



Financial Reporting of Income Taxes — The Best of Both Worlds for Tax Practitioners

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Agenda

- Overview of applicable accounting pronouncements
 - FAS 109 (Financial Accounting Standard No. 109)
 - Other accounting literature relevant to income taxes
 - FIN 48 (FASB Interpretation No. 48)
- Understanding tax footnotes and other disclosures
 - Effective tax rate drivers and rate reconciliations
 - General disclosure requirements
 - New disclosures under FIN 48
 - What do investors expect to be disclosed?
- How tax and finance departments should work together
 - Communication protocols and best practices
 - How outside advisors fit into the mix
- What does it mean to you?



Overview of Applicable Accounting Pronouncements

GAAP for income taxes

- FAS 109: Accounting for Income Taxes
 - FAS 109 Q&A
 - EITF discussions
- Other guidance
 - FAS 5: Accounting for Contingent Liabilities
 - APB 23: Accounting for Income Taxes, Special Areas
 - APB 28: Accounting for Income Taxes in Interim Periods
 - FIN 18 – an interpretation of APB 28
- FIN 48: Accounting for Uncertainty in Income Taxes
 - Exposure draft
 - Final interpretation (June 2006)

FAS 109 - Objectives

- To recognize the amount of taxes payable or refundable for the current year
- To recognize the amount of deferred tax liabilities/assets for the future tax consequences of events that have been recognized in an enterprise's financial statements or tax returns
- To record total income tax expense or benefit for the year: the sum of income taxes currently payable plus the change in the deferred tax balances plus reserve additions

FAS 109 - Taxes currently payable

- Calculate the estimated amount of taxes to be paid with current year returns
 - Tax computed by applying current year rates to projected taxable income and subtracting estimated allowable tax credits
 - Includes federal, state, and non-US estimated taxes payable
- Taxable income differs from pretax book income due to the following:
 - Permanent items: book/tax differences that never reverse
 - Temporary items: book/tax differences that will reverse some time in the future

Poll question

Which of the following is NOT a permanent book/tax difference?

- Tax exempt interest income
- Non-deductible meals and entertainment expenses
- IRC Section 199 manufacturing deduction
- Accelerated tax depreciation
- R&D credits

FAS 109 - Deferred taxes

- Key assumption inherent in financial statements: reported amount of assets and liabilities will be recovered/settled
- Difference between book basis and tax basis of assets and liabilities will therefore result in taxable or deductible amounts in future
- Basis difference times the applicable tax rate equals the deferred tax asset/liability
- Future deductible amounts and loss or credit carryforwards are deferred tax assets
- Future taxable amounts are deferred tax liabilities

FAS 109 - Deferred tax assets

- Important considerations
 - Some deferred tax assets may not be assured of realization due to uncertainty about future taxable income or future tax amounts
 - In this case, deferred tax assets are reduced to the amount “more likely than not” to be realized with a valuation allowance (contra asset account)

Poll question

Which of the following items are temporary book/tax basis differences, resulting in deferred tax assets/liabilities?

- Accelerated depreciation
- Bad debt reserve accruals
- Deferred compensation expense not yet paid
- Fair market value adjustments to securities
- Warranty reserve accruals
- All of the above

FAS 109 – Accounting for tax contingencies

- FAS 5

- Overview

- If loss is probable and estimable, must accrue
 - If loss is probable but not estimable, disclose
 - If loss is reasonably possible, disclose
 - If loss is remote, do nothing

- Challenge for tax: rules above not easily translated into tax opinion levels so application was not consistent and disclosure was limited

- FIN 48 evolution

FAS 109 - Uncertain tax positions (FIN 48)

- New interpretation effective for years beginning after 12/15/06
- An uncertain tax position is a tax position claimed or expected to be claimed that may not be sustained on audit by tax authorities
- A tax benefit related to an uncertain tax position can be recognized in financial statements when:
 - Based on a technical analysis it is determined that it is more likely than not that position can be sustained, or
 - The position is ultimately settled via an audit, a negotiation, or a court decision
- An unrecognized tax benefit is recorded as a liability on the balance sheet

FAS 109 - Total tax expense

- Total tax expense recorded on the income statement is:
 - Taxes payable on current year returns;
 - Change in deferred tax balances for the year; and
 - Tax benefits expected to be claimed in current year returns but not yet recognizable due to FIN 48



Understanding Tax Footnotes and Other Disclosures

What is the “Effective Tax Rate”?

- Effective Tax Rate (ETR)
 - Income tax expense divided by pretax book income
- Expected rate for US corporation filing in many states: 40% (35% Federal plus 5% State (net of Federal benefit))
- Temporary differences do not impact the ETR
- Only permanent items cause the ETR to vary from the expected 40%
- Permanent items include rate differences, credits, unusable tax attributes and many other items

What is a “rate reconciliation”?

<i>In millions</i>	2005	2004
Pretax earnings	\$590	\$720
Statutory U.S. income tax rate	35%	35%
Tax expense @ US statutory rate	207	252
State and local income taxes	25	20
Foreign rate differential	(30)	(40)
Non-deductible business expenses	10	25
Tax audit settlements	(441)	0
Tax credits	(35)	(25)
Other	(15)	10
Income tax expense (benefit)	(\$280)	\$242
Effective income tax rate	-47%	34%

Poll question

Which of the following items does NOT cause the ETR to be different from an expected tax rate of 35%?

