered for disclosure. In addition to other disclosures discussed in the context of particular topics, examples of such policy choices in the income tax area may include:

- Effects of intercompany transfers of indefinite-lived assets
- Investment tax credits and related deferred taxes on basis differences
- Temporary differences relating to partnerships
- The method of accounting for tax leases and for recognizing revenue and allocating income tax benefits and asset costs to current and future periods

If the indirect method of reporting cash flows is used, income taxes paid during the period should be disclosed.

Consideration should also be given to disclosure of other significant assumptions that may be used, for example, to determine the measurement of deferred taxes. An example of this is the expected manner of recovery (e.g., disposal versus distribution) used to measure a DTL related to an equity method investment.

Additional SEC disclosures

Several footnote disclosures required by the SEC are not specifically required by ASC 740. These include:

- The source of income (loss) before tax expense (benefit) must be classified as foreign or domestic
- The amounts applicable to US federal income taxes, to foreign income taxes, and to other income taxes, separately for each major component of income tax expense (i.e., current and deferred)
- If applicable, (1) the aggregate dollar and per-share effects of any tax holiday and (2) the date on which the special tax status will terminate

These disclosure requirements apply not only to continuing operations, but also to total pre-tax income and total tax expense. However, overall disclosures of the components of total income tax expense (i.e., current vs. deferred and US federal vs. foreign vs. other) are acceptable. It is not necessary to make such disclosures with respect to each of the different categories (continuing operations, discontinued operations, extraordinary items, etc.) in which income tax expense is reported.

Uncertain tax positions

Disclosures for uncertain tax positions require the use of professional judgment. While management might be concerned with including information in the financial statements that could be helpful to a taxing authority, users base their investment decisions on the same financial statements. ASC 740 addresses this tension in part by requiring a qualitative discussion of only those positions that management

expects will change significantly within the next 12 months. Further, the quantitative reconciliation of unrecognized tax benefits required in public company footnotes is prepared on a worldwide aggregated basis.

Disclosures should be provided for each annual reporting period presented. To meet this requirement, disclosures related to historical information

reflected in the financial statements (e.g., the tabular reconciliation of unrecognized tax benefits) should be based on the years for which the relevant income statements are presented. Disclosures that are primarily forward-looking in nature may be presented as of the most recent balance sheet date only. If applicable, significant changes to the disclosures would be reported in interim periods.

| Topic | Disclosure |
|------------------------------|--|
| Interest and penalties | <p>Accounting policy for the classification of interest and penalties, either as components of income tax expense or as part of pre-tax income. In either case, however, they should not be included in the annual tabular reconciliation disclosure because they are not considered unrecognized tax benefits.</p> <p>Total tax-related interest and penalties recorded in the statement of operations and the total amount of interest and penalties accrued as of the balance sheet date. Interest expense should be disclosed on a gross basis, although interest income, as well as related tax benefits, can also be disclosed.</p> |
| Significant changes | <p>The nature of uncertain positions and related events if it is reasonably possible that the positions and events could change the associated recognized tax benefits within the next 12 months. This includes unrecognized tax benefits that are expected to be recognized upon the expiration of a statute of limitations. Disclosure should include an estimate of the range of the reasonably possible change or a statement that an estimate cannot be made.</p> |
| Examination years | <p>All tax years that remain open to assessment by major tax jurisdictions.</p> |
| Tabular reconciliation | <p>Reconciliation of the beginning and ending balances of unrecognized tax benefits. This includes all unrecognized benefits, whether they are reflected in a liability, a decrease in a DTA (irrespective of whether a valuation allowance would be required), or even an off-balance-sheet exposure such as an uncertain stock option windfall benefit that has not been recorded because it has not yet reduced taxes payable.</p> <p>Disclosure includes the following minimal line items (which can be further expanded by the preparer):</p> <ul style="list-style-type: none"> • Gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during a prior period • Gross amounts of increases and decreases in unrecognized tax benefits as a result of tax positions taken during the current period • Amounts of decreases in unrecognized tax benefits relating to settlements with taxing authorities • Reductions to unrecognized tax benefits as a result of a lapse of the applicable statute of limitations <p>A decrease in unrecognized tax benefits resulting from concessions or adjustments by the taxing authority should be reflected as a change to prior-period unrecognized tax benefits. A settlement agreed with a taxing authority as of year end should generally be shown, even though the actual cash or other form of payment is made subsequent to year end.</p> |
| Foreign currency translation | <p>The effects of currency translation on the line items within the tabular reconciliation may be presented as a separate line item or included in the amount presented in each line item. Disclosure may include reference to the manner of presentation.</p> |

