

IBFD Book "Tax Risk Management: From Risk to Opportunity", Editors Anuschka Bakker and Sander Kloosterhof, 2010

Chapter: 3
Tax Accounting

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This chapter is based on information available up to 1
November 2009

1. Introduction

Risk is pervasive in today's business and increasingly stakeholders, even those outside the tax function itself, are recognizing that tax risk management is critical. As you have read in the preceding chapters, there is hardly a business decision or area of an organization that doesn't have tax implications.

The area of financial reporting is no different. Financial reporting is not a new area of business operations impacted by taxes. Companies, particularly those that are listed / publicly-traded, have historically been obligated for one reason or another to report financial results whether to investors, creditors, or otherwise. And taxes have indeed always occupied lines on the balance sheet, income statement, and impacted the cash flow statement, the statement of changes in equity, and disclosures, and have therefore always been part of the financial reporting process. However, this component of financial reporting that was once "under the radar" relative to financial instruments, revenue recognition, and other complex areas of financial reporting has in recent years been shoved into the spotlight. It has come to the attention of regulatory bodies, auditors, and - as a result - the highest level of management and decision makers within companies.

Before delving too far into the "who's", "why's", and "how's", a bit more definition should be given to what tax risk in the context of financial reporting really means. First, we should clarify what we mean by "financial reporting" and "taxes". "Financial reporting" in this Chapter refers to accounting and reporting under International Financial Reporting Standards ("IFRS") and United States Generally Accepted Accounting Principles ("US GAAP"). Specifically, we will focus in this chapter primarily on "income taxes", the standards and related interpretations and guidance of International Accounting Standard ("IAS") 12 and Accounting Standards Codification ("ASC") 740 (formerly known as Financial Accounting Standard ("FAS") 109)¹, respectively. Nearly every country has its own particular brand of local GAAP; however, this discussion focuses on IFRS and US GAAP since these are the most widely used financial accounting standards globally, especially as countries around the world continue to convert to IFRS. "Taxes", for purposes of this chapter, primarily refer to corporate income taxes as defined by both IAS 12 and ASC 740. Both standards generally define income taxes as taxes imposed on revenues less expenses. This Chapter does however also briefly touch on certain financial reporting implications of Value-Added Tax ("VAT") and other indirect or non-income-based taxes since such taxes are significant to many companies operating globally.

Having defined "financial reporting" and "taxes", what exactly is meant by "tax risk in the context of financial reporting"? First, there is the risk of incorrect financial reporting of income taxes - namely, the risk of the numbers reported in the tax accounts and related disclosures of the financial statements being materially wrong. IAS 12 and ASC 740 and their related interpretations and guidance prescribe numerous rules around the accounting for and presentation/disclosure of income taxes that can sometimes seem counterintuitive and so require very involved, technical calculations and analyses. Add to this the complexities of tax law as well as time and resource constraints within the Tax and/or

¹ In 2009, the Financial Accounting Standards Board ("FASB"), which is the US body that governs US GAAP, undertook a codification project to organize all US GAAP accounting standards and related guidance into a uniformly referenced structure. The new structure, indicated by "ASC", became effective for interim and annual financial reporting periods ending after September 15, 2009, and as from this date, all references to US GAAP standards and related guidance included in US GAAP financial statements must use the new ASC reference. Note that the ASC structure did not change the underlying accounting texts, only the way in which it is organized and referenced.

Finance Departments of an organization, and the possibility of incorrectly reporting income taxes in the financial statements becomes a very tangible risk. Second, there is the way in which risk associated with income taxes - the risks identified in the previous chapters - is specifically accounted for under IFRS or US GAAP. For example, how should a company account for the potential tax impact of an aggressive position taken on a tax return or a complex transaction for which the tax implications are not fully clear in the tax law? If you've heard of an "uncertain tax position" or "FIN 48", then you probably already have a sense of the complexities of this area.

While there are clear overlaps of the above two tax risk considerations, there is also a clear distinction - the first consideration is the risk itself associated with financial reporting of income taxes whereas the second consideration addresses how to account for an organization's tax risks under the applicable financial reporting standards. Because of this distinction, this Chapter will discuss these two considerations separately.

2. Part I - Risk of incorrect reporting of income taxes in the financial statements

2.1. Overview

What makes the calculation and reporting of income taxes under IFRS and US GAAP such a risky business? As alluded to previously, a number of factors usually combine to make financial reporting of income taxes very high-risk. The driving force of the risk is primarily attributed to the *technical* complexity of the calculations and analyses prescribed by IAS 12 and ASC 740, which is further exacerbated in jurisdictions where the tax law is also very complex. This complexity then drives other factors, specifically *operational* factors such as the following, that further increase the risk if not adequately addressed:

- The need for personnel competent in both financial accounting rules and local as well as international income tax law.
- The need for detailed data, often on a separate-entity basis in consolidated group scenarios.
- The subjectivity of certain analyses which then requires judgement calls and often management representations.

- The need for sufficient time to finalize calculations and analyses including assessments of tax considerations related to last-minute pre-tax accounting changes or complex business transactions
- The need to coordinate information and processes across departments and jurisdictions, particularly in the case of large multi-national companies ("MNCs")

A glitch in any of the above *operational* areas can result in improper reporting of income taxes in the financial statements and if severe enough, mistrust on the part of investors, creditors, and other stakeholders who rely on the accuracy of the information in the financial statements. Indeed, the risk and the stakes are high.

2.2. Complexity and pervasiveness equals risk

2.2.1. IAS 12 and ASC 740 overview

To better understand the complexity behind the income tax accounting standards that drives the financial reporting risk, we should naturally first spend some time discussing the standards themselves - IAS 12 and ASC 740 - and their impact on the financial statements.

In general, from an overall principles and conceptual standpoint, IAS 12 and ASC 740 are very similar. Both standards require that the financial statements reflect current income taxes and deferred income taxes. To give a brief definition of each:

- Current income taxes are income taxes currently due to or receivable from the tax authorities in respect of the taxable profits (or losses) of the period.
- Deferred income taxes represent the future income tax consequences of activities and events that are reflected in the current or prior years' financial statements.

The differentiation between current and deferred income taxes is very important because it lends to the complexity of income tax accounting. Take a closer look at IAS 12 and ASC 740, and you'll find relatively little discussion regarding current income taxes. This silence in the standards is acknowledgement that the current income tax amount reported in the financial statements is governed by local tax laws and rules, not rules or

calculations prescribed by international accounting standards. While it may be the case that the current income tax calculation is difficult due to the complexities of the applicable local tax laws, this calculation is still generally regarded as straightforward from a financial reporting perspective, since someone in the company - the person(s) responsible for preparing the income tax return - should generally know how to accurately make this computation. Further, current income taxes are normally calculated and audited as part of local statutory reporting requirements, so even smaller companies or subsidiaries should already be equipped to handle this calculation (putting aside consideration of the impact, if any, of uncertain tax positions, which will be discussed at more length later in this chapter).

The deferred income tax calculation, on the other hand, is a concept heavily grounded in the principles and requirements of IAS 12 and ASC 740, and requires not only knowledge of these standards to properly compute deferred income taxes but also requires a general understanding of common pre-tax accounting standards as well as international and local tax law. Another implication of deferred income taxes is that a taxable loss in a given year doesn't relieve a company from performing an income tax analysis for financial reporting purposes. Even though no taxes may be currently due to the tax authorities, there are still activities and events that occur in a given period, including generation of the tax loss itself, which must continue to be accounted for under the IFRS and US GAAP income tax frameworks.

There are other elements of accounting for income taxes under IFRS and US GAAP that are worth mentioning to give additional insight into the complexity of the analyses and calculations involved.

2.2.1.1. Recognition of deferred tax assets

Recognition of deferred tax assets is an assessment that is relevant for many companies, and is one of the key analyses that is often particularly scrutinized by financial statement auditors and regulators. While a company may be entitled to a future tax deduction or other tax benefit, it's not necessarily the case that the company will ultimately realize such benefit. IAS 12 and ASC 740 have very similar approaches in the determination of the amount of recognizable deferred tax assets. Both dictate that if there is a greater than 50% probability that all or a portion of a deferred tax asset cannot be

realized, then no net deferred tax asset should be recognized in the financial statements. ASC 740 requires a valuation allowance - a contra-asset - to be established against the deferred tax asset to reduce the asset to its net realizable value. IAS 12 requires recognition of the net realizable deferred tax asset only without mention of a contra-asset account. This difference, however, is generally a difference in terminology as the net deferred tax asset determined under the criteria of both standards is generally expected to be the same.

