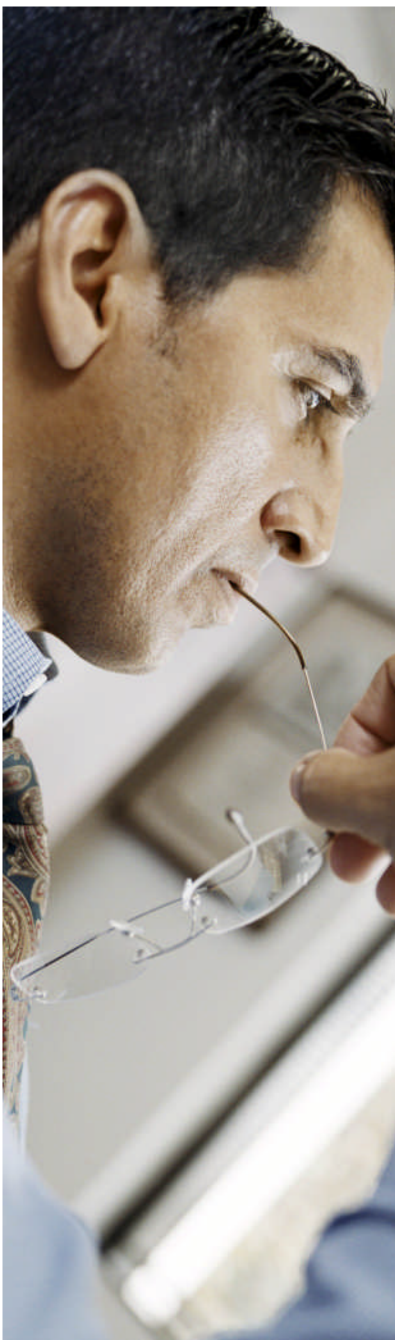
FAS 109 Tax Accounting in the Current Regulatory Environment



The Sarbanes-Oxley Act of 2002 (SOX) and other regulatory initiatives by the PCAOB and SEC have dramatically changed the environment in which public companies operate. These regulatory factors have affected how companies calculate and report financial results — and also how executives utilize external auditors, tax advisors and other consultants to help them manage financial aspects of their businesses.

Although these changes may be burdensome, significant reforms were needed to restore investor confidence in capital markets in the wake of several major corporate accounting scandals.

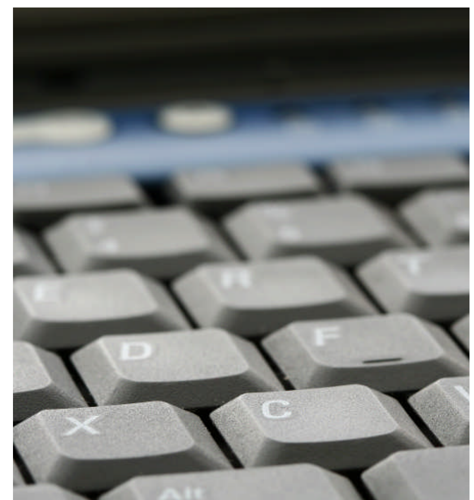
According to a Huron Consulting Group study, "2004 Annual Review of Financial Reporting Matters," there were a record 414 financial restatements for accounting errors last year. The study also cited several trends and events that affected financial reporting in 2004:

- Creation and implementation of SOX legislation
- Creation of the PCAOB and actions it has since taken
- Implementation of SOX section 404 internal control procedures
- Increased SEC staffing and greater scrutiny by this agency
- Increased diligence by audit firms and resulting cleanup of prior period errors.

According to the Huron Group study, taxes ranked as the number three accounting issue for the manufacturing industry and the number five accounting issue for the transportation, communications, electric, gas and sanitary services industries. This is not surprising considering the sometimes overwhelming complexity of tax accounting rules.

This guide focuses on accounting issues related to FAS 109 and financial reporting and oversight changes resulting from SOX and other regulatory activity. It is based on the experience of Freed Maxick & Battaglia accounting and tax advisors who are helping clients through tax accounting and financial reporting situations.

The FAQ format of this guide is designed to provide a quick reference to help you navigate through this complex environment.



