ASC 740 Year-End Guide

Correctly accounting for and disclosing income taxes under ASC 740 is complex. As the end of the year draws closer, now is a good time to evaluate your company's income tax accounting policies.

That is especially so this year, given the impending effective date of Accounting Standards Update (ASU) No. 2023-09, "Income Taxes (Topic 740): Improvements to Income Tax Disclosures," which the Financial Accounting Standards Board (FASB) issued in late 2023. Given the potential complexity of the ASU's new requirements, firms should consider whether processes, systems, and internal controls should be modified to facilitate effective implementation.

Special attention should be given to your tax function's internal controls, which are vital to reducing risk and capitalizing on available resources.

This year-end planning guide walks you through the most important aspects of the ASU, as well as what to consider in designing strong internal tax controls that can help reduce reporting errors.

FASB Issues Final ASU to Improve Income Tax Disclosures

In response to feedback from the investor community requesting the disclosure of additional information pertaining to income taxes, the FASB issued ASU 2023-09 in December 2023. One of the ASU's overarching themes is the disaggregation of information that may previously have been aggregated or commingled, a change that's expected to provide greater transparency and consistency. In particular, the disclosure requirements seek to increase visibility into various income tax components that affect rate reconciliation, as well as the qualitative and quantitative aspects of those components.

MAIN PROVISIONS

The ASU requires public business entities ((PBEs) replacing the term "public entities") to disclose additional information in specified categories with respect to the reconciliation of the effective rate to the statutory rate for federal, state, and foreign income taxes. It also requires greater detail about individual reconciling items in the rate reconciliation if the impact of those items exceeds a threshold.

Under the ASU, PBE information pertaining to taxes paid (net of refunds received) must be disaggregated for federal, state, and foreign taxes and further disaggregated for specific jurisdictions if the related amounts exceed a quantitative 5% threshold. That threshold is determined by multiplying 5% by the product of pretax income (or loss) from continuing operations and the applicable federal statutory rate, and it essentially emulates the requirement in SEC Regulation S-X.

The ASU also describes items that need to be disaggregated based on their nature, which is determined by reference to the item's fundamental or essential characteristics.

UPDATED ANNUAL DISCLOSURE REQUIREMENTS

Rate Reconciliation

ASU 2023-09 specifies categories for which disclosures associated with the rate reconciliation are required, and each category has varying degrees of qualitative and/or quantitative disclosure.

PBEs

The following categories must be included in annual disclosures in the rate reconciliation in tabular form both in amounts in the applicable reporting currency and in percentages:

- State and local income taxes in the country of domicile net of related federal income tax effects
- Foreign tax effects, including state or local income taxes in foreign jurisdictions
  - Reflects income taxes imposed by foreign jurisdictions.
  - Disaggregation is required when individual reconciling items equal or exceed the 5% threshold. This would include the statutory rate differential between the foreign jurisdiction and that of the county of domicile.
  - If an individual foreign jurisdiction meets the 5% threshold, it must be separately disclosed as a reconciling item. Further disaggregation is required for that jurisdiction for cross-border tax laws, tax credits, and nontaxable or nondeductible items that meet the 5% threshold.
- Effects of changes in tax laws or rates enacted in the current period
  - Applies to federal taxes of the country of domicile.
  - Reflects the cumulative tax effects of a change in enacted tax laws or rates on current or deferred tax assets and liabilities at the date of enactment.
- Effect of cross-border tax laws
  - Applies to incremental income taxes imposed by the jurisdiction of domicile on income earned in foreign jurisdictions. When the country of domicile taxes cross-border income but also provides a tax credit on the same income during the same reporting period, the tax effect of both the cross-border tax and its related tax credit may be presented on a net basis.
  - Disaggregation required when individual reconciling items equal or exceed the 5% threshold and by nature of the item.
- Tax credits
  - Applies to federal taxes of the country of domicile.
  - Disaggregation required when individual reconciling items equal or exceed the 5% threshold and by nature of the item.
  - This category does not include foreign tax credits.
- Changes in valuation allowances
  - Applies to federal taxes of the country of domicile. For example, any change in valuation allowance in a foreign jurisdiction would be included in the foreign tax effects category and separately disclosed as a reconciling item if greater than the 5% threshold.
- Nontaxable or nondeductible items
  - Applies to federal taxes of the country of domicile.
  - Disaggregation required when individual reconciling items equal or exceed the 5% threshold and by nature of the item.
- Changes in unrecognized tax benefits
  - Aggregate disclosure of changes in unrecognized tax benefits is allowed for all jurisdictions.
  - This category reflects reconciling items resulting from changes in judgment related to tax positions taken in prior annual reporting periods.
  - When an unrecognized tax benefit is recorded in the current annual reporting period for a tax position taken or expected to be taken in the same reporting period, the unrecognized tax benefit and its related tax position may be presented on a net basis in the category in which the tax position is presented.