A common example of deferred tax asset recognition called into question is with respect to tax loss carry-forwards, particularly those that expire within a finite period of time. If a company has tax loss carry-forwards but does not expect to have sufficient future taxable profits against which to utilize the tax loss carry-forwards the company likely should not record a net deferred tax asset for those tax loss carry-forwards. The key to this analysis is future taxable profits (or as you will see, taxable profits in prior year(s) where applicable). Both IAS 12 and ASC 740 provide similar considerations in this respect:

- forecasted future profits;
- future reversals of taxable temporary differences (tax-effected these are deferred tax liabilities. As you may know or have already guessed, these are future taxable amounts - the opposite of deferred tax assets);
- tax planning strategies that could be implemented to generate taxable profits in the future; and
- income in prior tax years where carry-back of tax losses is permitted under the local tax law.

It is also important to highlight that these same criteria apply to all other deferred tax assets as well. Deferred tax assets related to other deductible temporary differences, such as reserves, should also be assessed for future realizability.

While it may seem straight-forward enough to attach a "Yes", "No", or "Not Applicable" and a figure to each of the points above, great care should be taken in analyzing a company's future profit position. And moreover, this analysis should be thoroughly documented. It is important to consider such questions as:

- How reliable is the future profits forecast? Has the company recently been in a taxable loss position, and if so, what facts and circumstances exist to indicate that the company will be profitable in the future?
- Will all of the deferred tax liabilities (if any) reverse within the same periods as the deferred tax assets? Are there any deferred tax liabilities that relate to long-lived or indefinite-lived assets or liabilities that aren't expected to fully reverse until long after existing tax attributes have expired?
- Is the tax planning strategy (if any) a feasible strategy? What are the operational and other business impacts of implementing such strategy? Will the company be willing to take such action?

In addition, a deferred tax asset recognition analysis usually must be done on a taxable entity by taxable entity basis and can be further complicated by fiscal unity situations or special tax rules such as the group relief mechanism in the United Kingdom. Needless to say, there are a number of considerations to be made and in most cases these considerations are very subjective. No objective, "bright line" tests are set forth in the standards to make the determination. Therefore, there is greater risk of coming to a conclusion that may not be accepted by the financial statement auditors or regulators. Companies are often biased in this analysis since very few are eager to not recognize deferred tax assets or to postpone recognition of deferred tax assets. Financial statement auditors and regulators understand this natural bias and therefore require a thoughtful and well-supported analysis.

2.2.1.2. Special topics

There are a number of special topics within income tax accounting that can be very complex. By using the term "special topics" it is not to imply that these topics are rare. In fact, many of these topics are relatively common. Particularly:

- purchase accounting in the context of business combinations;
- outside basis differences;

- share-based payments;
- intercompany transfers of assets;
- uncertain tax positions; and
- intra-period allocation (US GAAP only).

It is not the intention of this chapter to discuss the technical aspects of each of these items in detail or to suggest that this is a comprehensive list of all areas that you should consider in your risk analysis. However, we have singled these out as these are areas in which we have seen a number of issues arise, because of the highly technical nature of these topics as well as the magnitude of the figures often involved. Common issues encountered include:

Purchase accounting: determining the tax accounting impacts of goodwill itself as well as understanding when income tax accounting implications of a business combination should be recorded through goodwill versus income tax expense.

Outside basis differences: in jurisdictions where there is no possibility to fully exempt dividends (or distribution of net equity, whether positive or negative) from income taxes, determining the amount and timing of all possible future distributions for the purposes of making the deferred tax impact analysis.

Share-based payments: implementation and proper execution of recharge agreements, which if not done appropriately may result in both unfavourable cash tax and income tax accounting consequences. In addition, general understanding of both the current and deferred tax accounting is often weak especially due to a lack of understanding/information regarding the particulars of local tax treatment of stock-based compensation. This is further exacerbated by the often significant data requirements where analyses should be performed on an exercise-by-exercise basis, etc.

Uncertain tax positions: determining provisions for income taxes in line with the guidelines dictated by the standards. Often, a "gut feeling" approach is used, which may be reasonable and pragmatic from a company's view, but not in accordance with IAS 12 or ASC 740. This topic will be addressed in more detail in Part II of this chapter.

Intercompany transfer of assets (US GAAP): awareness of the special rules, which are generally regarded as unintuitive and therefore are often overlooked. This is primarily the case where the income tax consequences of intercompany asset transfers are assessed for local tax purposes immediately upon transfer rather than deferred until the asset in question is transferred to an unrelated party.

Intra-period allocation (US GAAP): similar to intercompany transfers, awareness of the special rules, which are generally regarded as unintuitive and therefore are often overlooked. Intra-period allocation dictates the income tax accounting treatment of the impacts of items outside of continuing operations, e.g. - other comprehensive income ("OCI"), discontinuing operations, additional paid-in capital ("APIC"), etc. This can be relevant for pensions and unrealized gains/losses where part or all of the accounting is reflected through OCI, stock-based compensation where part or all of the accounting is through APIC, etc.

2.2.1.3. Interim reporting

To further add to the complexity, IFRS and US GAAP have special requirements and calculations for interim period (i.e. quarterly or semi-annual) reporting. To understand the reporting requirements for income taxes under IFRS and US GAAP, IAS 34 and ASC 740.270, respectively, must be referred to. Again, the IFRS and US GAAP standards are quite similar in overall concept and approach. Interim period tax accounting generally requires an estimated annual effective tax rate approach where a company must estimate its effective tax rate for the year and apply this estimated effective tax rate to year-to-date pre-tax IFRS or US GAAP income to determine year-to-date tax expense. Where there are special transactions or adjustments made in an interim period that are not appropriate to forecast (as discussed more specifically in the above-mentioned guidance), these items should be reflected discretely in the period.

When considering all of the above, it becomes clearer that the impact of income taxes upon financial reporting extends beyond a few accounts on the balance sheet and income tax expense on the income statement. Indeed, income taxes can be found in the statement of changes in equity, the cash flow statement, footnote disclosures and on and on. Income taxes also impact upon financial metrics, perhaps most notably earnings per share, on which investors and creditors base decisions.

The stakes are high. The potential of an error in accounting for income taxes to affect multiple areas of the financial statements or the risk of omitting certain required information altogether is very real.

2.3. Consequences

The consequences of a significant error in the financial reporting of income taxes can be severe. Usually the primary concern on the mind of the CFO and down the financial chain of command is a restatement of the financial statements to correct the current period and applicable prior period figures. A restatement is a problem for many obvious reasons. It indicates to investors and other stakeholders that the financial information they're using (or may have already used) to make decisions is wrong. It requires additional manpower and company resources to work through the restatement process to reissue corrected financial statements. It signals a deeper problem in a company's internal controls over income taxes and/or other areas of the finance functions. This is particularly critical for publicly-traded U.S. companies and other Security Exchange Committee ("SEC") registrants, which are required to have an audit opinion on both the financial statements and internal controls. All of these work to damage the reputation of a company, which can lead to a drop in share price, reduced credit lines, pull-out of investors, etc. In addition, there will be increased scrutiny from the auditors and regulators moving forward, which will require more man-hours to address in the form of more time spent documenting key decisions and calculations and more time spent interacting with the auditors. Another by-product of this increased scrutiny is increased audit scope and therefore increased audit fees.

The previous pages indicated the technical complexity of financial reporting of income taxes under IFRS and US GAAP and the dire consequences of getting it wrong. But is it enough for a company to hire an IAS 12 or ASC 740 expert and/or purchase a state of the art software solution that can perform the needed calculations based on basic data input? Unfortunately, the answer is an emphatic "no". While employing a technical expert, be it human and/or machine, in financial reporting of income taxes can mitigate the risk of errors in the technical calculations and analyses, operational limitations must still be addressed and solved. In the coming sections, we will set the scene of financial reporting of income taxes in today's Tax Department and discuss the challenges and

risks faced in this environment. Finally, we will conclude Part I with tools and suggested approaches that can be used to manage the risks of financial reporting of income taxes.

2.4 Today's tax department

The Tax Department within an organization can take on many shapes and sizes. A Tax Department may not be a "department" at all - it can be an outside consultant hired to handle the annual income tax compliance obligation of a company. On the other end of the spectrum, a Tax Department can be a fully-fledged department with 10's if not over 100 dedicated personnel globally at both the headquarter and business unit or subsidiary levels.

