



CAMPUS TO CLIENTS

Accounting for Income Tax: A Student Research Project

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In a research project in the Master of Accountancy Program at the University of North Carolina at Charlotte, students completed an in-depth study of the consolidated financial statements and accompanying footnotes of a publicly traded, multinational company based in the southeastern United States. This project is easily adaptable for use in both undergraduate and graduate accounting and tax programs.

Background of ASC Topic 740

Standards for accounting for income taxes were previously provided in FASB Statement No. 109, *Accounting for Income Taxes*, which was issued in 1992. This statement was codified mostly in FASB Accounting Standards Codification (ASC) Topic 740, *Income Taxes* (Topic 740). When the statement was issued, FASB recognized that “income taxes must be computed for complex business transactions within the context of voluminous, complicated, and constantly changing tax laws, rules, and regulations” (§69).

The Financial Accounting Foundation issued its *Post-Implementation Review Report* on the standard in 2013, in which the review team found that “complying with Statement 109 is more difficult today than when the standard was issued because of increased complexities resulting from changes in the economic environment and the tax laws as well as increased operations by U.S. companies

in many different foreign jurisdictions.”

The review team found preparers and practitioners had difficulties in applying the standard in the following areas: (1) accounting for valuation allowances and (2) computing deferred tax liabilities and deferred tax assets. Preparers and practitioners also face operational challenges in the following areas: (1) intraperiod tax allocations; (2) accounting for intercompany transfers of assets; and (3) situations in which a deferred tax liability is not recognized for earnings determined to be indefinitely reinvested in foreign subsidiaries. The review team also found that investors who participated in the study had difficulty understanding income tax information provided in the financial statements.

In 2006, FASB issued Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes*, which clarified accounting for uncertainty in recognition of income taxes in financial statements. FIN 48 (which is also incorporated mostly into Topic 740) provided guidance on measuring and reporting the benefits of tax positions taken or expected to be taken on tax returns. However, companies continue to face uncertainty in estimating the probability that a tax position would be sustained on audit. This estimate is necessary because a company may recognize only the amount of a benefit from a tax position that has more than a 50% likelihood of being sustained on examination by the taxing authority in its financial statements.

**An opportunity
to learn financial
statement language
and practice thinking
analytically.**

Purpose of the Student Project

The research project was designed to give students a better understanding of the application of Topic 740 in the real world. Students often find this subject challenging, in part because of the complexities described above. Another reason students fail to fully understand this area of accounting is their lack of experience in reading and analyzing published financial statements, particularly those segments covering accounting principles and reporting practices for income tax expense and related accounts.

Accounting students need to gain an awareness of the variety and complexity of business transactions to succeed in understanding how businesses measure and report income tax expense and related accounts. The study of financial statements and related footnotes in an annual report provides a path for students to gain this awareness and an understanding of Topic 740.

Nature of the Project

The project was an independent study in which graduate students committed to study a published annual report of a designated company for one semester. The students' objective was to learn as much as possible about current financial reporting practices in audited financial statements prepared in accordance with GAAP. In that context, students focused on all significant accounts involving application of Topic 740's rules. For each account, the students conducted research on the applicable U.S. tax rules and consulted Topic 740 to determine the applicable GAAP rules.

The instructor met with the students and discussed the nature of the assignment, as well as the sequence of research steps. The students' first step was to read the annual report to learn about the company's operations and financial statements. Then the students began identifying balance sheet and income statement accounts that involve

book-tax differences. The instructor and students had several meetings and exchanged emails about the preliminary findings and the identification of the most significant accounts requiring analysis in the student reports.

A master of accountancy student may have (or may acquire) an internship or full-time job with a company under study, or with the accounting firm that provides tax and/or audit services for the company. The students were instructed not to obtain any supplementary information from the company or its accounting firm because that could result in disclosure of confidential information. For this project, the research sources were limited to the published annual report and other documents filed with the SEC. This restriction is consistent with the intended focus of the research project.

Research Procedure

As noted earlier, the first step was to identify accounts that involve (1) one set of rules for computing book income and (2) a different set of rules for computing taxable income on a U.S. corporate income tax return. The students conducted research to determine applicable GAAP rules and tax rules the company used for those accounts. Resulting differences in book income and taxable income for the current period were identified as either permanent or temporary differences. Deferred tax assets and deferred tax liabilities resulting from temporary differences in the book and tax basis of assets and liabilities were described. Also identified were deferred tax asset accounts associated with losses and credits carried forward and used in future periods.