What makes the tax provision process so difficult and complex?

Although the basic rules appear straightforward, FAS 109 is full of special rules and exceptions. If you encounter one or more of the following situations, your tax provision will increase in complexity:

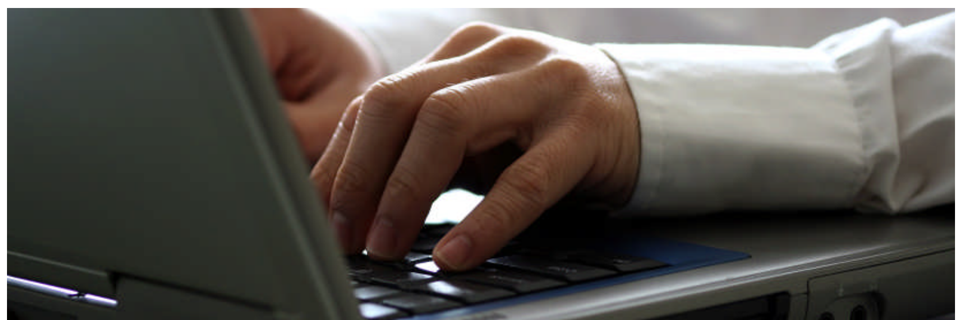
- Deferred tax assets, requiring analysis of the need to record a valuation allowance
- Business combinations (acquisitions) involving purchase accounting adjustments and goodwill
- Exceptions to comprehensive deferred tax accounting
- Leveraged leases (FAS 13)
- Non-deductible goodwill
- Intercompany transfers
- Foreign currency translation (FAS 52)
- Stock options and other stock-based compensation (FAS 123R)
- International operations
- Inside vs. outside basis differences of foreign subsidiaries and the APB 23 exception for earnings permanently reinvested
- Converting foreign tax computations to US GAAP
- Hedges and derivatives
- Tax exposure items (FAS 5)
- Changes in tax laws or rates

The tax provision is further complicated by timing issues. Taxes can't be calculated until pre-tax income is final. This often turns the tax provision into an eleventh hour "fire drill" — not an ideal condition for a company to make one of its most complex financial computations. This can be exacerbated by late adjusting journal entries that require a recomputation of the tax provision.

We've always done our own tax provision in-house. It's not perfect, but we've never had a problem in the past. Why are auditors suddenly questioning everything?

In the current environment, tax provisions are getting more intense auditor scrutiny. This is particularly true with valuation allowance analysis and foreign tax provisions. It's no longer enough to rely on numbers provided by a foreign subsidiary or the foreign tax advisor firm. Now, the expectation is that management will have proper oversight and controls to verify the foreign tax computations and track foreign deferred taxes.

In addition, the FASB has issued an exposure draft regarding "Accounting for Uncertain Tax Positions" which will require additional record keeping and potentially change the recognition of tax positions perviously recognized or unrecognized in the financial statements.



I don't see a specific rule that says my audit firm can't prepare my tax provision. Why can't my auditor just continue to provide this service?

SOX section 201 amended the Securities and Exchange Act of 1934 to prohibit a registered public accounting firm from providing certain non-audit services to any audit client, including bookkeeping services related to the client's accounting records or financial statements. As a result, the SEC added a provision to Regulation S-X, to further define bookkeeping services to include "preparing or originating source data underlying the client's audited financial statements."