Of course, key factors that determine a Tax Department's structure are generally the size and geographical footprint of the company. Whether a single entity doing business in one country or a large MNC with subsidiaries and operations all over the world, nearly all businesses have tax filing obligations with the local tax authorities. This of course calls for ongoing tax planning to understand the global cash outlay to the tax authorities, which most Heads of Tax consider (or once considered) their primary responsibility within the Tax function. Many of these companies, particularly the larger companies that need third party investment and financing, will have financial reporting obligations. A Tax Department's involvement in the financial reporting of income taxes under IFRS or US GAAP can also vary widely from company to company. In some cases, the responsibility is shared by both the Tax and Finance functions where the Tax Department is responsible for determining the global current income tax position and the Finance/Accounting group deals with the deferred income tax calculation and other IAS 12 or ASC 740 implications. In other cases, the Tax Department is responsible for all aspects of financial reporting for income taxes.

Given the numerous possibilities of what constitutes a Tax Department and its responsibilities with respect to financial reporting of income taxes, we will focus our discussion on two scenarios that we most commonly see in practice in the European context. We will first discuss a European-headquartered MNC with subsidiaries and other operations in various countries around the world. Then, we will discuss the scenario of a European group of entities that are subsidiaries of a US publicly-traded

company. Many of our readers may identify with one scenario or the other, but it is also quite possible that they will find that their situation is in fact a combination of the two.

2.4.1. European headquarters - Scenario 1

There are certainly a number of Tax Departments in Europe faced with the headquarter scenario. The Tax Department within the parent company of a large MNC is responsible for income tax accounting under IFRS for the entire worldwide group. This responsibility, which in the "early days" following IFRS adoption was generally dealt with by the consolidation accounting team in the Finance Department, has now been placed in the hands of the Tax Department in the company's efforts to ensure that oversight and ownership of the financial reporting of income taxes belongs to the department with the income tax expertise.² This seems to make sense from an internal controls perspective, which the company is in the process of addressing within the organization at the insistence of its auditors.

The Tax Department at headquarters ("HQ") is a small team and all - from the Head of Tax down to the recently-hired consultant - primarily have tax law and consulting backgrounds, with the exception of the VAT specialist. Globally, there is generally one Tax Manager specialized in local tax law in each of the largest foreign subsidiaries who is responsible for the tax affairs of that entity. In the smaller subsidiaries, it is normally the local finance personnel such as the local controller who is responsible for the tax affairs, whether they are handled internally or outsourced to a local tax firm. None of the local Tax or Finance personnel at the subsidiary level is up-to-speed on income tax accounting under IFRS. The HQ Tax Department, however, has spent many days and weeks of seminars, outside reading, and on-the-job trial and error to improve the quarterly and year-end income tax financial reporting process. They have likely developed a tax reporting package in Microsoft Excel that they require to be completed by the local tax personnel responsible in each of the foreign subsidiaries on an annual basis. The tax packages are generally local tax-oriented, requesting such items as an estimated current income tax calculation for the year, tax payments made during the year, a schedule of tax loss

² Partly also because IFRS drives more and more cash taxes as well, especially in the jurisdictions where IFRS can/should be used for statutory accounting.

carry-forwards, status of tax authority audits, changes in local tax laws, etc.

It's the middle of the year-end financial reporting close process. Technical complexity of IAS 12 aside, what operational challenges are likely being faced by HQ Tax Department?

Local Tax Packages: All but two tax packages have been submitted by the local Tax personnel. Upon a high-level review of the tax packages a number of questions arise. For example, a few of the packages indicate ongoing tax authority audits where potential adjustments have already been communicated, though informally, by the tax auditors. Additional questions must be asked and possibly calculations made to determine the need for a provision for uncertain tax positions and how much to record. For the two packages that were not received, the local controllers responsible for submission of the tax packages indicated that an accurate current income tax estimate for the year could not be made because the local GAAP accounts on which the income tax calculation is normally based were not up-to-date at the time. While the local GAAP accounts have since been updated, the local controllers indicated that they cannot prepare the tax packages because they are now in the middle of the year-end close process for other areas of the financial statements and no longer have time to address income taxes. The entities in question are not the most material entities of the Group but are considered middle-tier and can have a significant impact in aggregate.

2.4.2. HQ income tax calculation and consolidation

Now the HQ Tax Department is faced with a number of tax packages to sort through. In addition to the two that were not submitted, there will inevitably be tax packages that are not adequately or correctly completed or that are poor in quality of information. The packages will most certainly require follow-up with the local tax personnel responsible and all of the back-and-forth communication required to understand the issues and to resolve them. At the same time, the HQ Tax Department is requesting information from Human Resources, and the Finance Department, including the Fixed Asset Group, to obtain information needed in the HQ jurisdiction deferred tax calculation. While the HQ Tax Department relies heavily on the equity reconciliation for its deferred tax calculation, it recognizes that the reconciliation does not capture the deferred tax consequences of local income tax treatment in several significant cases such as fixed

assets, stock-based compensation, and certain provisions. Additionally, in looking at the latest version of the consolidating income statement, the HQ Tax Department noted some unusual adjustments in the elimination of an entity for which they needed to contact the Finance Department to discuss further. Later, it was determined that these entries were the result of the last-minute liquidation of a smaller entity in the group into its immediate parent. When the tax package of the liquidated entity as submitted by the local controller was referred to, there was no indication that the entity had been liquidated and that the local income tax consequences were considered. Here is another follow-up item. And the list goes on. In general, operational/practical challenges at the HQ level can be categorized into the following:

- managing the volume of information and calculations;
- communication within the organization (across departments and time zones) related to specific transactions, information requests, and follow-up items;
- consolidation/intercompany issues; and
- timing of close.

Considering these operational challenges in conjunction with the already technical nature of financial reporting of income taxes under IFRS, the possibility for errors is enormous. Of course it is not feasible within this Chapter to list every single possible challenge that may arise during the year-end or interim period financial close process. But there are a number of fundamental questions that should be addressed to minimize the risk of error in the financial reporting of income taxes from an operational perspective. In the context of the scenario above, the HQ Tax Department should ask itself:

- How can we minimize surprises related to discovering such issues as business transactions with tax impact and pending tax authority audits during the close process?
- How do we monitor the timely and complete submission of the tax packages? If the Finance personnel at the local level are not cooperative or need guidance to prioritize income tax vs. non-income tax financial statement close tasks, who within the organization

is responsible for managing (and dictating to, as needed) the local Finance personnel?

- Is it appropriate to consider deferred taxes only at the consolidated level? What about push-down accounting? How can we get comfortable that all deferred tax items have been captured?

2.4.3. US subsidiary - Scenario 2

Now consider the case of a European subsidiary of a US publicly-traded company. The challenges faced by European subsidiaries of US companies are in many ways very similar to those faced by European-headquartered companies, particularly where there is regional oversight function - i.e., the European regional headquarters of a US company is responsible for the review and sign-off of US GAAP financial reporting of income taxes for all European entities/operations. This is a common case where the US has got into trouble from an internal controls perspective in the area of income taxes and is implementing a new process around financial reporting of income taxes globally to remediate the internal control problem. This new process often involves ownership of the US GAAP income tax accounts to be taken primarily at the local subsidiary level supplemented by a regional review, even though it is usually well known that there is minimal if any US GAAP tax accounting knowledge at the local and even regional levels. To compensate for this, the US Tax Department rolls out a robust monthly/quarterly/annual tax accounting process globally. This process includes a Microsoft Excel tax package that must be completed annually as well as tax accounting software that must be updated each quarter and include working paper attachments supporting the calculation entered into the software. These tax packages and calculations included in the software must be formally signed-off by the local and regional personnel. Understanding the lack of expertise and experience in US GAAP tax accounting at the local and regional levels, the US Tax Department develops a comprehensive web-based training session on the process and the software tools. It also makes an effort to travel to each of the regions to hold live training sessions where the tax personnel in each of the regions and local subsidiaries within those regions can learn in an interactive setting. Long e-mails with detailed instructions on timelines, reminders, special issues, etc. are sent each quarter to the local and regional tax personnel to reinforce the process. While you would be hard-pressed to find anyone to call this process "dummy-proof", some may agree that on paper

the US Tax Department has established a generally successful process that enables the local Tax and Finance Departments to own the figures in the US GAAP income tax accounts.

The stakes in this scenario are significantly higher at the local and regional levels. While in the European HQ scenario discussed earlier, the local personnel were responsible for current taxes and information items, here the US parent expects a full-blown income tax provision calculation in compliance with ASC 740. This means that all of the special rules related to deferred taxes and treatment of special items such as business combinations, unrealized gains and losses, and intercompany asset transfers, must be correctly accounted for at the local level. Then the time factor must be considered. A publicly-traded company in the US has a very short window at the quarters and year-end to file its audited financial statements with the SEC. This of course means that there is immense pressure to complete the income tax accounting in a very limited amount of time, especially related to the foreign reporting since the US HQ team must then perform a top-level review and consolidation of the worldwide income tax accounts.