| Topic | Disclosure |
|-------------------|--|
| Impact to the ETR | <p>The total amount of unrecognized tax benefits that, if recognized, would impact the ETR — that is, unrecognized tax benefits that would affect (if recognized) the tax provision within continuing operations. This would generally not include (1) timing-related uncertainties, (2) windfall tax deductions from stock-based compensation, and (3) measurement period adjustments. Supplemental disclosures should be considered to indicate, for example, the amount of gross unrecognized tax benefits included in the ending balance whose tax effects, if recognized, would be recorded in equity and/or goodwill.</p> <p>Uncertain tax positions embedded in a loss or credit carryforward that carries a full valuation allowance would not impact the effective tax rate on a net basis, as long as the uncertainty is expected to be resolved while a full valuation allowance is maintained. A company may disclose that if the unrecognized tax benefit is recognized, it would affect the ETR but then go on to indicate that, if recognized, such amounts are likely to attract a full valuation allowance thereby offsetting the ETR impact.</p> |
| Backwards tracing | With respect to uncertain tax positions relating to discontinued operations, extraordinary items, intercompany transactions, and items included in other comprehensive income, there may be policy choices that should be considered for disclosure. |
| Subsequent events | Relevant developments occurring after the balance sheet date but before issuance of financial statements (including the discovery of information that was not available as of the balance sheet date) that affect unrecognized tax benefits should be considered a non-recognized subsequent event. Accordingly, the effects are not recorded in the current period financial statements, but an explanatory disclosure of the event and its potential impact should be considered. |

Other footnote disclosures

Stock-based compensation

Disclosures related to the tax effects of stock-based compensation should include:

- The amount of cash received from exercise of share options (and similar instruments) and the corresponding tax benefit realized from stock-based compensation during the current year
- The total compensation cost recognized in income, as well as the total recognized tax benefit for each year for which an income statement is presented

Additionally, under both the direct and indirect methods of reporting cash flows, windfall tax benefits from stock-based compensation should be classified as cash inflows from financing activities.

Other stock-based compensation disclosures may include:

- Anticipated near-term DTA write-offs from the expiration or settlement of awards
- Accounting policy used in determining allocable compensation expected to be disallowed under Internal Revenue Code section 162(m) or similar tax laws
- Accounting policies for calculating windfalls and for determining when a windfall benefit is realized (i.e., when the deduction is considered to have reduced taxes payable)
- Accounting policy for determining windfall pool(s) when there are benefits and shortfalls from employee and non-employee awards

Foreign currency

The amount of income tax expense or benefit allocated to currency translation must be disclosed on the face of the financial statements or in the notes. There are several forms of acceptable presentation.

Other foreign currency tax-related disclosures may include:

- Disclosure of intercompany financing arrangements that are considered to be of a long-term investment nature, the extent to which tax effects on the respective translation amounts have not been recognized, and the types of events that would cause the tax accounting to change
- Policy or assertions with respect to providing deferred taxes currency translation amounts related to subpart F earnings of foreign subsidiaries or foreign branch earnings
- Policy for presenting revaluations of foreign deferred tax balances as transaction gains or losses or as deferred tax benefit or expense. If reported as deferred tax benefit or expense, those amounts are still included in the aggregate transaction gain or loss disclosed for the period.

Other comprehensive income

Disclosures related to other comprehensive income include:

- The amount of income tax expense or benefit allocated to each component of other comprehensive income, including reclassification adjustments, on the face of the financial statements or in the notes

- Gains and losses that are later reclassified out of accumulated other comprehensive income into net income are disclosed along with their respective income tax effects
- The policy applied with respect to clearing tax effects related to available-for-sale securities

Business combinations

Several tax accounting policy elections may be disclosed in connection with business combinations, including:

- Consideration of whether acquired DTLs support realization of existing versus acquired DTAs
- Effects of a planned post-acquisition restructuring on the ability to benefit from acquired loss or credit carryforwards
- Tax effects from remeasuring a previously held investment
- The effects on tax-deductible goodwill from contingencies or contingent consideration
- Effects of a step-up in basis of tax-deductible goodwill obtained through a transaction that occurs outside of acquisition accounting
- Tax effects of acquisition-related transaction costs

Other business combination disclosures may include:

- Contingent consideration and indemnification assets
- The total amount of tax-deductible goodwill
- Bargain purchases and partial acquisitions
- Measurement period adjustments

Interim disclosures

Financial statement disclosures required during interim periods are generally prepared under the assumption that users have read or can access the audited financial statements for the preceding year. For this reason, interim reporting disclosures are not expected to be as robust as the disclosures required at year end.

