



## **AICPA National Conference on Federal Taxes**

### **FAS 109 Update**

Jeffrey R. Hoops    Ernst & Young LLP    New York, NY

## **Agenda**

- Recent Developments
- Tax Reserves/  
FAS 5 Contingencies
- Interim Financial Reporting
- APB 23

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## **Recent Developments**

- SEC (Green and Nicolaisen) speeches
- SEC Comment Letter on tax contingencies
- Auditor Documentation Issues
- Other: new Schedule M-3, CEO signatures, etc.

## SEC Staff Speech, Dec. 11, 2003

- *In my view, the recognition of the gross amount of a contingent tax asset, whether or not resulting from a tax-advantaged transaction, should be evaluated for initial recognition like any other asset. That is, the company and auditor should conclude that it is at least probable the deduction will be sustained and the temporary difference will truly exist before that asset is recognized in the company's financial statements.*
- Implications on Day 1/Day 2 accounting model
- “Should” = probable?

## SEC Staff Speech, Feb. 11, 2004

- On the adequacy of current tax disclosures:
  - “Sunlight is said to be the best of disinfectants, and the area of income tax accounting could use more sunlight.”
- On the issue of disclosing tax exposure items:
  - “A company's concern about maintaining confidentiality in this area is understandable, but it has to be balanced with the need for the company's investors, analysts, and regulators to gain a clear understanding of liquidity and the financial position and results of operations.”
- On the concern of IRS access to auditor workpapers:
  - “But, at the Commission, our policy has been that the auditor's obligation to report to shareholders on the company's financial statements takes precedence over any request from the company for confidentiality.”

## Recent SEC Comment Letter

- Provide an analysis of all tax reserves recorded in your financial statements, including:
  - The amount of each specific tax reserve recorded and the date it was recorded
  - A description and analysis of the tax issue and the alternative viewpoints underlying each specific tax reserve
  - A complete and full analysis supporting your accounting treatment under FAS 5
  - The amount and dates of any subsequent payments or adjustments to the reserve. As part of your response, explain in detail the facts and circumstances that resulted in the reversal for prior tax years during 2003.
  - The current status of the issues surrounding the reserve

## Recent SEC Comment Letter (Cont.)

- The Company recently closed the IRS audit cycle for the 1997 and 1999 tax years, resulting in a reduction of your tax reserves. For each year, clarify whether you prepared your financial statements and your tax returns using the same assumptions.
- If you have recorded amounts related to potential audits, please explain why you believe it is probable that you will have an unfavorable outcome.
- Please explain to us how you determined that your legal liability has been extinguished for any adjustments to tax cushion amounts recorded prior to settlement of the issue with the IRS.

## **Relevant Audit Documentation Rules**

- Sarbanes-Oxley Section 802, “Criminal Penalties for Altering Workpapers”
- Retention of Records, SEC Rule 2-06
- Evidential Matter, AU section 9326
- SAS 96

## **Implications of New Rules**

- Increased requirements regarding workpaper content and retention
- Increased focus on audit documentation
- Non-compliance could reach to criminal level

## **Evidential Matter, AU 9326**

- **Audit documentation of tax exposure items**
  - Documentation sufficient to enable engagement supervisors and reviewers “to understand the nature, timing, extent, and results of auditing procedures and evidence obtained”
  - Documentation should include either:
    - Actual advice or opinion from third-party advisors (if relied upon by company in preparing its financial statements)
    - Other sufficient documentation or abstracts supporting the facts, the analysis, and conclusions
  - “If it isn’t in the working papers, you didn’t do it.”

## **Summary – It’s Not (Just) About the IRS Anymore**

- **Concern regarding identifying issues for tax authorities may take second place to SEC risk**
  - Increased regulator attention to tax accruals
  - Enhanced public disclosures of changes to tax accruals
  - Enhanced documentation of sensitive issues by independent auditor (and prolonged retention period)
  - Increased IRS access to audit working papers
  - Schedule M-3 and CEO certification

## Schedule M-3 and Form 8858

- Schedule M-3
  - Replaces Schedule M-1 for taxpayers with total assets of \$10 million or more
  - Differences between financial accounting and taxable income become more apparent
  - Intended to assist IRS in:
    - Selecting returns for audit (data mining)
    - Identifying issues that should be of particular interest to examining agent
- Form 8858
  - Information return with respect to foreign-owned disregarded entities and/or true branch operations

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## Levi Is Unable to Verify Reserves

Levi Strauss & Co. (*Wall Street Journal*, Sept. 17, 2003)

- Levi Strauss & Co. said it lacks internal documentation to support six years of tax reserves—believes immaterial.
- Among the allegations made by two employees is that Levi manipulated its tax reserves to improve its results. Levi denies the claim, but conceded that “these tax reserves were not supported by sufficient contemporaneous documentation that related the reserves to specified tax exposures.”
- Levi said its use of the reserves was “communicated to and discussed with the company’s outside independent auditors at the time they were created and maintained,” and that the company and the audit committee take the position that the reserves were “not intended to, and did not, materially affect the company’s SEC-filed financial statements.”