The processes put into place to stream-line and standardize the financial reporting, though well-intended, add to the local controllers' frustrations and the time needed for the close. The tax accounting software required to be populated by the local controllers is considered by many local controllers to be US-centric and does not, in their view, seem to be conducive to efficient use in a statutory accounting environment where there is an intermediary step to derive the tax figures. Similarly, the year-end tax reporting packages developed by the US Tax Department that must be completed in conjunction with updating the tax software are also considered to be US-centric. Much time is spent by the local controllers to fit their calculations and circumstances into the US templates and software. In addition, there are transactions that have been historically accounted for and addressed from an income tax accounting standpoint "top-side" at the US HQ level. The income tax accounting effects were pushed-down to the local entity level during the year, but minimal explanation was given to the local controllers in terms of how the figures were calculated and what the underlying technical analysis is. Other adjustments to the income tax accounts, perhaps related to a valuation allowance or provision for tax contingencies, were made by the US HQ Tax Department in the prior year following

their overall review. These adjustments were probably made in the last-minute rush of the HQ close and were booked in consolidation due to lack of time and the fact that the local books were already closed at that stage. They were pushed-down to the local entity in the course of the current year, but again minimal explanation was provided. Given the clear responsibility of the local and regional teams to own the figures in their income tax accounts, such a disconnection in the process is understandably discouraging. And while communication is a joint effort, it can be easy for a local controller to lose track of an unfamiliar entry.

2.5 Risk mitigation

Despite the "doom and gloom" impression you may have received from the preceding pages around financial reporting of income taxes, there are indeed ways to mitigate the risk and to organize the Tax Department to effectively and efficiently handle the financial reporting requirements. The strategies may be common sense, and yet time and time again we see Tax Departments struggle under their financial reporting responsibilities because they continue to take a reactive rather than proactive approach from reporting deadline to reporting deadline and simply keep hoping that things will improve next time because they are trying harder.

Meeting the needs of financial reporting of income taxes is really no different than adapting to any other new responsibility handed to a department. It's about identifying the task, developing a plan of action, identifying the resources and skills needed, identifying the tools to help in the process, setting goals and milestones, and sticking to it all! Sounds easy? It's not. You would think that the hardest part of the process should be the technical financial reporting itself, but it is dealing with the internal politics and budgetary constraints of getting the Department what it needs to get the job done that can be the true culprits behind poor financial reporting of income taxes.

2.5.1. Internal controls

It is easy to dismiss internal controls around financial reporting of income taxes. Indeed we hear it all the time - it's extra work, especially where the stringent documentation and testing requirements of SOX 404 must be met each quarter. But the intention of internal controls is good and can help an organization - be it at the headquarters or subsidiary levels - to identify holes in

current processes or ways to improve them and clarify who has ownership over those processes. Of course it's no fun to have an auditor checking your working papers to see if there are tick-marks, margin notes, and other evidence that a calculation was reviewed. However, a sincere review of the processes for the purposes of constructively critiquing and improving them can only be beneficial, as opposed to simply going through the motions of review to satisfy a SOX requirement.

2.5.2 Standardization

Standardization, if implemented and utilized correctly, can be a very useful tool to mitigate risk in the financial reporting of income taxes. Checklists can be used as a means of facilitating a minimum level of completeness of an income tax provision calculation. For example, a checklist that lists main issues to consider or a checklist that indicates the schedules to be completed and supporting documentation to be provided. Standardized tax packages create a familiar platform on which figures can be consistently input and reported period after period. Such standardization is also useful from a review perspective where the reviewer doesn't need to spend time and brainpower becoming familiar with different tax packages and the way in which the packages calculate or present the final information requested based on the particular preferences of the preparer.

However, there is risk in the use of standardization itself. Standardization should not be used to replace analysis. The same standard checklists and tax packages that can be a helpful to promote efficiency and a consistent work product should not be relied upon as a comprehensive set of instructions or assumed to represent a perfect template free of exceptions. In other words, standardization should not be used to compensate for lack of technical knowledge and experience. The pitfalls of doing so should be clear. A local controller with minimal knowledge of accounting for income taxes is likely to only consider the items on the checklist and input the minimum required fields in a template if there is no understanding of the purpose or the end result of what he/she is doing. There is no comfort that all issues have been considered and that an overall "sense check" has been performed. Understanding that local tax personnel often are not truly competent in accounting for income taxes, standardization in conjunction with ongoing training can be a powerful tool to improve the quality of income tax accounting across an organization.

2.5.3. Personnel training

Personnel training is another area of risk mitigation that may seem obvious and yet so many companies don't invest enough in it both at the local and HQ levels. It only makes sense that those responsible for the financial reporting of income taxes should receive the proper technical and practical training needed to sufficiently fulfil their responsibilities. It is certainly not to say that accounting for income taxes is a proficiency that can be acquired overnight or that one training session or even a series of sessions will result in a local controller who is fully competent in income tax accounting. However, continued training is the only way short of hiring the required skillset, to equip the tax personnel with the information they need to be accountable for the figures in their income tax accounts.

2.5.4. Technology

Technology, similar to standardization, is useful if implemented and utilized correctly - meaning that technology is a useful tool if the expectation is just that - that it's a useful tool, not a one-click solution. Technology can be very useful for data-gathering and certain automation, such as pulling relevant data directly from financial systems into the tax provision calculation. Software can easily organize and manipulate large quantities of data that would otherwise be nearly impossible to deal with manually in an accurate and efficient manner. This is useful in consolidations as well as performing analytics using certain report functions. Appropriate software provides for comfort over mathematical accuracy and consistency in presentation.

2.5.5. Interim period and year-end strategies (e.g. preliminary hard close process)

Even with a very thorough and consistent training effort, it is not realistic to expect that local controllers with limited tax law knowledge or Tax Managers with limited IFRS or US GAAP accounting experience will be as proficient in IAS 12 or ASC 740 as a dedicated tax accounting specialist at HQ. Certainly, they can and should continue to learn and the resulting income tax provision calculation and issue-spotting should continue to improve over time. In light of this experience gap, however, the best ally a company can have is time. Even where very experienced and knowledgeable personnel are involved in the process, time is still an obvious benefit

to any close process. Time to perform a thorough review, time to resolve technical issues, time to ask questions and gather additional information - more time allows for more thoroughness that can make the difference between a correct and incorrect income tax provision. More time removes much of the element of surprise, of being caught off-guard by issues that should have and could have been raised and resolved prior to the close process. But how can more time be added to a close process that has a set, limited window between the close of the financial year and the final filing date of the financial statements?

More and more companies are buying themselves precious extra time in the close process by performing a company-wide early hard-close income tax provision. That is, performing the full-blown income tax provision calculation and going through all of the processes of a year-end financial statement close, but prior to year-end based on 10-month (for example) financial accounting and income tax figures. Rather than a calendar-year company waiting until January to perform the year-end tax provision calculation, the process in this case is started in November based on January through October figures. This allows for the time to perform the reviews and address and resolve the issues that so often are rushed during the normal year-end close process and cause further delays and headaches. Then the close process in the following January becomes more of an update/roll-forward exercise where the income tax provision is updated for the final 12-month figures and only the transactions and events of the last two months of the year need to be reviewed. This approach can be critical to achieving an accurate and timely close, particularly since any issues that arise during true year-end close will require time of the HQ and the local controllers that is already stretched thin by other demands such as the tax consolidation at the HQ level or completing the year-end close for non-income tax areas for the local controllers. Therefore, it goes without saying that the earlier income tax provisions can be worked through, the better.

2.5.6. Outside resources

It may seem self-serving that we, as income tax accounting consultants, discuss the use of outside resources such as income tax accounting consultants as a tool to improve a company's processes and output around the financial reporting of income taxes. However, the reasons to work with outside consultants specialized in IAS 12 or ASC 740 are nearly the same as those for

assessing the tax implications of a complex business transaction or even preparing tax returns. The right outside consultants have specialized knowledge, previous experience, and a wide network of resources. Outside consultants working closely with the local tax personnel, whether preparing the income tax provision calculations and analyses or reviewing them or a combination thereof based on risk factors, lends to more accurate income tax provision calculations and a more efficient process.

