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A CLOSER LOOK AT ACCOUNTING FOR INCOME TAXES

By Rachel Sawyer, CPA

As the tax environment grows more complex, so too does accounting for income taxes. Missteps in this area can cause material weaknesses, financial restatements and management disclosures that can be costly and include loss of investor confidence, drop in shareholder value, and significant expense related to financial restatements.

Having the in-depth knowledge, tax technical understanding, and experience to manage estimates and assumptions related to tax provisions is critical to getting ASC 740 calculations and disclosures right. The following questions and answers explore common compliance issues related to ASC 740. For a more detailed 10-step guide to calculating and reporting ASC 740, go to TaxOps Insights at TaxOps.com and subscribe to our ASC-740 Fundamentals series.

What is accounting for income taxes?

Missteps related to accounting for income taxes can cause material weaknesses, financial restatements and management disclosures.

Accounting for income taxes, referred to here by the umbrella term of ASC 740, is a complex set of financial accounting standards for reporting the effects of income taxes resulting from a company's activities during the current and preceding years. This set of regulations further requires businesses to analyze and disclose income tax risks. ASC 740 includes FAS 109, FIN 48, and related pronouncements covering income tax accrual, provisions, and reporting.

Reporting current and deferred taxes

The primary objective of accounting for income taxes is to account for the total tax expense or benefit related to pretax book income in the same period in which the pretax book income is reported. In the United States and many foreign locations, the differences between book income and taxable income can be vast. Many of these differences will reverse over time and are "temporary." Some of these differences will never reverse and are "permanent." It is the accounting for temporary differences that satisfies the underlying matching principle required by most accounting standards.

Mistakes related to ASC 740 can be costly and include:

- *loss of investor confidence;*
- *drop in shareholder value;*
- *significant expense related to financial restatements; and*
- *a distraction for the company.*

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Why do companies struggle with accounting for income taxes?

Complex skill set

Properly accounting for income taxes requires a thorough understanding of both financial and tax accounting. In most companies, tax professionals are responsible for the calculation of the income tax provision and drafting the disclosures required in the financial statements. Unfortunately, many tax professionals are not as comfortable with debits and credits and U.S. GAAP accounting standards as their financial accounting counterparts. Conversely, their financial accounting counterparts are not as comfortable with the tax treatment of financial transactions. If a company does engage an individual that possesses both skill sets, how does it justify that person's annual salary for a process that occurs four times a year?

Limited time

To appropriately account for income taxes, it is not enough to know the ins-and-outs and hidden pitfalls associated with accounting for income taxes. Often to account for the tax consequences of a transaction, it is also necessary to have a thorough understanding of the associated *pretax* accounting. For tax professionals already working to keep up with tax planning opportunities, never-ending tax compliance, and monitoring changes to federal and state tax laws, there may just not be enough time.

The calculation and review process compounds the timing squeeze. For tax directors at public companies, the time between having a final pretax book income number available with which to begin the income tax provision and the deadline for auditor sign-off on the income tax provision is generally just a matter of days. That's not a lot of time to calculate one of the most difficult numbers presented in the financial statements.

Why does accounting for income taxes matter?

Material misstatements and restatements

Accounting for income taxes is one of the leading causes for financial restatements at U.S. companies, and restatements of financial results and disclosures found in management's annual report on Internal Controls over Financial Reporting. According to a study by Deloitte, the leading causes of tax-related material weaknesses are insufficient tax accounting expertise and insufficient review.

The compliance challenges of ASC 740 are numerous and require an in-depth knowledge of financial accounting and tax technical rules. In addition, certain areas are highly judgmental, requiring the use of estimates and assumptions.

> "Lack of Expertise in Accounting for Income Taxes. The Company lacks personnel with adequate expertise in accounting for income taxes in accordance with U.S. GAAP. This material weakness resulted in a material misstatement of the income tax benefit...the Company did not maintain effective internal control…with respect to income taxes…. the Company did not (i) maintain a sufficient number of staff, (ii) train its internal staff sufficiently, with respect to income taxes, to anticipate, identify and resolve accounting for income tax issues timely…"
>
> – Excerpts from restated financial statements

Tax-related material weaknesses are primarily due to lack of tax accounting expertise and inadequate review procedures.

