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Income Statement – Reporting Comprehensive Income (Topic 220) – Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income

FASB Accounting Standards Update No. 2018-02 (Issue Date: February 2018)
Link to Standard: *Update No. 2018-02*

Overview

The Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2018-02, *Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income*, in February 2018.

This update permits entities to reclassify the stranded tax effects caused by the Tax Cuts and Jobs Act from accumulated other comprehensive income (AOCI) to retained earnings. The FASB describes these stranded tax effects as items within AOCI that do not properly reflect the appropriate tax rate, which are caused by the adjustment of deferred taxes due to the reduction of the corporate income tax rate being included in income from continuing operations.

Under the new guidance, if a company elects to reclassify the tax effects from AOCI to retained earnings, the reclassification amount will include the following:

- The effect of the change in the U.S federal corporate income tax rate on the gross deferred tax amounts and related valuation allowances at the date of enactment of the Tax Cuts and Jobs Act related to items remaining in AOCI.
- Other income tax effects of the Tax Cuts and Jobs Act on items remaining in AOCI that an entity elects to reclassify.

Excluded from this reclassification amount is the effect of the change in the U.S. federal corporate income tax rate on gross valuation allowances that were originally recorded in income from continuing operations.

Background

This update amends both ASC Topic 740, *Income Taxes*, and ASC Topic 220, *Income Statement – Reporting Comprehensive Income*. ASC 740, Income Taxes, requires deferred tax liabilities and assets to be remeasured for a change in tax laws or rates, with the adjustment included in income from continuing operations in the reporting period that includes the effective date. Stakeholders voiced concerns about the stranded tax effects in AOCI resulting from the reduced corporate income tax rate. In other words, because the adjustment of deferred taxes due to the change in tax rate is required to be included in income from continuing operations, the tax effects within AOCI reflect a disproportionate amount. The disproportionate tax amount is due to the tax effects within AOCI reflecting the previous corporate income tax rate of 35%, as opposed to the newly enacted corporate income tax rate of 21% under the Tax Cuts and Jobs Act. Stakeholders noted that the disproportionate tax effects caused by guidance in ASC 740 may be confusing to financial statement users.

To address the stakeholder concerns regarding the disproportionate tax rate within AOCI, the FASB issued this updated guidance, ASU 2018-02. By allowing entities to reclassify the stranded tax effects from AOCI to retained earnings, the FASB aims to increase transparency and usefulness for financial statement users. Additionally, the update addresses stakeholder concerns regarding regulatory capital requirements. The banking and insurance industries pointed out that recording the adjustment of deferred taxes through income from continuing operations may have a negative impact on regulatory capital. As such, these stakeholders requested that the FASB allow the effects of the change in corporate income tax rate on deferred taxes that were originally recorded in other comprehensive income to be recorded within other comprehensive income (a process known as backwards tracing). While the update does not permit backwards tracing, is does provide an alternative solution by allowing entities to reclassify stranded tax effects from the Tax Cuts and Jobs Act from AOCI to retained earnings.

Although the reclassification from AOCI to retained earnings is optional, certain disclosures related to the update are required by all firms. All entities must disclose a description of the accounting policy related to income tax effects in AOCI. If an entity elects to reclassify the stranded tax effects from AOCI to retained earnings, it must disclose the following in the period of adoption:

- A statement that an election was made to reclassify the income tax effects from the Tax Cuts and Jobs Act from AOCI to retained earnings.
- A description of other income tax effects related to the application of the Tax Cuts and Jobs Act that are reclassified from AOCI to retained earnings, if any.

If an entity elects not to reclassify the stranded tax effects of the Tax Cuts and Jobs Act, it must disclose that an election was not made to reclassify the income tax effects from AOCI to retained earnings.

Entities may adopt the new guidance using one of the following transition methods: (1) at the beginning of the period of adoption, or (2) retrospectively to each period in which the income tax effects of the Tax Cuts and Jobs Act are recognized. Entities that adopt the new guidance at the beginning of the period of adoption must make the following disclosures in the first interim and annual period of adoption:

- The nature of and reason for the change in accounting principle.
- The effect of the change on the affected financial statement line items.