This is not to say that hiring outside consultants is a complete solution to improving a company's financial reporting of income taxes. Data gathering, understanding company history, internal coordination between departments, etc. are among many vital roles of a Tax Department. In addition, company personnel in the context of internal controls must be knowledgeable enough and involved enough to still take final ownership of the figures in the income tax accounts. Outside consultants should therefore be viewed as a key tool in the process rather than as a total solution. Like the other tools we've discussed above, outside consultants can be instrumental in improving the technical analyses around accounting for income taxes.

2.6. On the horizon

Around the globe there are more and more countries converting or planning to convert from their local GAAP to IFRS as the primary accounting framework for statutory accounting. The US is among these countries. In 2009, the SEC issued a "Roadmap" in which it set forth a tentative plan, including timing, of conversion from US GAAP to IFRS for all US publicly-traded companies. While this Roadmap is only a tentative plan subject to comments and amendments, it nonetheless indicates the SEC's and the FASB's initiative to move toward conversion to IFRS. As additional evidence of this initiative, the FASB and IASB have engaged in a number of convergence projects in an effort to converge certain FAS (now ASC) and IFRS standards. The Roadmap indicates 2011 as a key milestone year. The Roadmap proposes that the conversion becomes mandatory for publicly-traded US companies (large accelerated SEC filers) for fiscal years ending on or after December 15, 2014. This timing for most companies may still seem far enough in the distance to push the project to the bottom of the priority list; however, the Roadmap also indicates a requirement to have two prior years of comparative financial statements under IFRS in the year of conversion. Therefore, a company that converts in 2014 would be required to begin its books and

records and internal accounting controls with respect to IFRS reporting for all three years of audited financial statements that would be required in its first year of IFRS reporting (e.g. 2012 to 2014 for large accelerated SEC filers)³. Add to this the potential change to IAS 12 itself vis-à-vis the Exposure Draft issued by the IASB in 2009, and the conversion to IFRS may be that much more complex.

Perhaps for most Tax Departments of US companies, it is not yet time to lose sleep over the conversion from US GAAP to IFRS and what this means to income tax accounts and related financial statement disclosures. But now is now the time to start thinking about the impact of the conversion – from a technical standpoint (for example, what does it mean to convert from accounting for income tax contingencies under ASC 740.10.50 to IAS 12, specifically the new IFRS governing accounting for income taxes?) as well as from a process perspective and cash tax perspective⁴.

3. Part II – Accounting for income tax risks in the financial statements

3.1. Overview

As mentioned in the previous chapters, income tax risk itself is not necessarily bad. Every organization has its own level of risk tolerance and aversion which it manages, for the most part, through its tax planning. This planning and cash tax management in general previously was the primary responsibility and objective of the Tax Department. Obviously managing cash taxes remains very important, especially in recent economic times, however, the “fun” and ingenuity of tax planning has arguably been dampened by the restrictions of financial reporting. Reducing current taxes through the use of aggressive tax planning may save on current cash taxes but may be no help to the effective tax rate and overall IFRS or US GAAP income tax expense.

Tax planning has become a delicate and cautious matter because any tax risk built-in to tax planning has a relatively good chance of washing out in the financial statements. What does this mean exactly? The fundamental principle is that no benefit should be recognized in the

³ Securities and Exchange Commission, RIN 3235-AJ93.

⁴ The move to IFRS is, for a large number of US MNCs, already impacting ongoing cash tax as in quite a number of jurisdictions it is already allowed/mandatory to apply IFRS for statutory accounting.

financial statements for tax positions taken (or expected to be taken) that are not expected to ultimately be accepted by the tax authorities, whether the tax authorities have knowledge of the position or not. And to add insult to injury, as some companies might see it, such tax positions must be disclosed in the footnotes to the financial statements. A common complaint of many Heads of Tax is the transparency required by IFRS and US GAAP with respect to uncertain tax positions. The required disclosures in the financial statements are viewed as a roadmap that can be used by the tax authorities to identify areas of risk or uncertainty that they can then focus on in order to drive assessments.

The reporting requirements are such that tax planning and tax risk are no longer primarily cash management driven - the impact upon the financial statements must also be heavily considered. Of course there is much more colour and qualification to add to this fundamental principle, and the remaining part of this Chapter will discuss in more detail the applicable rules and requirements - and consequences - around financial reporting of income tax risks

This also doesn't mean that traditionally risk-adverse companies are off the hook in terms of scrutinizing the accounting for income tax risk in their financial statements. It is also important to recall that there are risks that are both within and outside of the control of a company. An aggressive position (to be) taken on a tax return is a straightforward example of a controllable risk whereas lack of clarity in the local tax law on how to treat a particular transaction or event is a circumstance that cannot be controlled by a company. There are even issues that may fall somewhere in between with respect to the level of control. For example, a company may claim a tax credit based on an estimate of qualified expenses; however the company might not have the financial systems capability or personnel resources to examine the details of the expenses to ensure that they all in fact meet the specified qualifications. Theoretically, the company could purchase the financial systems or hire the personnel needed to accurately determine the amount of expenses that qualify for the tax credit. But issues generally outside the company's (or Tax Department's) firm control, such as budgetary constraints, prevent these steps from being taken to eliminate the tax risk in the calculation of the tax credit. It's the inherent risks - the risks that are generally outside the control of the company - that even the most risk-adverse companies must pay attention to in

the context of financial reporting. IFRS and US GAAP do not differentiate between accounting treatment for controllable or uncontrollable income tax risks.

3.2. A Brief history

For better or for worse, the US Financial Accounting Standards Board ("FASB") which governs US GAAP issued Financial Interpretation Number ("FIN") 48 *Accounting for Uncertainties in Income Taxes* in 2006. FIN 48 was an interpretation of Financial Accounting Standard ("FAS") 109, now ASC 740.10.50 and ASC 740, respectively, following the FASB's accounting standard codification initiative in 2009 which reorganized all existing US GAAP standards and guidance into a more uniformly-ordered system. ASC 740.10.50, then FIN 48, became the primary US GAAP guidance specifically addressing accounting for uncertain tax positions, or put another way, income tax risks.

The issuance of this interpretation was not an attempt by the FASB to influence companies' tax strategies and behaviours or as a favour to the tax authorities. The motives were generally designed to clean up the financial reporting of income taxes. Leading up to the issuance, a closer look at many US companies' income tax accounts by the SEC and the Public Company Accounting Oversight Board ("PCAOB") found that companies had recorded provisions for general income tax contingencies and were (allegedly) using these "tax cushions" as a mechanism to manage or smooth-out their effective tax rates. Many companies believed at the time and continue to believe that a stable effective tax rate was almost as important to investors and other stakeholders as a low effective tax rate. The SEC and PCAOB believed the provisions for general income tax contingencies were adjusted upward or downward, as necessary, to maintain stability of the effective tax rate. To be clear, these were generally not cases of blatant fraud in the financial statements; however companies often struggled to provide clear, compelling reasons to support adjustments to the provisions, and there was a lack of consistency in the judgement and criteria used to determined set-up, adjustments, and release of the provisions. As a result, FIN 48 was born to provide more rigour and structure around accounting for uncertain tax positions. In fact, the guidance is nearly a step-by-step approach in this regard as you will see in the coming section.

In contrast to FIN 48(now ASC 740.10.50), IAS 12 is essentially silent with respect to the accounting for

income tax risks. However, the standard does state that current taxes related to prior and current periods that are based on taxable profits and expected to be paid to or received from the tax authorities should be accounted for using enacted or substantively enacted tax rates and laws. This implies the need for a provision for income tax risks. But like FAS 109 prior to the issuance of FIN 48, there is currently no structured guidance explicit in the standard that indicates how such provision should be determined⁵. The preferred approach that is generally accepted as reasonable by the public accounting community borrows significantly from the approach outlined in IAS 37, which is the IFRS that governs provisions for general contingencies. It should be noted, however, that this standard explicitly indicates that it does not apply to provisions for income tax contingencies and refers to IAS 12. Nonetheless, the concepts, which will be discussed at greater length in the coming sections, are very similar.

3.3. Accounting for uncertain tax positions under US GAAP and IFRS - An overview

We have already spent plenty of time alluding to the rigours and requirements imposed by US GAAP and IFRS around accounting for income tax risks. In this section, we will finally get into the meat of the guidance. Laying this basic foundation is very important in order to fully appreciate the impact of income tax risk and therefore tax planning on the financial statements as well as the analyses required to assess and quantify that income tax risk. The discussion will focus primarily on ASC 740 since, as previously mentioned, the existing guidance on this topic within IAS 12 is, well, virtually nonexistent. However, we will discuss the commonly applied IAS 12 / IAS 37 approach and compare and contrast with its US GAAP counterpart as appropriate.