- State tax expense
- Non-deductible expenses
- Accelerated depreciation
- Income earned in Ireland (12.5% rate in Ireland)
- R&D credits
- Increase in unrecognized tax benefit liability

Disclosures – General requirements

- Current Tax Expense by Jurisdiction
- Deferred Tax Expense by Jurisdiction
- Total deferred tax liabilities, by significant item
- Total deferred tax assets, by significant item
- Total valuation allowance on deferred tax assets
- Reconciliation of expected tax expense (35%) to reported tax expense (ETR)
- Net operating loss carryforwards and their expiration dates
- Deferred tax not accrued on certain foreign income

Tax footnotes: A good read?

- What they will tell you:
 - Is income taxed in jurisdictions other than the US?
 - Are some available tax credits being recognized?
 - Are there tax attributes that may expire unused?
- What they will not tell you:
 - What jurisdictions and at what rate of tax?
 - Are all available credits claimed and/or recognized?
 - Were there any unusual tax planning items put in place during the year?

Current/deferred tax expense

<i>In millions</i>	2005	2004
Current tax provision (benefit)		
U.S. federal	(\$300)	\$152
U.S. state and local	(50)	20
Non-U.S.	110	140
	(\$240)	\$312
Deferred tax provision (benefit)		
U.S. federal	(\$10)	(\$30)
U.S. state and local	(10)	10
Non-U.S.	(20)	(50)
	(\$40)	(\$70)
Income tax provision (benefit)	(\$280)	\$242

Deferred tax detail

<i>In millions</i>	2005	2004
Deferred tax assets:		
Postretirement benefit accruals	\$ 340	\$ 350
Alternative minimum and other tax credits	300	520
Net operating loss carryforwards	1,810	1,520
Nondeductible reserves	40	100
Other	300	460
Gross deferred tax assets	\$ 2,790	\$ 2,950
Less: valuation allowance	(150)	(130)
Net deferred tax assets	\$ 2,640	\$ 2,820
Deferred tax liabilities:		
Plant, property, and equipment	\$ (2,600)	\$ (2,730)
Other	(300)	(280)
Total deferred tax liabilities	\$ (2,900)	\$ (3,010)
Net deferred tax liabilities	\$ (260)	\$ (190)

Excerpts from footnote explanations

“The 2005 income tax provision included a net \$441 million reduction resulting from an agreement reached with the US Federal tax authorities concerning the 1997 through 2000 returns.”

“The company has Federal net operating loss carryforwards of \$1,810 million that will expire in 2007 through 2025.”

“Deferred taxes are not provided for temporary differences of approximately \$2.4 billion representing earnings of non-US subsidiaries intended to be permanently reinvested.”

Other tax disclosure locations

- **Critical accounting policies footnote**
 - Addresses overall provision methodology and critical estimates/assumptions included in provision calculations such as tax reserve accruals
- **Management Discussion and Analysis (MD&A)**
 - Addresses key reasons for ETR in current year, changes in ETR from prior year, and may include a forecast of next year's ETR (in a range)
- **Contingent liabilities**
 - Some companies discuss ongoing audit issues in more detail here

Disclosures - New requirements (FIN48)

- Total unrecognized tax benefits at beginning and end of year
- Unrecognized tax benefits that would impact the ETR if recognized
- Accounting policy for interest and penalties on unrecognized tax benefits and the total of each accrued at balance sheet date
- If unrecognized tax benefits will change in next 12 months, description of change
- Open tax years by major jurisdiction

Tax disclosures: The moral of the story...

- Footnotes in 2006 and prior years tell you general tax information about a company
- Footnotes in 2007 and forward will tell you more – but it will take an educated reader to know exactly what the “more” really means



How Tax and Finance Departments Should Work Together

Communication and best practices

- Communicate continuously throughout the year
 - **Tax → Finance** – discuss current tax planning strategies and the impact on the financial statements
 - **Finance → Tax** – get tax involved early in discussions about potential business transactions (tax impact?)
 - **Tax → Finance** – meet quarterly to discuss projected ETR, tax reserve changes, status of other transactions
- Two-way communication regarding:
 - Current income tax accounting guidance/rule changes
 - Disclosures (discuss what may/may not be needed)
 - Estimates and judgments related to taxes

How to work with outside advisors

- Working with the attest firm (primarily the auditor)
 - Initiate frequent discussions regarding transactions, structure maintenance, tax/accounting treatment, documentation, disclosures, status of tax audits and other items impacting taxes (auditing the provision throughout the year)
 - Utilize as a resource for technical issues, “industry practice” information, updates on new pronouncements, etc.
- Working with outside tax advisors (primarily tax technical)
 - Primarily tax technical
 - Also a resource for “industry practice” information, updates on new pronouncements
- Important to remember the Company is responsible for its financial statements, including income tax accounts and disclosures (advisors cannot replace management)



WHAT DOES IT MEAN TO
YOU?

Income tax accounting – past and present

- How did we get here?
 - Wall Street acknowledged a company's earnings could be “managed” by controlling the ETR
 - Over the past two years, numerous material weaknesses and significant deficiencies reported related to income taxes
 - Increased focus by the SEC, IRS and others on all areas of income tax accounting particularly transparency and disclosure
- Where are we today?
 - Tax is recognized as a key risk area particularly for multinational companies operating in numerous jurisdictions
 - Tax expense is often one of the largest line items on the Company's income statement
 - Deferred income taxes (assets and liabilities) as well as tax reserves are often significant balance sheet items

What does it mean to YOU?

- Traditionally, tax professionals evaluate transactions from the point of view of the tax return – what's the tax support?
- Tax professionals involved in reviewing income taxes in financials must know accounting literatures
- After Sarbanes 404, tax professionals may be responsible for testing the design and execution of controls related to taxes
- Its important in today's environment for tax professionals to understand and articulate GAAP issues

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Recorded on February 2, 2007.

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