Disclosure requirements for significant income tax items generally include:

- Tax effects of significant unusual or infrequent items that are recorded separately or items that are reported net of their related tax effect
- Changes in estimates or provisions for income taxes, such as changes in the assessment of a valuation allowance, that occur during the period
- Variations in the customary relationship between income tax expense and pre-tax accounting income, if not otherwise apparent
- Significant changes to the presentation of liabilities for unrecognized tax benefits in the contractual obligations table
- Changes related to uncertain tax positions and respective

disclosures, including reasonably possible changes to the total amount of unrecognized tax benefits within the next 12 months

- Impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period
- Tax impacts of significant risks and uncertainties
- Significant changes DTAs or DTLs, if not otherwise apparent

Additionally, appropriate financial statement disclosures should be made for interim-period income tax policies. Examples of specific areas where such policies may impact the estimated annual ETR include the treatment of:

- Non-recognized subsequent events
- Zero-rate jurisdictions
- Windfall tax benefits
- A business combination occurring during the year
- Acquisition-related transaction costs

In a similar fashion, interim MD&A disclosures are intended to enable users to assess significant changes in

financial condition. This includes addressing significant changes in the results of operations that did not arise from or are not necessarily representative of the ongoing business.

Users of the financial statements can assume, for instance, that a company's ETR for the most recent periods will continue into the near-term future. If items impacting the interim rate will not recur, disclosure would generally be appropriate.

In the event interim statements are used in lieu of annual statements (e.g., in a registration statement), disclosure is required of the components of interim income tax expense.

Form 8-K

Form 8-K and its variants are used to report specific events, normally, within four days of occurrence (unless otherwise stated). The filing of Form 8-K may be required as a result of any number of potentially important events, including:

- Entering into an agreement (or amendment of an agreement) that is material and is not in the ordinary course of business. Disclosure would include the agreement's date, terms, and conditions that are material to the company as well as identification of the parties and description of material relationships between the parties
- Terminating a material definitive agreement that was not made in the ordinary course of business, other than by expiration or completion of the agreement. Disclosure would include the termination date, identity of the parties involved, material relationships between the parties, the agreement's

terms and conditions, the circumstances surrounding the termination, and material early-termination penalties that the registrant incurred

- Creating a material, direct financial obligation or a direct or contingent liability for a material obligation arising out of an off-balance-sheet arrangement
- The occurrence of events triggering an increase or acceleration of a direct financial obligation on the part of the company or an obligation under an off-balance-sheet arrangement that has material consequences for the company
- A material charge for impairment of assets
- A conclusion that previously issued financial statements should no longer be relied upon because of an error in such financial statements

Although Form 8-K filings often arise from third-party commercial events, there are instances in which tax-related transactions, events, or agreements occur for which an 8-K filing would be considered. For example:

- Tax examination or litigation developments
- Conclusion that DTAs require a valuation allowance
- Certain transfer pricing, tax sharing, tax indemnity, or other agreements, particularly where minority investors or other unrelated parties are affected
- Advance pricing agreements or government incentive arrangements
- Agreements or other legal steps to prevent a change in ownership that would cause a limitation on loss carryforwards or other tax assets

Other presentations

Separate company financial statements

Businesses that prepare consolidated (or group) financial statements also often prepare separate financial statements for one or more divisions, business units, and/or subsidiaries. Such statements ('carve-out' or 'standalone' financial statements) can be necessitated by a pending transaction such as an initial public offering, spin-off, or business combination. Alternatively, they may be required for certain statutory or regulatory filings on an ongoing periodic basis.

The selection of an appropriate income tax allocation method requires significant judgment. Accordingly, disclosures regarding the chosen policy should be sufficiently transparent to enable users to make informed decisions.