3.3.1. Accounting for uncertain tax positions under ASC 740

⁵At the time this book was written in late 2009, the International Accounting Standards Board ("IASB"), the body that governs IFRS, issued an Exposure Draft ("ED") for a revised IAS 12. Among the revisions proposed in the ED is more robust, explicit guidance on the determination of provisions for income tax risks in a similar spirit to ASC 740.10.50, though not quite to the same extent. The ED was open for public comments until mid-2009 and issuance of the final revised IAS 12 standard (to be given a new "IFRS" reference upon issuance) is the next step in the process, though the IASB has not yet given any indication on timing of the issuance.

Accounting for uncertain tax positions ("UTPs") under ASC 740 as originally dictated by FIN 48 was designed to place much more rigour around companies' evaluations and calculations of provisions for income tax contingencies. As a result, the interpretation provides an almost step-by-step approach in this regard.

The first step is the recognition test. For each potential income tax exposure, a company must determine if, based on the technical merits of the tax position, it is more likely than not that the tax return position can be sustained.⁶ There are three key points to note here:

- (1) ASC 740 prescribes a tax benefit-oriented approach. The question is whether or not the tax benefit taken (or to be taken) on the tax return can be sustained. This can seem somewhat counter-intuitive in cases where the tax benefit results from non-recognition of income rather than an increased income tax deduction. For example, the tax benefit associated with a lower-than-recommended cost-plus mark-up for the taxpaying entity is having less pre-tax profits on which to assess income tax. There is no deduction that can be pointed to on the tax return to indicate this benefit - it is a function of a lower pre-tax income starting point.
- (2) Determination of sustainability of a tax return position must be made on technical merits alone and on the basis that the tax authority is aware of all relevant facts, circumstances, and information. ASC 740 prohibits consideration of detection risk, the risk that an exposure will be identified by the tax authorities under audit, in the recognition step. Even if a company believes there to be only a remote possibility that an issue will be discovered by the tax authorities, such a belief is not necessarily sufficient to bypass the full UTP analysis and record no reserve.
- (3) The term "more likely than not" refers to a greater-than-50% probability (i.e. 51% - 100%) of having a sustainable tax position.

The determination of whether or not a tax position meets the recognition threshold can be relatively subjective, especially if tax law and related case law are unclear. It is the responsibility of management to analyze the technical basis that supports the position and conclude

⁶ ASC 740.10.25, para. 13

on its sustainability. In some cases, a "should" or other high level of opinion from tax or accounting advisors may help in management's final determination. If it is ultimately determined that a tax position is not "more likely than not" to be sustained, a UTP liability in the full amount of the benefit must be provided for in the financial statements and the next step, the measurement step, is bypassed.

The second step of the UTP analysis is measurement. In this step, a company must determine the largest amount of tax benefit that has a cumulatively greater than 50% likelihood of being realized.⁷ This entails identifying the potential sustainable tax benefit outcomes and their relative percentage likelihood of sustainability for a given tax position. The cumulative amount of tax benefit that has a more than 50% likelihood of being sustained is the tax benefit allowed for financial reporting purposes. To the extent the tax benefit amount calculated is less than the benefit to be reflected on the tax return for that tax position, a UTP liability is required for the difference between the calculated benefit and the tax return benefit. The methodology above is probably best summarized in an example.

Example

Company A, a publicly-held manufacturer, has a foreign subsidiary, Company B, which performs sales and marketing services for Company A in the foreign market. As compensation for these services, Company A ensures Company B earns an operating margin of 5%. Company A has analyzed a benchmark study prepared by its tax advisors regarding this arrangement and determined that while the 5% return-on-sales ("ROS") margin is within an acceptable range, it may be higher than the percentage ultimately accepted by the tax authorities, given the nature of services provided by Company B as compared to similar arrangements among other companies in the same industry. At the end of the fiscal year, Company A management had not finalized a decision to amend the intercompany agreement with Company B to lower the margin, and therefore the 5% rate continued to be used. As part of the year-end tax provision calculation, Company A prepared the following recognition and measurement analysis for this UTP:

Recognition: Is the Recognition threshold met?

⁷ ASC 740.10.30, para. 7

Yes. In the case of transfer pricing uncertain tax positions, the recognition threshold is in most cases met because it is reasonable to expect - and in fact most tax law requires - that a party performing service for a related party should be remunerated at an appropriate arm's length price. This is a position that the tax authorities will more likely than not accept.

Measurement: Given that the Recognition threshold was met, how should the uncertain tax position be measured?

Assumptions:

- Company B's reimbursable sales for the year were 200,000.
- Company A determined that the tax authorities may apply a 2.5%, 3%, or 4% mark-up percentage with individual probabilities of acceptance by the tax authorities of 25%, 30%, and 35%, respectively. Company management believed the current 5% mark-up position to have a 10% chance of acceptance.
- Company A's statutory tax rate is 10%.

(Amounts are tax-effected)

ROS %	Potential Benefit	Potential Cost	Individual Probability	Cumulative Probability	
5%	1,000	0	10%	10%	
4%	800	200	35%	45%	
3%	600	400	30%	75%	Probability > 50%
2.5%	500	500	25%	100%	

Benefit to be taken on the tax return = 1,000
 (200,000 x 5% mark-up x 10% tax rate)
 Benefit allowed in the financial statements = 600
 (200,000 x 3% mark-up x 10% tax rate) -----
 Required UTP liability under ASC 740 = 400

Company A expects to recognize a 1,000 tax benefit on its tax return since its total expenses, and therefore tax deductions, will reflect an intercompany charge at the 5% mark-up percentage related to the remuneration of Company B. However, based on the other possible outcomes and the related individual probabilities of

those outcomes determined by Company A, the amount of benefit that has a greater than 50% likelihood of acceptance by the tax authorities is 600, the tax benefit associated with a cost-plus mark-up of 3%. As a result, a provision of 400 is required. This amount may or may not represent the exact amount of additional tax that Company A management expects to ultimately pay to the tax authorities, but it is the amount the Company is obligated to record as a liability in accordance with ASC 740. It should also be noted that the provision of 400 is more appropriately known as an unrecognized tax benefit ("UTB"). As its name suggests, a UTB is the amount of benefit taken on the tax return that is not recognized in the financial statements, which is in-line with ASC 740's tax benefit-oriented approach

The values and percentages included in the example above would have been determined by Company A management based on its knowledge and experience on the subject matter, its understanding of the relevant tax authority's tendencies and prior determinations on related issues, etc. Accordingly, measurement is often an area of considerable subjectivity and an area that should be thoroughly analyzed and documented.

The UTBs have been determined, now what? In some cases, a UTB may in fact give rise to a future tax benefit elsewhere that should also be determined. For example, a UTB may relate to a temporary difference where a tax deduction is accelerated. There may be some uncertainty as to whether or not all qualifications were met in order to sustain the deduction acceleration. If sufficient uncertainty exists, a provision should be established for the amount associated with the accelerated deduction that is expected to be disallowed by the tax authorities. However, if the accelerated deduction is in fact disallowed, the deduction will then be allowed, in most cases, in the future tax year in which all criteria for deductibility are met. A deferred tax asset should/could⁸ therefore be recorded in conjunction with the provision to reflect the deduction available in the future year. Again, an example to illustrate this is in order.

Example

⁸ A deferred tax asset set-up in the context of a UTP analysis is, like all deferred tax assets, subject to a recoverability test. Therefore, valuation allowance considerations should be made in accordance with ASC 740.