The FASB has determined that all reconciling items should be presented on a gross basis. However, it will allow net presentation of the effects of specific cross-border tax laws and the associated effects of foreign tax credits, as well as the netting of current-year uncertain tax positions and current-year tax positions against the relevant category. If a foreign jurisdiction meets the 5% threshold, it must be disclosed as a reconciling item. Irrespective of whether any foreign jurisdiction satisfies the 5% threshold, any individual item meeting the 5% threshold must be disclosed by nature.

PBEs must disclose the state and local jurisdictions that contribute to the majority (greater than 50%) of the effect of the state and local tax category, beginning with the state or local jurisdiction having the largest effect and proceeding in descending order.

If the information is not otherwise evident, PBEs must explain any disclosed reconciling items in the categories above, including their nature, effect, and underlying causes, as well as the judgment used in categorizing them.

It is noteworthy that the FASB decided to align the disclosure requirements with those in SEC Regulation S-X Rule 4-08(h)(2). The federal rate for a foreign entity should normally be that of the entity's jurisdiction of domicile. However, if that rate is other than the U.S. corporate rate, both the rate and the basis for its use must be disclosed.

Entities Other Than PBEs

For entities other than PBEs, a qualitative disclosure of the nature and effect of the categories of items discussed above is required along with the individual jurisdictions that result in a significant difference between the statutory and effective tax rates. A numerical reconciliation is not required.

Income Taxes Paid

The ASU requires that all entities annually disclose the amount of income taxes paid (net of refunds received) disaggregated by federal, state, and foreign jurisdictions. It requires further disaggregation for any jurisdiction where the amount of income taxes paid is at least 5% of the total income taxes paid. In quantifying the 5% threshold for income taxes paid, the numerator of the fraction should be the absolute value of any net income taxes paid or income taxes received for each jurisdiction and the denominator should be the absolute value of total income taxes paid or refunds received for all jurisdictions in the aggregate.

Income Statement

The ASU makes some minor changes to the required income statement disclosures relating to income taxes, stipulating that income (loss) from continuing operations before income tax expense (benefit) be disclosed and disaggregated between domestic and foreign sources. It mandates the disclosure of income tax expense (benefit) from continuing operations disaggregated by federal, state, and foreign jurisdictions. Income tax expense and taxes paid relating to foreign earnings that are imposed by the entity's country of domicile would be included in tax expense and taxes paid for the country of domicile.

ELIMINATED DISCLOSURES

ASU 2023-09 eliminates the historic requirement that entities disclose information concerning unrecognized tax benefits having a reasonable possibility of significantly increasing or decreasing in the 12 months following the reporting date. It also removes the requirement to disclose the cumulative amount of each type of temporary difference when a deferred tax liability is not recognized because of the exceptions to comprehensive recognition of deferred taxes related to subsidiaries and corporate joint ventures. Entities should continue to disclose the types of temporary differences for which deferred tax liabilities have not been recognized under ASC 740-30-50-2(a), (c), and (d).