Next, the students addressed issues related to (1) uncertainties whether deferred tax assets will be realized and whether valuation accounts may be needed and (2) uncertainties whether tax positions will be sustained upon audit, which may require the accrual of additional tax liabilities. Finally, the students examined the procedure for computing

both the income tax provision and the effective income tax rate.

The company in this study had sales of about \$255 million in its latest fiscal year. In each of the last three years, the company had net income before tax expense (benefit) in the range of \$14 million to \$15 million. The company's federal corporate statutory income tax rate was 34% in each of the last three years, while the company's effective income tax rate ranged from negative 7.3% to positive 7.9% during that period.

Companies report effective tax rates that are lower than the statutory rates as a result of: (1) earning income that is not subject to income tax, such as municipal bond interest income; (2) earning income in a foreign country where income tax rates are lower than the U.S. statutory income tax rate; (3) reducing the valuation account balance for deferred tax assets; and (4) other factors. The company in this study reduced the effective tax rate by 26% for the latest fiscal year as a result of reducing the balance in the valuation account for deferred tax assets. A study by the U.S. Government Accountability Office found that about 33% of large corporations had effective tax rates of 10% or less (*U.S. Multinational Corporations: Effective Tax Rates Are Correlated With Where Income Is Reported*, Rep't No. GAO-08-950 (8/12/08)).

The balance sheet for the company contains seven asset and liability accounts related to income tax. The footnotes indicate the company had gross deferred tax assets of approximately \$30 million and deferred tax liabilities of about \$5 million. Operating loss carryforwards accounted for about 80% of the total amount of deferred tax assets. A valuation allowance of \$12 million was reported for the deferred tax assets. Unrecognized tax benefits are related to 27% of the gross deferred tax assets. Significant deferred tax assets and deferred tax liability accounts are listed in the exhibit on p. 371.

Adapting Project for Use as a Regular Course Assignment

Using this project in a stand-alone course requires students to commit more time than is usually required for an extra project in a standard tax course. However, the instructor has modified the project substantially to use it in the corporate tax course and in other tax courses.

The headquarters for a major home improvement chain (Lowe's) is near the university. Each semester, the corporation provides copies of its annual report for all students in tax courses taught by the co-author, Howard Godfrey. Before the first class, the instructor studies the financial statements, the income tax footnote, and other footnotes containing relevant information about accounts affected by Topic 740. The annual reports are distributed on the first day of class, and the instructor leads the class on a journey—moving from the financial statements to the footnotes and back several times as information about various accounts or notes is analyzed.

For example, the footnote for proper-

ty indicates that the straight-line method of depreciation is used in the financial statements, setting the stage for a visit to the balance sheet and to the tax footnote showing a substantial deferred tax liability for the property. The effective income tax rate found in the tax footnote is verified by referring to the income tax provision in the income statement. The details of the income tax provision in the tax footnote are related to the income tax provision shown in the income statement. The deferred tax asset for net operating losses in foreign jurisdictions and the related valuation allowance account are explained by the instructor, as well as the note indicating that the company has not provided for deferred income taxes for undistributed earnings of foreign subsidiaries. A substantial part of the first class is devoted to studying the annual report. Students are asked to keep their copies of the report for reference later in the semester, especially when the accounting for income tax topic is covered.

Benefits From the Project

In many cases, students in a master of accountancy tax course are just a few months away from starting careers in public accounting (or corporate accounting, etc.). A new graduate may quickly become involved in a “crash course” learning about an important client (or the individual's corporate employer). The graduate may need to quickly learn about the company's (1) business operations; (2) applicable GAAP; (3) tax issues; (4) tax returns; and (5) financial reporting practices.

Students reported the following benefits or discoveries from the project:

- Learning about, and reconciling, book-tax differences using the annual report, tax law, and FASB resources is quite different from learning in a classroom setting or solely from a textbook.
- At the beginning, the project can be somewhat intimidating if they

do not have experience studying financial statements.

- Conducting research using a tax research service and the FASB ASC may help when they work simulations on the Uniform CPA Examination.
- The project provides a glimpse into the type of tax issues students will face when preparing tax returns.

It provides an opportunity to learn the language used in financial statements and gain practice thinking analytically.