Having the in-depth knowledge, tax technical understanding and experience to manage estimates and assumptions related to tax provisions is critical to getting ASC 740 calculations and disclosures right.

Intraperiod allocations

ASC 740 requires that total tax expense for any period be allocated to the various components of equity and comprehensive income (CI), such as continuing operations, discontinued operations, extraordinary items, and other comprehensive income. A "with-and-without" approach is employed to determine the appropriate allocation. In other words, the tax effect of a certain component of CI or equity is the difference between the tax expense calculated *with* that particular component included and the tax expense calculated *without* that particular component included.

For year ended December 31, 201X, assume the following for ABC, Inc.

Book income equals taxable income

Pretax book income attributable to continuing operations	*$1,000*
Pretax book loss attributable to discontinued operations	*($1,000)*
Total pretax book income	*0*

The intraperiod allocation would be as follows.

Tax expense *with* all components included in comprehensive income

Pretax income attributable to continuing operations	*1,000*
Pretax income attributable to discontinued operations	*(1,000)*
Total taxable income	*0*
Tax Rate	*35%*
Tax Expense	*0*

At this point, it might seem appropriate to conclude there is zero tax expense and move on. That would be a mistake. Applying the rules of ASC 740 yields a much different answer.

Tax expense *without* any component of CI except continuing operations.

Pretax income attributable to continuing operations	*1,000*
Total taxable income	*1,000*
Tax Rate	*35%*
Tax Expense	*350*

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ASC, the financial accounting standard for computing and reporting income tax provisions, demands painstaking attention to detail. The guidance addresses financial accounting and reporting for the effects of income taxes that result from business activities in the current and preceding years. As a result of these efforts, companies recognize current year taxes due or refundable and manage expected future tax consequences of deferred assets and liabilities.

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Allocation of tax expense in accordance with ASC 740

Total tax expense – with all components of CI	*0*
Tax expense – without any component of CI except continuing operations	*350*
Tax benefit attributable to discontinued operations	*(350)*

The importance of this calculation becomes apparent in the financial statement presentation.

Net Income before income tax expense	*$1,000*
Income tax expense	*(350)*
Net income before discontinued operations	*650*
Discontinued Operations net of income tax benefit	*(650)*
Comprehensive Income	*0*

Valuation allowance

Valuation allowances should only be recorded if a company does not believe it will have sufficient taxable income in the future against which to realize its deferred tax assets. In other words, insufficient future taxable income is the only circumstance that leads to a valuation allowance. It is not appropriate to record a valuation allowance in the following circumstances.

- To provide a reserve for an uncertain tax position
- To reduce the amount of a deferred tax asset for a net operating loss that is subject to limitation in accordance with statutory tax law
- To reduce a deferred tax asset because the company has the ability to and intends to indefinitely postpone the reversal of the temporary difference

Indefinite lived intangibles

A company must be able to demonstrate that they will have sufficient taxable income to record a deferred tax benefit. One of the sources of taxable income is the future reversal of an existing temporary difference. It is not unusual to have a future taxable temporary difference with respect to an indefinite live intangible (such as an asset with no discernible useful life over which amortization can be claimed, such as a trademark).

The reversal of this taxable temporary difference will generate taxable income against which a deferred tax asset can be realized. The problem arises in the timing of the reversal. By definition, the reversal will occur at some indefinite point in the future. Since it is impossible to know when the taxable temporary difference will reverse, it is not appropriate to consider this as a future source of taxable income. As such, it is entirely possible to have a 100 percent valuation allowance for deferred tax assets and a "naked" deferred tax liability.

Organizations are required to establish a tax reserve for potential liabilities that could result from uncertain tax positions. The term ASC 740 stands for the Financial Accounting Standards Board (FASB) Accounting Standards Codification Topic (ASC) 740, Income Taxes. ASC 740 includes FASB Interpretation No. 48 (FIN 48) Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement (FAS) No. 109.

