Have You Analyzed Your Tax Balance Sheet Lately?

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2013 - Issue 52—Along with the holidays, the calendar year-end is quickly approaching, and preparation for the sometimes daunting year-end close will soon be a primary focus. For many in accounting, tax and finance departments, year-end financial reporting is synonymous with tight deadlines, long hours, the reconciliation of accounts, performing detailed analyses of full-year results and projecting future-year results.

If you are saddled with the seemingly thankless task of predicting your company's future taxable income, tax liabilities and tax assets, you may find that you and your department are spending more and more time focused on balance sheet classification and reconciliation. While predicting your expected annual tax rate in this ever-changing tax landscape is still the primary focus, financial statement auditors have begun to broaden their focus beyond the effective tax rate to the deferred tax accounts.

If your financial statement auditor has not recently performed an in-depth examination of your deferred tax assets and liabilities on your balance sheet, they will likely do so very soon. This article emphasizes the importance of sufficient review of tax accounts, examines the reasons for increased scrutiny by financial statement auditors, and details the benefits of using a tax basis balance sheet to document such reconciliations.

The Evolution of Accounting for Income Taxes

Just as the financial statement balance sheet represents the book basis of assets and liabilities in accordance with GAAP, the tax basis balance sheet represents the tax basis of assets and liabilities in accordance with tax rules and regulations by tax jurisdiction. Tax basis balance sheets have become increasingly important, as there has been a shift of financial statement audit focus related to the accuracy of the tax account balances.

Historically, income tax accounts on the balance sheet were not a significant emphasis of review by financial statement auditors, as the income statement method was used to calculate the tax provision. Under the historical income statement method, the tax expense/benefit shown on the income statement and the effective tax rate were the primary focus of the financial statement audits. Tax departments frequently spent most of their time calculating the total tax expense and often paid little to no attention to the deferred tax items. The Financial Accounting Standards Board (FASB) took the first step in dealing with this potential issue in the late 1980s. It determined the income statement approach to be inadequate and issued revised standards that required companies to use the balance sheet method in determining accounting for income taxes.

Unlike the income statement method, the balance sheet method requires that temporary book/tax differences recorded on the balance sheet represent the future value of the temporary book/tax amounts. This change required a significant amount of documentation, as it was necessary for companies to track temporary book/tax differences on the balance sheet. Over the years, audit procedures applied by financial statement auditors have increasingly scrutinized balance sheet tax accounts. However, many tax departments still only track the significant deferred tax adjustments, such as depreciation, amortization, net operating losses and tax credits. All other changes to temporary book/tax differences are often deemed as less important or immaterial. Additionally, as not all deferred items were analyzed at year-end, any reconciliation of the true ending of deferred tax balances can be difficult. As a result, the actual change (or movement) in deferred tax balance is commonly the measure used to verify the accuracy of the accounts. The weakness in the approach of only tracking the deferred tax movement is that total tax account balances are at risk of being misstated, as the beginning account balance may no longer be correct. For example, if an acquisition or disposition was not properly recorded in the deferred tax accounts, then the ending deferred balance may also be unreliable.

As we discuss below, financial statement auditors have recently come under scrutiny by the Public Company Accounting Oversight Board (PCAOB) for not adequately auditing accounting for income taxes. A recent study issued by the Center for Audit Quality, "Analyses of Alleged Auditor Deficiencies in SEC Fraud Investigations," dated May 2013, examined auditor deficiencies related to Securities and Exchange Commission investigations of financial reporting fraud. The study included both national and non-national audit firms and identified 16 primary deficiencies cited by the SEC in the audit process. The study concluded that the top deficiency cited by the SEC was the failure to gather sufficient competent audit evidence. The SEC also cited firms for incorrect interpretation of the application of GAAP requirements, including accounting for income taxes. The conclusion of this study was consistent with the recently released inspections of audit firms issued by the PCAOB.

In these annual inspection reports, the PCAOB criticized the quality of financial statement audits performed by two of the major accounting firms. For example, one inspection revealed that inadequate audit procedures were applied to current and deferred income taxes during certain audits, and that controls were repeatedly insufficiently tested for selected current and deferred income taxes. Another inspection revealed that tests of certain controls over the accounting for income taxes were also insufficient. Given the negative reviews specifically related to accounting for income taxes, an emphasis on the audit of accounting for income taxes is expected.