EFFECTIVE DATES AND TRANSITION

All entities should apply the ASU prospectively with an option for retroactive application to each period in the financial statements. For PBEs, the guidance will be effective for fiscal years beginning after December 15, 2024, and for interim periods for fiscal years beginning after December 15, 2025. For entities other than PBEs, the guidance will be effective for fiscal years beginning after December 15, 2025, and for interim periods beginning with fiscal years beginning after December 15, 2026. Early adoption is allowed.

Planning Considerations

- When developing a plan to implement the new disclosure requirements, consider whether amounts meeting the 5% threshold are material to help guide an assessment of the jurisdictions and items that will be disaggregated in the disclosures. Specifically, it may be prudent to quantify those amounts in order to effectively assess the materiality of the amounts disaggregated.
- Given the potential complexity of, and the resources necessary to satisfy, the new requirements established by the ASU, consider whether adoption will be made prospectively or retrospectively. Also contemplate the modifications to processes, procedures, systems, and internal controls that will be necessary to facilitate an effective implementation process. Those considerations will be of particular importance for entities with foreign operations.

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Reducing Risk With Tax Internal Controls

Internal controls are complex. Two decades after the enactment of Section 404 of the Sarbanes-Oxley (SOX) Act, income-tax-related material weaknesses continue to plague companies, with a recent report showing that tax-related restatements account for approximately 12% of all restatements.[1]

Without proper internal controls, companies may be susceptible to reporting errors, which can lead to reputational risk and financial burdens stemming from remediation. Companies with strained or limited in-house resources must prioritize income tax accounting and reporting before it is too late.

Correctly accounting for and disclosing income taxes under ASC 740 is increasingly important to mitigate a company's risk of restatement, material weakness, and SEC comments. In-depth knowledge of tax and financial reporting, proper audit documentation, and clear and transparent disclosures can help reduce income reporting risk.

While all public companies must be SOX compliant, many have not refreshed income tax controls since initial implementation, and new guidance has changed the standards required for compliance.

[1] Center for Audit Quality, "Financial Restatement Trends in the United States: 2013-2022" (June 2024).

Controls often fail because they are not adequately designed or operating as intended. For instance, it is unlikely that one overarching management review control can cover all the areas of an income tax provision or clearly identify the nature of the review procedures for each key provision component. Controls also might lack supporting evidence of performance and review.

Planning Consideration

- If that sounds familiar, it's probably time to examine your control framework. Improper design and execution of internal controls can result in material weaknesses and costly remediation, even with management review procedures in place.

The inherent benefits of a strong control environment may be crucial to a private company, despite internal controls often being viewed as a "public company problem." Private companies are not immune from intense stakeholder scrutiny into accountability and risk and may want to consider implementing internal controls similar to those required by SOX Section 404. Public-company-level controls could be useful in the event of rapid growth, an initial public offering, or a sale to a private equity buyer.

Planning Consideration

- Companies with a clear understanding of the inherent risks that come from inadequate accounting practices demonstrate the ability to think big picture and be better prepared for growth or change in ownership.

There are many reasons to strengthen income tax accounting internal controls, including to reduce reputational risk, minimize consulting fees, preserve investor confidence and market capitalization, and improve resource capacity.

Planning Considerations

- *Reputational risk*: SOX, which is intended to protect investors from accounting errors and fraudulent financial reporting, requires the establishment of internal controls and reporting methods to ensure those controls. Corporations often view SOX compliance as onerous and expensive; however, the cost and effort to remediate can be far greater than the cost to implement and execute strong controls.
- *Consulting fees*: The direct costs of remediating a material weakness — with or without a restatement — can be particularly burdensome. They can include audit, remediation, and legal fees, and they add up quickly.
- *Investor confidence and market cap*: A material weakness can spark worries from investors about reduced future performance. Regardless of their validity, investor concerns are often demonstrated by a drop in stock price. With restatements posing the risk of possible stock decline, the impact on market capitalization for any given company could be in the billions.
- *Resource Capacity*: Focusing on the remediation and/or restatement of a past event is not a value-added use of already-strained resources. Tax capacity could be used more effectively to generate cost-saving ideas, improve and streamline processes, and focus on managing risk and delivering value.