## Income Tax Exposures

Accruals for income tax exposures result from various contingencies, including:

- Liabilities related to permanent differences (deductible vs. nondeductible items)
- Uncertainties related to basis differences
- Legislative and administrative changes
- Negotiated settlement amounts (settled or pending)
- Penalties and interest due to the taxing authorities
- Income allocation issues
- Tax advantage transactions

## Income Tax Exposures – FAS 5

- Accounting for income tax exposures governed by FAS 5
- Estimated loss contingency is accrued if both of the following are met:
  - Information is available prior to the issuance of the financial statements that a liability had been incurred at the balance sheet date (loss must be probable of occurrence)
  - The amount of loss can be reasonably estimated

## Income Tax Exposures – FAS 5 (Cont.)

- If one but not both conditions are met – disclosure
- Likelihood of taxing authority discovery should not be considered
- Presume taxing authority will focus on exposure—presumption continues through expiration of statute of limitations or resolution with taxing authority
- Does ***more likely than not*** opinion the Company will prevail preclude the accrual of ***probable*** loss pursuant to FAS 5?

## How Much to Accrue?

- Estimating amount of contingent loss accruals governed by FASB Interpretation 14
- Best estimate (likely outcome) of a contingency should be accrued
- Accrue minimum amount within a range of loss if single best estimate is not available
- Accrue and maintain detail on an exposure-by-exposure basis
- Weighted average calculation is **not** appropriate

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## Example

Assume Company A has recognized three separate items in its prior-year tax returns, which are currently under examination. Company A has concluded that the taxing authority is likely to disallow a portion of the previous tax deduction. The accrued income tax liability related to the probable adjustments follows:

<u>Exposure Issue No.</u>	<u>Gross Amount of the Permanent Item</u>	<u>Range of Probable Loss (Estimated Exposure)</u>	
1	\$ 1,000,000	\$ 400,000	\$ 600,000
2	1,000,000	500,000	600,000
3	3,000,000	<u>900,000</u>	<u>1,200,000</u>
		1,800,000	2,400,000
Tax rate		<u>40%</u>	<u>40%</u>
Range of tax exposure		\$ 720,000	\$ 960,000

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## **Changes to the Accrual Amount**

- An accrual for income tax exposures should be reversed in the period that either one or both of the conditions of FAS 5 are no longer met
- In the event of a change in estimate, the accrual is adjusted in the period that the change in estimate regarding the liability is determined
- The timing of the reversal or adjustment should occur in the period the underlying event occurs

## **Changes to the Accrual Amount (Cont.)**

Examples of underlying events include:

- A court ruling related to another taxpayer having the same exposure
- The taxpayer agreeing to a settlement with the taxing authority for an amount different from the amount accrued
- The statute of limitations has expired

## Disclosures

- For an accrued tax exposure, disclosure of the nature and amount of the accrual may be necessary
- SEC registrants should disclose material changes and charges to accruals for income tax exposures
  - Consistent with disclosure of material changes in and charges to restructuring and purchase accounting reserves

## Disclosures (Cont.)

If a tax contingency was not accrued, or there is loss exposure in excess of the amount accrued, and there is at least a reasonable possibility that a material loss or an additional loss may have been incurred, the following disclosures are required:

- The nature of the contingency
- An estimate of the possible loss or range of loss or a statement that an estimate cannot be made

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## Interim Reporting Considerations

APB 28, FIN 18 and FAS 109 specify interim reporting requirements for income taxes

- Disclose the reasons for significant variations in the “customary” effective tax rate
- Make best estimate of the annual effective tax rate and apply to year-to-date earnings
- Effective tax rate should anticipate need for valuation allowance against deferred tax assets originating in the current year
- Changes in the valuation allowance against existing deferred tax assets should be recognized in the period of the change in judgment about their realizability
- Effect of a change in tax laws or rates on deferred tax balances should be recognized in the period the new legislation is enacted, even if the change is retroactive

## **FASB and IASB Short-Term Convergence Project – APB 23**

FAS 109 ¶31 and IAS 12 ¶39 include similar language that provides an exception from the recognition of a deferred tax liability for excess book over tax basis of an investment in a subsidiary.

- FAS 109 exception relates to foreign subsidiaries; IAS 12 exception relates to all subsidiaries, foreign and domestic
- Stated goal of convergence project is to reduce or eliminate differences between FAS 109 and IAS 12
- Core issue – whether to make the exceptions similar so simple convergence is achieved, or to remove both exceptions so that convergence and a more principles-based standard are achieved

## **FASB and IASB Short-Term Convergence Project (Cont.)**

- Issuance of FAS 109 in early 1990s
  - FASB concluded that the APB 23 exception is inconsistent with the theoretical balance sheet approach of FAS 109, but that change should occur slowly.
- IAS 12 Development
  - Last July the IASB tentatively voted to eliminate this exception (12-2 vote)—the change in rules is not yet effective.
- FASB Development
  - FASB agreed at its April meeting to further analyze whether the APB 23 exception remains viable.
  - FASB believes APB 23 repeal will have little impact because of the ability to repatriate tax-free.

## Potential Ramifications of Repeal

- Tax basis in shares of CFCs
- E&P and Tax Pool Calculations
- Calculation of residual U.S. and foreign income taxes upon hypothetical distributions/sales
- Implications on tax planning/interaction with Kerry proposal re: deferral and repatriation tax proposals
- Other/business implications