XYZ Company ("XYZ" or "the Company") recorded a restructuring reserve for severance wages at the end of Year 1 of 10 million. The Company will pay these expenses in Year 2. Normally, reserves are only deductible when paid; however, the tax law allows for a deduction in the year of accrual if certain criteria are met (assuming the years in which the reserve is accrued and paid are different). XYZ intends to fully deduct the reserve on its Year 1 tax return. However, the Company believes that there is significant risk that some of the criteria required for accelerated deduction have not in fact been satisfied. The Company performed a UTP analysis and determined that, while the recognition step was met (since the deduction was a temporary difference and would ultimately be allowed), the single best estimate benefit to be allowed in Year 1 was zero. Assuming a statutory tax rate of 30%, XYZ therefore recorded provision of 3 million in Year 1 for the restructuring reserve as follows:

Restructuring reserve	10 million
Tax rate	30%

ASC 740.10.50 provision	3 million
DR Current tax exp	3 million
CR ASC 740.10.50 provision	3 million

However, should the tax authorities in fact disallow the deduction for the reserve in Year 1, XYZ can take the deduction in Year 2 after the severance wages are paid. As a result, XYZ should/could also record a deferred tax asset in Year 1 for the future tax benefit of the tax deduction that can then be taken in Year 2 through the following entry:

DR Deferred tax asset	3 million
CR Deferred tax exp	3 million

Interest and penalties for underpayment of taxes are also items of consideration that have direct impact upon the financial statements. Typically, interest and penalties are not applicable upon initial set-up of a UTP liability since financial statements for a given taxable year are often prepared prior to the filing of the applicable tax return at which time penalties would be assessed, and the clock begins ticking on interest obligations.⁹

⁹ Consideration should also be made with respect to a company's accounting policy on how to present interest associated with

Presentation and disclosure of UTBs as well as any associated deferred tax assets, interest, and penalties on the face of the financial statements and within the footnotes are the next items of consideration. ASC 740 provides specific guidelines for balance sheet presentation of UTP liabilities in a classified balance sheet. Namely, a UTP liability should be recorded as a current liability to the extent payment of cash to the tax authority is expected within one year (or the operating cycle, if longer than one year) or as a non-current liability if cash payment is not anticipated within this time frame. The UTP liability should not be netted against current or non-current deferred tax liabilities except in special cases where the UTP liability arose from an uncertain tax position associated with a deferred tax liability. An expected tax benefit associated with a UTP liability, however, should be classified as a deferred tax asset assuming the tax benefit is not expected within one year, and there is no legal right of offset against the related UTP liability (e.g. the tax benefit is related to a jurisdiction other than the jurisdiction in which the tax associated with the UTP liability will be assessed, such as federal vs. local or Country A vs. Country B). If the tax benefit is expected within one year, the benefit should be reflected as a current tax receivable and may be netted against any income tax payable, including any current UTP liability amounts, if legal right of offset exists.

ASC 740 also has specific guidelines regarding disclosure in the footnotes to the financial statements. Perhaps the most significant disclosure requirement introduced by ASC 740 is the tabular roll-forward. This roll-forward must reflect increases and decreases in the UTBs related to current period and prior period tax positions taken, tax authority settlements, and statute of limitations expirations. Other items required to be disclosed include:

- total amount of UTBs that would impact on the effective tax rate if recognized;
- total amount of interest and penalties recognized in the financial statements;

uncertain tax positions in the financial statements - specifically, whether to present interest "above the line" in the income statement as a component of pre-tax book income or "below the line" as an income tax expense. Under both ASC 740 and IAS 12, presentation of interest is an accounting policy to be made by the company and disclosed in the footnotes to the financial statements.

- the nature and estimated amount of tax positions expected to change significantly within the next year, and the reason for the expected change; and
- descriptions of open tax years for significant tax jurisdictions.

Careful consideration of disclosure language should be made regarding the nature of uncertain tax positions. While companies are obliged to be fully transparent about their uncertain tax positions, the financial statements are on public record and can be viewed by tax authorities (i.e. "roadmap") in addition to the general public. Therefore, companies should take care to fully understand the required disclosures and disclose accordingly.

It may be evident from this overview that ASC 740 is heavy with definitions and "rules" around the recognition and disclosure of uncertainties in income taxes. Such rigour does not yet exist under IAS 12 despite efforts by the IASB and FASB to converge IFRS and US GAAP. While the two standards are not drastically different in the overall approach to accounting for tax uncertainties, notable differences do exist.

3.3.2. IAS 12 versus ASC 740 - Overview and key differences

As alluded to previously, IAS 12 is relatively silent on accounting for tax uncertainties compared to ASC 740. IAS 12 states that current taxes related to prior and current periods that are based on taxable profits and expected to be paid to or received from the tax authorities should be accounted for using enacted or substantively enacted tax rates and laws. There is no defined two-step process (recognition and measurement) as included in ASC 740. However, a recognition and measurement process is implicit in the standard. Some insight into the application of IAS 12 with respect to tax reserves may be drawn from IAS 37, the IFRS standard that governs non-income tax provisions (reserves) and loss contingencies. To be clear, this standard specifically does not address income tax-related reserves and contingencies, though its footnote disclosure requirements should be followed for such reserves and contingencies. IAS 37 includes a "probable" threshold for recognition of a non-income tax provision, which is also applied to recognition of a tax reserve under IAS 12. "Probable" as defined in IAS 37 is in fact the same as the "more likely than not" threshold in ASC 740 - greater than 50% likelihood. IAS 37

indicates the "single best estimate" and "weighted average probability" approaches with respect to measurement, methods also used for measurement of tax uncertainties under IAS 12. The single best estimate approach utilizes just that - management's single best estimate of the amount to be assessed by the tax authority for a given tax position. The weighted average probability method considers all potential assessment outcomes and uses each outcome's individual probability to determine the weighted-average outcome. These measurement approaches differ from the cumulative probability model used under AC 740 and can result in materially different outcomes between the two standards. Consider the measurement table in the previous ASC 740 benchmarking example, modified to include the probability-weighted cost as shown below. The differences among the ASC 740 and IAS 12 measurement approaches become apparent.

ROS %	Potential Benefit	Potential Cost	Individual Probability	Probability Weighted Cost	
5%	1,000	0	10%	0	
4%	800	200	35%	70	<- Single best est.
3%	600	400	30%	120	
2.5%	500	500	25%	125	
Total probability weighted cost				315	

Recall that under ASC 740, the amount of UTP liability recorded was 400 using the required cumulative probability approach. Under the weighed-average probability model used for IAS 12, the amount of liability recorded is 315. Under the "single best estimate" approach also currently accepted under IAS 12, the liability amount recorded is only 200 (highest individual probability of occurrence among all potential outcomes, i.e. the most likely outcome determined by management). Due to the potential for significantly varying outcomes, it is important to apply the appropriate methodology depending on the applicable standard and in the case of IAS 12, the methodology in-line with the current accounting policy of the company. Regarding the treatment of tax benefits associated with uncertain tax positions, IAS 12 is again silent as is IAS 37. There is diversity in practice in this area, and it is perhaps most important to develop a reasonable accounting policy and use it consistently.

Presentation and disclosure requirements of tax reserves under IAS 12 are less stringent and may vary among users

of IFRS. IAS 12 does not provide specific requirements with respect to balance sheet presentation of tax reserves, and therefore the guidelines for current and non-current tax liabilities within IAS 12 are generally followed. The current vs. non-current liability balance sheet presentation criteria is similar to that in ASC 740, i.e. - the one year threshold. However, in the event deferred tax assets arise in connection with a UTP liability, these deferred tax assets should be reflected as non-current assets on the balance sheet, consistent with the current IAS 12 presentation rules for all deferred taxes. In addition, the principle of legal right of offset is also applicable under IAS 12 to determine the netting of tax reserves and related tax assets. The IFRS standards are otherwise silent regarding offset of tax reserves against deferred tax assets and presentation of deferred tax assets associated with tax reserves on the balance sheet. IAS 12 also does not provide any specific disclosure requirements around UTPs and related tax reserves other than to refer to IAS 37. Both IAS 37 and IAS 1 are looked to for more specific guidance. These standards currently require that the nature and estimated financial effect of the UTP be disclosed as well as an indication of the uncertainty that exists that gives rise to a potential future payable amount. These requirements do not demand the level of detail that ASC 740 requires. However, the IASB is in the process of finalizing further guidance regarding accounting for tax uncertainties under IAS 12, which is expected to include more specific requirements around the calculation and analysis of provisions for UTPs, though it is not anticipated that the detailed requirements will rise quite to the level of those under ASC 740.

In spite of some quite significant differences between ASC 740 and IAS 12 around accounting for and disclosing income tax uncertainties, the overall process of analyzing tax risks is currently largely the same, i.e. determining recognition, an amount to be recognized (measurement), other impacts such as interest and penalties, and presentation and disclosure in the financial statements.

3.3.3. What Does This Mean?

Now you have a general understanding of the framework for accounting for income tax risks under US GAAP and IFRS. You can see the level of analysis involved. So as with everything else, what does this mean to a Tax Department?