Getting CPAs Involved in the Project

There is a potential for getting CPAs involved in the project in at least two ways. First, the instructor may have a guest speaker who has a role in preparing the financial statements and the footnotes, either as an accountant or as a tax specialist for the company under study. The speaker may explain the process by which the company accumulates the information for the financial statements and the footnotes, and the process for preparing those documents. The speaker may shed some light on how decisions are made about the need for an allowance account for deferred tax assets, the identification and measurement of uncertain positions, etc. The speaker may be able to use some of the footnotes as a foundation for the presentation and may be able to present some “problems” for classroom discussion. The corporation may understandably limit the scope of the speaker's presentation somewhat, but such a presentation can potentially provide valuable insights for the students and the instructor.

The second alternative is to invite an individual in an accounting firm who has a role related to accounting for income tax, whether as an auditor or as a tax specialist. If the company under study is a client of the firm, discussion of material in the company's annual report would likely be off-limits. However,

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if the individual is not involved with the company in that way, he or she can provide valuable information about the firm's policies and practices related to determining what should be disclosed, and how it is disclosed in the relevant footnotes of its clients. Other topics may include firm procedures related to deferred tax asset valuation issues and determining the level of authority needed to support tax return positions.

Conclusion

Accounting for income taxes is an exciting and important subject for both students and tax faculty. Many forces collide at the intersection of (1) a government enforcing a complex income tax law; (2) a company seeking to minimize its global income tax burden while providing reliable financial statements to its users; and (3) a CPA firm providing assurance regarding the adequacy of the income

tax expense accounts, and other related accounts, and the overall reliability of the financial statements including the footnote disclosures. A project, as described in this column, using a corporation whose headquarters is close to the center of academic study, can provide a helpful bridge for accounting and tax students to see the important intersection of GAAP and tax, and be better prepared for their intended career path. ■

Exhibit: Accounts for the company under study

(Amounts rounded, generally to nearest \$1,000,000)

1. Accounts receivable	\$26,000,000
Allowance for uncollectible accounts	\$ (600,000)
GAAP basis of accounts receivable	\$25,400,000
Tax basis of accounts receivable	\$26,000,000

Deferred tax asset computation is based on the difference between tax basis and the GAAP basis of the asset, caused by use of the allowance method for uncollectible accounts in financial statements and the direct-write-off method on the tax return.

2. Property, plant, and equipment	\$ 72,000,000
Accumulated depreciation	\$(41,000,000)
Book value of property, plant, and equipment	\$ 31,000,000
Deferred tax liability	\$ 4,000,000

A deferred tax liability is the future tax impact of a difference between tax and GAAP basis of the asset, presumably caused here by the use of accelerated depreciation on tax returns.

3. Deferred tax asset (liabilities and other)	\$500,000
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Presumably this is caused by current accrual of estimated future liabilities that will result in deductible expenses when the company becomes liable for the debt.

4. Deferred tax asset (compensation)	\$2,000,000
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Presumably this deferred tax asset resulted at least in part from current recognition of stock option expense, to be deducted on the tax return in a future year.

5. Alternative minimum tax credit	\$1,000,000
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Deferred tax asset for the benefit of the credit carryforward expected to be realized in the future.

6. Earnings of foreign subsidiaries	\$55,000,000
"Potential" deferred tax liability	\$20,000,000

Company could "potentially" be required to recognize deferred income tax expense and a deferred tax liability for \$20,000,000.

However, the company has permanently invested those earnings in the foreign countries. Therefore, no accrual of deferred tax liability is required.

7. Operating loss carryforward	\$60,000,000
Deferred tax asset	\$23,000,000

Deferred tax asset: potential future income tax savings as a result of deducting the loss carryforward.

8. Deferred tax asset valuation allowance account established in 2009	\$27,000,000
Reduction of balance in 2010	\$(5,000,000)
Reduction of balance in 2011	\$(6,000,000)
Reduction of balance in 2012	\$(4,000,000)
Current allowance balance for 2012	\$12,000,000

In 2009, company established full valuation allowances against U.S. and China deferred tax assets (because of the losses being realized at that time). In 2010, company reduced the allowance balance and recorded an income tax benefit of \$5,000,000. In 2011, company recorded an income tax benefit of \$6,000,000, partly from realization of loss carryforwards and partly due to a change in judgment about the company's future profitability. In 2012, company reduced the allowance balance and recorded an income tax benefit of \$4,000,000.

Note: Company had an allowance for discounts, returns, etc., which is ignored in this summary.