Entities that elect to apply the new guidance retrospectively must make the following disclosures in the first interim and annual period of adoption:

- The nature of and reason for the change in accounting principle.
- A description of the prior-period information that has been retrospectively adjusted.
- The effect of the change on the affected financial statement line items.

An example of the impact to the financial statements is provided, in which an entity elects to reclassify. Assume that before the enactment date of the Tax Cuts and Jobs Act, a company recognized, in 2016, $10,000 in income related to currency translation gains at a 35% tax rate, resulting in net currency translation gains of $6,500. The company in 2017 also recognized a $2,000 loss due to currency translations at the 35% tax rate, resulting in a net currency translation loss of $1,300. On the enactment date of the Act, the company reduced AOCI by $1,120 and recognized a corresponding increase in income tax expense, equal to the net difference of $8,000 multiplied by 14%, which is the difference between the previous corporate income tax rate of 35% and the newly enacted corporate income tax rate of 21%. Upon adopting the ASU and making the corresponding reclassification, the company would then recognize a one-time reclassification to move the stranded effect of the corporate tax rate reduction from AOCI to retained earnings.

	Common Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Income, Net of Tax	Retained Earnings	Total Shareholders' Equity
Balance at January 1, 2016	$ 500,000	$ 200,000	$ (65,000)	$1,100,000	$ 1,735,000
Other comprehensive income, net of tax	-		6,500		6,500
Net Income	-		-	250,000	250,000
Balance at December 31, 2016	**500,000**	**200,000**	**(58,500)**	**1,350,000**	**1,991,500**
Other comprehensive loss, net of tax	-		(3,250)		(3,250)
Reclassification adjustment - Legislative rate change from 35% to 21%			(700)	700	-
Net Income	-			200,000	200,000
Balance at December 31, 2017	**$ 500,000**	**$ 200,000**	**$ (62,450)**	**$1,550,700**	**$ 2,188,250**

Insights

While the reclassification of stranded tax effects from AOCI to retained earnings permitted by this update is optional, all companies must adopt the ASU. That is, all entities must provide certain disclosures set forth in the update, whether they opt to reclassify or not. An entity that elects to reclassify must disclose that an election was made to reclassify the income tax effects from AOCI to retained earnings, in addition to a description of the other income tax effects, if any, from the Tax Cuts and Jobs Act that are reclassified from AOCI to retained earnings. Because there is no requirement for entities to assess the potential impact of electing the optional reclassification, an entity can simply elect not to reclassify the stranded tax effects. An entity that elects not to reclassify must disclose in the period of adoption that it has not elected to reclassify the tax effects from AOCI to retained earnings.

It is worth noting that if an entity elects to reclassify the stranded tax effects from AOCI to retained earnings, it must do so for all items within AOCI. A company cannot pick and choose certain stranded tax effects to reclassify to retained earnings, while leaving others in AOCI.

Although the reclassification is optional, we anticipate that the benefits of doing so will outweigh the costs for most companies. By reclassifying the stranded tax effects from AOCI to retained earnings, an entity will increase the usefulness of the financial statements by eliminating disproportionate tax effects in AOCI. Reclassification would be especially beneficial to firms in the banking and insurance industries who have significant holdings of available-for-sale securities in other comprehensive income. They would derive the benefit of being able to offset the negative effects of tax reform on their regulatory capital requirements and present financials statements that would allow for proper comparison across industries. However, it is expected that the cost of calculating and reclassifying the stranded tax effects may not justify the benefits for certain companies with complex situations, such as when there has been a business combination. As such, each entity must assess its own unique situation to determine whether to elect the reclassification option.

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Final Thoughts

Entities should apply the amendments in this Update either at the beginning of the period of adoption, or retrospectively to each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs act is recognized.

	Effective Date Public Entity	Non-Public Entity
Interim Periods	Beginning after December 15, 2018	Beginning after December 15, 2018

Early adoption is permitted if financial statements were not issued.

Annual Periods	Beginning after December 15, 2018	Beginning after December 15, 2018

Early adoption is permitted if financial statements were not made previously available for issuance.

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Please look for future updates on other technical accounting matters at www.fidatopartners.com

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