Gone are the days that income tax risk and tax planning can be viewed in a bubble. It is certainly not to say that a company should let the financial accounting implications dictate a tax planning strategy, but it would also be very naïve to disregard the implications of ASC 740 or IAS 12 in tax planning considerations. The impact of tax planning on the effective tax rate, the footnote disclosures, deferred income taxes, etc. should be considered alongside the impact on cash taxes and operations. It is true that at the end of time, the income tax expense reported in the financial statements related to a tax planning strategy will generally ultimately equal the cash tax impact of that tax planning strategy. However, timing can be very important. For example, a company may implement an aggressive tax planning strategy and reduce its immediate cash tax bill. But if the strategy doesn't meet the ASC 740 recognition threshold in the year of implementation, this immediate cash tax saving will not also translate to an immediate reduction of income tax expense in the financial statements. The full financial statement benefit associated with the strategy will be disallowed, leaving the company in the same or even worse position¹⁰ from a US GAAP (or IFRS) income tax expense and effective tax rate perspective - as if the tax planning strategy was never implemented. The point is that a Tax Department should understand these different outcomes between the timing of the benefit to cash taxes and the benefit (or lack thereof) to income tax expense, effective tax rate, etc. on the financial statements so that appropriate expectations can be set with the stakeholders within the company.

Then there is the matter of performing the analyses and calculations around UTPs required by ASC 740 and IAS 12 and ensuring that the Company's tax risks are properly captured in the financial statements and related disclosures.

In a statutory accounting environment, prudence and a best-estimate calculation are generally enough to support a provision for income tax contingencies¹¹. And often, such provision is only established when there is a feeling that an assessment from the tax authorities is imminent. The issuance of FIN 48 (now integrated into ASC 740) and its stringent accounting and disclosure requirements in combination with more attention to

¹⁰ A worse position can result where interest and penalties would apply whereas no interest and penalties would result if a conservative tax position was taken and higher taxes were paid.

¹¹ This is obviously depending on the jurisdiction at hand.

internal controls around income tax accounting has turned this mindset upside-down. Prudence and a best-estimate are helpful but not enough. As you may have gathered from the previous overview, ASC 740 requires consideration of such details as the likelihood of probable outcomes (expressed in percentages), the impact on deferred taxes, the amount of related interest and penalties, and the list stretches on. These are all separate calculations that must be made and regularly updated. There are also the documentation demands of creating and maintaining a financial statement audit file – What is the background of the UTP? What is the technical basis used to conclude that the uncertain tax position meets the recognition threshold (or doesn't meet it)? On what basis does the Company believe that X amount of tax benefit can ultimately be sustained? Even once a reasonable comfort level is achieved with respect to understanding the technical requirements of ASC 740, the practical element of gathering the necessary information for the calculations, executing the calculations, and documenting the technical analysis cannot be underestimated. These are precious hours, if not days, that can be added to a financial statement close process. It is probably fair to say that currently, in practice, much of the analysis and documentation of uncertain tax positions are performed at the HQ level in the US, sparing the tax personnel outside of the US from the brunt of this work. However, as the trend continues to push more and more responsibility of the local income tax accounts to the local Tax and Finance Departments, the level of effort needed to analyze and document uncertain tax positions should be considered in resource and process planning.

3.4. Accounting for non-income based tax risks

While this Chapter was intended to address accounting for tax risks associated with corporate income taxes, it is worthwhile spending a few moments to discuss non-income based taxes, most notably VAT. VAT falls outside the scope of IAS 12 and ASC 740 and the related US GAAP income tax contingency guidance of ASC 740 since it does not meet the definition of taxes based on income within these standards. Instead financial reporting of contingencies for VAT and other non-income based taxes falls within the scope of IAS 37 for IFRS filers and ASC 450, formerly known as FAS 5, for US GAAP. These standards cover general gain and loss contingencies (and "provisions" as defined in IAS 37) within financial accounting.

While there are a number of similarities between IAS 37 and ASC 450, the differences in terminology and application are enough to warrant brief separate discussions about each.

IAS 37 addresses provisions and contingent liabilities and assets.¹² The standard is careful to differentiate between provisions - a liability - and contingent liabilities where a provision is a *present obligation* that results from past events whereas a contingent liability is a *possible obligation* related to past events that would result depending on the outcome of certain future events outside of a company's control. Uncertainty related to a provision is associated with timing of the obligation and amount, and uncertainty related to a contingent obligation is a question of will an obligation materialize, and if so, how much. Said another way, the difference is a question of "when and how much?" vs. "if and how much?" This distinction is important because provisions are required to be recognized in the financial statements whereas contingent liabilities are disclosed unless they are remote. IAS 37 follows a recognition and measurement process. If it is more likely than not that a present obligation exists at the balance sheet date, then a provision should be recognized assuming that future outflow of economic benefits is probable and that the amount can be estimated.¹³ If this recognition threshold is not met, then a contingent liability probably exists and should be disclosed, unless outflow of future resources related to the contingency is remote. With respect to measurement, a provision or contingent liability should be measured based on the best estimate of the ultimate obligation or on the weighted-average of possible obligations.¹⁴ Contingent assets are not recognized in the financial statements and are only disclosed where recognition of future economic benefits is probable.¹⁵

US GAAP addresses gain and loss contingencies. In general, loss contingencies encompass both provisions and contingent liabilities under IAS 37. The uncertainty related to a loss contingency addresses the uncertainty of timing and the uncertainty of materializing, and must be recorded where the following two criteria are met:

¹² Note that, as per 1 November 2009, the IASB is reviewing the requirements of IAS 37, which it intends to ultimately replace with a new IFRS.

¹³ IAS 37, para. 14

¹⁴ IAS 37, para. 36 & 39

¹⁵ IAS 37, para. 89

1. It is probable as of the financial statement date that an asset has been impaired or a liability incurred

2. The amount of the loss is reasonably estimable¹⁶

If one or both of these criteria are not met, the loss contingency should be disclosed in the financial statements if it is reasonably possible that a loss may have been incurred.¹⁷ The contingent loss to be recognized or disclosed in the financial statements is the best estimate of the loss. If a best estimate cannot be reasonably determined, the range of possible losses should be disclosed. In addition, the nature of the loss should generally be disclosed.

The thresholds of recognition for liabilities related to uncertainties differ between IFRS and US GAAP as do the means of measurement. However, the key point is that liabilities (or potential liabilities) for uncertainties, including non-income based tax uncertainties, under both standards will probably either need to be recognized or disclosed!

VAT is no exception and must be viewed through the lens of IAS 37 or ASC 450. It is not uncommon for companies to not register for VAT in certain countries and therefore not follow the appropriate collection and remittance requirements because the activity is determined at the time to be small. Or it could be a matter of simple oversight and not having a handle on the global VAT compliance requirements. Whatever the situation, the potential consequences are not only cash tax. Even if a company has been able to escape scrutiny by the tax authorities, it is required by both IFRS and US GAAP to assess the potential exposure of non-compliance with VAT rules. While VAT is often viewed as "an in and an out tax" where a company charging VAT is merely a remitting agent, it is not uncommon for a tax authority to later require VAT remittances from a company that can no longer go back to its customers to collect the VAT. Collection of VAT after the fact would not be well-received by its customers. If a company in that case were to take on the expense of the VAT, what considerations should be made - or should have been made - with respect to the financial

¹⁶ ASC 450.20.25-2

¹⁷ ASC 450.20.25-2. Note that, as per 1 November 2009, the FASB has an Exposure Draft outstanding which proposes to change certain disclosure requirements of ASC 450 (formerly FAS 5). The FASB is currently considering public comments made on the Exposure Draft prior to finalizing a revised standard.

statements? In fact, this situation should be anticipated, and a loss contingency should be appropriately recorded or disclosed in the financial statements even before a tax authority's bill is received and paid. Theoretically, a company should know the VAT rules and requirements as well as its own transactions. Thus, it's a hard argument to make that the impact of non-compliance is not determinable for purposes of consideration in the financial statements.

4. Conclusion

Tax is an inescapable part of ongoing business and comes with inherent as well as created risks. The effects of tax risk within the financial reporting environment are two-fold: the risk of properly reporting income taxes in accordance with the applicable financial reporting standard and the impact of tax risks themselves to the financial statements. Historically, these risks have been less important to many companies because the consequences were not viewed as impacting the "bottom line", that is operating profits, EBIT ("Earnings Before Income Taxes"), and the other "true" measures of a successful business. However, more and more consequences of not adequately addressing these risks do tarnish the business. This lesson is often learned the hard way in the form of financial statement restatements (and the increased scrutiny from financial statement auditors that comes with it), unexpected changes to the effective tax rate impacting EPS, internal inefficiencies and misuse of resources, etc. These consequences can result not only in reputational damage, but also in true cash impact via financing difficulties, increased audit fees, and additional consulting fees. However, with careful attention to accounting for income taxes and proactive measures, these risks just like many other tax risks can be effectively managed.