The Balance Sheet Approach and the Benefits of Maintaining a Tax Basis Balance Sheet

In light of the criticism by the PCAOB, audit firms have begun to put additional procedures into place to improve financial statement audits. Among them is a more in-depth review and reconciliation of the tax asset and liabilities accounts. Therefore, companies and tax departments should be prepared for increased audit procedures related to tax account balances. We believe that one of the best ways to ensure that your tax accounts are complete and accurate is to prepare and maintain a tax basis balance sheet. Doing this provides significant benefits, including some of the following:

- **Accuracy of Tax Accounts** — A proper implementation of a tax basis balance sheet must include a review of tax basis of assets and liabilities and a reconciliation of the activity in the income tax accounts. The overall exercise of the review, combined with the appropriate documentation, will provide significant support for income tax accounts and may help identify deferred tax assets and liabilities that have not been previously analyzed.
- **Financial Statement Audit Preparedness** — The auditability of tax accounts is essential to an efficient and successful year-end audit. The presentation of a tax basis balance sheet will help financial statement auditors to quickly and efficiently perform audit procedures. In turn, tax departments should be able to reduce the resources used to resolve financial statement audit questions.
- **Increased Efficiency in Tax Departments** — Multiple groups within tax departments will use a tax basis balance sheet for various purposes. For instance, the tax compliance group would use it to update the tax basis balance sheet after tax returns are filed. Additionally, the tax accounting group can use the information to calculate the provision and return to provision accruals.
- **Further Support for Sarbanes-Oxley Compliance** — The implementation and continual review of a tax basis balance sheet is a process that supports several internal control objectives. Most importantly, this process ensures that income tax balance sheet accounts are correct, financial statement disclosures are accurate, and tax laws and U.S. GAAP principles are appropriately applied.
- **Transaction Readiness** — Certain transactions such as divestures, acquisitions and mergers often occur with little to no warning. Having the proper supporting documentation for your company's tax accounts and tax bases demonstrates reliability in tax accounts to potential investors or a buyer.
- **Transparency of Book/Tax Differences** — Implementation of a tax basis balance sheet requires the tax department to analyze existing temporary book and tax differences and to determine if basis differences exist for which a book/tax difference has not been recorded. Such analysis can identify various tax planning ideas and potential tax accounting method changes that could lead to significant tax savings.

Although there are numerous benefits associated with implementing a tax basis balance sheet, a commitment to continual maintenance and review must be a priority in order to continue to reap benefits associated with a tax basis balance sheet. Accounting for income taxes remains one of the leading causes for material misstatements and internal control deficiencies. As detailed in a previous edition of *Tax Advisor Weekly*, “Tax-Related Material Weakness: Still Alive and Kicking in 2011,” material weaknesses of publicly traded companies related to accounting for income taxes remain prevalent. Furthermore, a Baseline Insights study cited in the Wall Street Journal CFO Report in 2012 analyzed SEC filings and indicated that as many as 14 percent of material misstatements result from issues related to income tax. An example of such restatement is a large multinational corporation that restated financial statements for numerous years in light of extensive errors in accounting for income taxes in its intercompany tax accounts. Soon after the company announced the restatement issues, the stock price plummeted and the company spent large amounts of fees to address the accounting issues. If an entity-by-entity tax basis balance sheet had been implemented and the account balances had been reconciled, the risk of restatement would likely have been greatly reduced or possibly eliminated.

Alvarez & Marsal Taxand Says:

In light of continued financial statement auditor scrutiny of financial statement accounts, implementation of a tax basis balance sheet is increasingly critical to the success of a tax department. It not only provides further assurance that all book/tax differences have been identified and analyzed, but it also acts as a significant source of documentation to be used by your financial statement auditors. Although implementation can be challenging, the increased role of technology in corporate tax departments has allowed such implementation of tax basis balances sheets to become much more common. The aforementioned benefits can save companies from many common financial reporting issues associated with accounting for income taxes. Given the proximity of year-end, the implementation of a tax basis balance sheet may seem daunting, but it is attainable. At a minimum, reconciliations of material deferred tax balances and a proof of income taxes payable should be completed. Such projects aid the year-end financial statement audit and are beneficial in the implementation of a tax basis balance sheet.

Author

Jessica Jackson Hill
Senior Director, San Francisco
+1 214 438 8490

For More Information

Layne Albert
Managing Director, New York
+1 212 763 9655

Robert J. Filip
Managing Director, Seattle
+1 206 664 8910

Mark Young
Managing Director, Houston
+1 713 221 3932

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