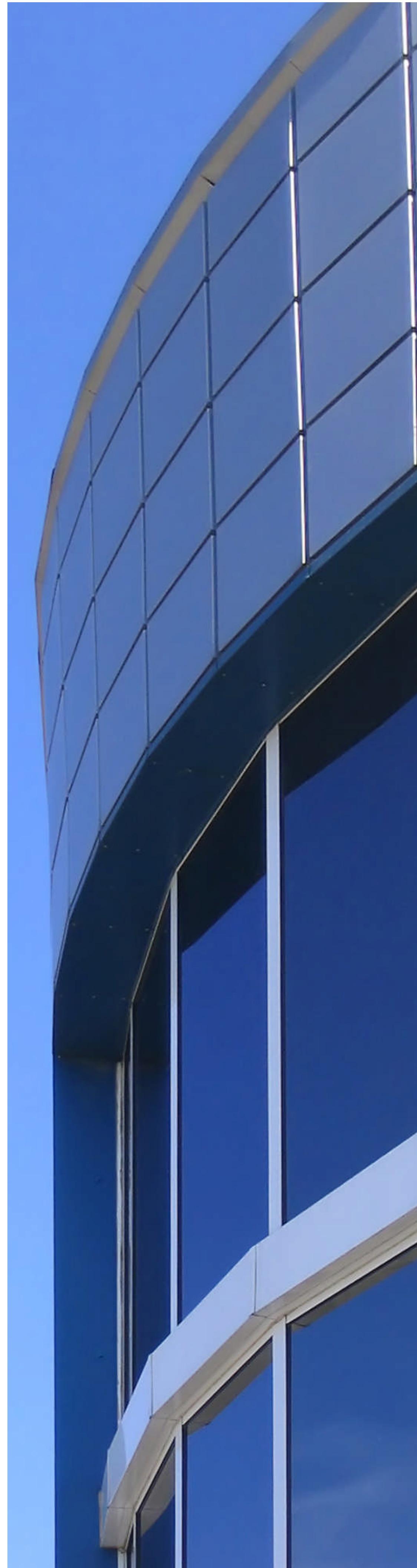
According to SEC staff, this definition includes preparation of the client's tax provision. The Big Four accounting firms have taken the conservative approach and have general policies against providing tax provision services for their audit clients, even if they are not SEC registrants.

Are my auditors prohibited from providing any of my tax services?

No. Your audit firm can still provide tax return preparation, certain tax planning and other traditional tax services. However, if your company is an SEC registrant, you must obtain pre-approval from your board's audit committee. In addition, proposed PCAOB regulations would treat a public accounting firm as not being independent if it does any of the following:

- Provides services related to planning or providing opinion on the tax consequences of a listed or confidential transaction under U.S. Treasury regulations.
- Provides services related to planning or providing opinion on a transaction that is based on an aggressive interpretation of applicable tax laws and regulations (with a significant purpose of tax avoidance unless the proposed tax treatment is more likely than not — greater than 50 percent chance — to be allowable).
- Provides tax services to officers in a financial oversight role for the company.

In addition, PCAOB regulations would require a significant amount of detailed information to be provided to the audit committee and require the audit firm to hold a documented discussion with the audit committee on the proposed tax services. With these rules, it may prove too cumbersome for companies subject to PCAOB standards (or who choose to apply them) to retain their audit firm to provide tax services. It may also be too cumbersome for audit firms to continue to offer tax services to such clients.



If my auditor can't prepare my tax provision, what alternatives do I have?

One alternative is to bring the work in-house. If you choose this alternative, it is best to hire a competent tax director with significant experience in FAS 109 matters. FAS 109 should be a significant focus of that person's duties. Some drawbacks to this approach are:

- Not all midsized businesses have the financial resources to create a tax function or add to their tax staff.
- There may not be a sufficient pool of FAS 109 talent in your geographic area.

The other alternative is to outsource the work to an accounting/tax firm that is independent of the audit firm. To make sure you are getting the right level of expertise, you need to choose a firm that has a significant technical focus on FAS 109 issues at the state, national and international levels.

How can I best manage working with two accounting firms on FAS 109 and possibly other tax matters?

Your external auditors need to be comfortable with the competence and reliability of your FAS 109 service provider, so look for one with sufficient expertise. Open communication between the FAS 109 service provider and the auditor is also critical to ensuring tax provision documentation meets the needs of the audit program.

How does SOX impact the tax provision process?

Tax accounts are a high-risk area of SOX internal control audits. Control procedures are frequently insufficient in this area due to several factors, including lack of financial or tax management control over foreign locations, lack of resources in the tax function, and reliance on third party tax providers without management oversight.

We're a private company (or small public company that is not an SEC registrant). Do we need to worry about any of this?

Technically, no. However, certain private and small public companies are being held to SOX compliance and independence standards by outside lenders or investors. In addition, many private companies adopt SOX compliance procedures if they are contemplating going public.

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