Alternative Minimum Tax

In accordance with U.S. statutory tax law, if a company is subject to the alternative minimum tax (AMT) they are allowed an AMT credit for the amount paid. The entry to record the current AMT tax expense and the deferred tax asset for the AMT credit is as follows:

DR: Current tax expense	*XXX*
CR: Cash/Taxes payable	*XXX*
DR: Deferred tax asset – AMT	*XXX*
CR: Deferred tax benefit	*XXX*

The current tax expense and deferred tax benefit net to a zero impact on total tax expense. As such, payment of AMT or generation of an AMT credit does not result in a rate reconciling item.

Balance sheet presentation

In 2015, FASB simplified how deferred taxes are to be classified on the balance sheet (Accounting Standards Update 2015-17, *Balance Sheet Classification of Deferred Taxes)*. The guidance eliminated the requirement to classify deferred taxes between current and noncurrent, effectively simplifying financial reporting for many entities and conforming U.S. GAAP and IFRS.

Effective for public companies in fiscal years beginning after December 15, 2016 and for other than public business entities in fiscal years beginning after December 14, 2017, FASB requires that deferred tax assets and liabilities, along with their related valuation allowance, be classified as noncurrent on the balance sheet.

Until a company adopts the new guidance, valuation allowances must be allocated on a pro rata basis between current and noncurrent deferred tax assets. The following example illustrates this requirement. Even though the only deferred tax asset in this example that requires a valuation allowance is the net operating loss, the pro rata allocation is still required.

Deferred tax assets allowance for doubtful accounts	*500*
Net operating losses	*2,000*
Total deferred tax assets	*2,500*
Valuation Allowance	*(2,000)*
Net deferred tax assets	*500*

Allocation of valuation allowance

Current deferred tax assets	*500*
Total deferred tax assets	*2,500*
Pro rata percentage	*20%*
Valuation allowance	*(2,000)*
Amount of valuation allowance allocated to current deferred tax assets	*(400)*
Current deferred tax assets per balance Sheet	*100*

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What checks can be performed to ensure accuracy of accounting for income taxes?

Rate reconciliation

The number one check is a rate reconciliation in which every item is identified.

Change in balance sheet tied to income statement

The change in the deferred tax asset or liability should reconcile to the reported deferred tax expense or benefit. However, the reported deferred tax expense or benefit is only the amount allocated to continuing operations. If a company has pretax items allocated to Other Comprehensive Income or Discontinued Operations, it may be necessary to reconcile the change in the deferred taxes per the balance sheet to the amount reported in the income tax footnote.

Likewise, the change in the valuation allowance from the beginning of the reporting period to the end of the reporting period (per the balance sheet) should reconcile to the amount reported as "change in valuation allowance" in the rate reconciliation (per the income statement). Again, there are reasons these amounts may differ, such as the expiration of a net operating loss for which a valuation allowance was recorded. Such differences should be accounted for in a reconciliation.

What are next steps?

A tax department must have the right resources in place to prepare a complete and accurate income tax provision and avoid potentially heavy negative consequences. Many CFOs and tax directors have suffered from the fallout of a restatement or disclosure of a material weakness due to a misstated income tax provision.

Being familiar with the requirements of ASC 740 is not enough. A company may have a world-class tax department in terms of tax compliance, but calculating an income tax provision is worlds away from calculating the current income tax liability. Individuals responsible for the income tax provision must have a thorough understanding of the nuances and intricacies of accounting for income taxes. Even for companies in a loss position, it is crucial to prepare a complete income tax provision every year for that time when the company becomes profitable. Trying to recreate data from prior years can be a costly and painful exercise.

CFOs and tax directors must take a hard look at who is preparing the company's income tax provision and determine if the required expertise is available in-house. If not, it is time to reevaluate staffing needs or start interviewing outside service providers.

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Rachel specializes in helping corporations develop tax strategies that meet compliance obligations and minimize tax exposure. Her professional emphasis is on income tax consulting and compliance, accounting for income taxes (ASC 740), and tax cash flow management. With skills and experience obtained from both the private sector and public accounting, she brings a broad perspective to her clients for interpreting the business impact of taxes at all levels -- federal, international, and state and local.

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