ASC 740 requires an entity that is a member of a group that files a consolidated tax return to disclose the following in its separate financial statements:

- The aggregate amount of current and deferred tax expense for each statement of earnings presented and the amount of tax-related balances due to or from affiliates as of the date of each statement of financial position 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 changes in that method (and in determining related balances to or from affiliates) during the years for which disclosures are presented

Although these disclosure requirements are in lieu of, rather than in addition to, the general

disclosure requirements of ASC 740, it is generally advisable to include a description of the types (and potentially the amounts) of significant temporary differences. In addition, if the carve-out financial statements will be filed with the SEC, the disclosures should generally be comprehensive.

Disclosures regarding uncertain tax positions of the carve-out entity would generally be appropriate. The level of uncertain tax position disclosures, however, may vary depending on the tax allocation method chosen as well as the other ASC 740 disclosures provided. For example, if income taxes are allocated to a carve-out entity using a method that provides that subsequent changes relating to uncertain tax positions are allocated to the parent company, the carve-out entity may not need to provide all the required ASC 740 disclosures. On the other hand, if the carve-out entity is allocated income taxes using the separate return method, it should generally provide all the required ASC 740 disclosures.

Disclosure should similarly be considered for an allocation of a windfall tax benefits pool to the separate filing entity.

It is also generally appropriate to disclose tax attributes that have been allocated to the carve-out entity but will not remain with the carve-out entity upon separation from the consolidated group. For example, there may be a separate return method DTA for a loss or credit carryforward that has been used in a consolidated tax return.

IFRS

Because International Financial Reporting Standards (IFRS) and US GAAP are based on comparable income tax accounting principles, many of the pertinent disclosure considerations are similar. However,

differences exist and some examples follow.

On the balance sheet, IFRS requires deferred taxes to be recognized on a net basis (valuation allowances are not allowed to be recorded) and recorded in a non-current account. A supplemental note that provides greater detail is required.

Under IFRS, a numerical reconciliation is required in either or both of the following forms:

- The relationship of income tax expense to the product of accounting profit multiplied by the applicable tax rate(s), with disclosure of the basis for determining the applicable rate(s)
- The relationship of the average effective tax rate and the applicable rate, with disclosure of the basis on which the applicable rate is computed

Accounting for uncertain tax positions is not specifically addressed within IFRS. As a result, there are accounting policies that may be disclosed, such as those for measuring tax positions and for determining the 'unit of account.' Relevant post-balance-sheet date events would be assessed for possible adjustment to the current period accounts or disclosure without current adjustment. There may also be accounting policy choices for interest and penalties.

Significant differences also exist with respect to stock-based compensation. There is no concept of a 'windfall pool' under IFRS, and all tax benefits or shortfalls upon settlement are reported as operating cash flows.

Non-GAAP measures

Companies often present users with additional accounting information that is not presented in accordance

with US GAAP. The information is based upon US GAAP amounts, but with adjustments. These presentations are referred to as ‘non-GAAP financial measures’ under SEC rules. The non-GAAP financial measures may be presented in addition to results prepared in accordance with US GAAP, but should not be considered a substitute

for US GAAP results. Companies are required to provide a reconciliation of the non-GAAP measures to the most directly comparable US GAAP amounts.

Income tax accounting items that are often adjusted in non-GAAP measures include valuation allowances, windfall tax benefits, tax effects related to unremitted foreign

earnings, and uncertain tax positions. Non-GAAP measures will generally need to include a reconciliation of the US GAAP effective tax rate.

Takeaway

Disclosures are a critical element of financial statements and accompanying communications. They enable a company to tell its story and strengthen the relevance of their financial statements. Disclosures pertaining to income taxes are no exception and in many respects can be among the most useful to financial statement users.

Today's financial statement users are more diverse than ever. To reach them,

good disclosure should be clear and crisp, and in plain English. In formulating effective disclosure, no one company department should go it alone. Many companies have disclosure committees that help ensure proper alignment of disclosure. The best assessment of the effectiveness of disclosure will often come from other than those specialists who may be most familiar with the intricacies of the respective financial accounts.

Companies should foster cross-functional teaming around income tax disclosure, as income tax reporting by its nature requires an integration of skill sets and multi-sourced data. Companies are likewise encouraged to have proactive conversations with their independent audit firm. Coordination among all participants in the external reporting chain is a best practice.

Let's talk

For questions about income tax accounting matters, please contact your local PwC team or our Tax Accounting Services leaders listed below.

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