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EDUCATION FOR TODAY’S BUSINESS NEEDS

THE GAAP IN TAX EDUCATION: INTEGRATING TAX AND FINANCIAL ACCOUNTING IN THE TAX CURRICULUM

Tax education has experienced several major shifts in the past two decades, driven by changes in the focus of tax practice. During the 1970s and 1980s, the emphasis in practice and in the classroom tended to be on compliance (i.e., teaching students to fill out tax forms properly and understand the nuances of the tax laws). Within corporate America, the tax function was treated as a cost center. The relation between the tax laws and financial accounting generally was mentioned only in passing, if at all. “Accounting for income taxes” was a topic left to instructors of intermediate or advanced accounting classes.

During the 1990s, tax practitioners at national and international CPA firms concentrated on selling tax planning strategies that affected their clients’ financial statements, either through a reduction in the income tax provision or an increase in pretax income. In corporate America, the tax function was elevated to a profit center; the emphasis shifted to “enhancing shareholder value.” This shift in emphasis created the need for a “new tax” curriculum, centered around taxes and business decision-making. The traditional rules-based tax textbook approach was challenged by texts that provided students with a conceptual approach to taxation, summarizing the general rules and their application to various decisions made by firms and individuals (e.g., savings, compensation, investment, mergers and international expansion). Tax decision-making classes became popular in master’s of business administration (MBA) and accounting programs.

At about the same time, the AICPA established a committee of practitioners and academics to craft a Model Tax Curriculum (MTC) for undergraduate, masters and MBA programs. (The model tax syllabi related to this curriculum can be accessed via the AICPA website, www.aicpa.org.) Professors who have incorporated the MTC into their curriculums shared their experiences; see, e.g., Dennis-Escobier, et al., Tax Education, “Experiences with the Model Tax Curriculum,” TTA, May 2001, p.340. In the preamble to the first undergraduate course, the task force stated that “it is extremely important that students be introduced to a broad range of tax concepts, particularly with-
in a framework of financial accounting" (emphasis added). The recommended syllabus, however, does not include any reference to introducing the financial accounting rules that apply to income taxes. The model syllabi for the second undergraduate (first masters) tax class suggests spending two hours on "financial tax accounting concepts," defined as Statement of Financial Accounting Standard (FAS) No. 109, Accounting for Income Taxes, and GAAP.

Need for a New Approach
The much-publicized bankruptcies of Enron Corp. and WorldCom ushered in a new "expectation" in tax practice at both the advisory and firm levels, one that might be characterized as tax risk management. At Congressional hearings investigating the rise and fall of these public corporations, government investigative bodies (i.e., the Joint Committee on Taxation) and others (including this column's authors) pointed out that the rules on accounting for income taxes left room for managers to manage earnings through the tax provision without detailed disclosure. FAS No. 109, the primary source of the accounting rules related to recording income taxes, went from a little understood—and often overlooked—accounting pronouncement, to a "shadowy world."

As a result, the tax function mission of "enhancing shareholder value," while still important, must now be evaluated through a new filter imposed by Congress and the IRS—"transparency through disclosure." Members of the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) have stated that "sunlight is the best disinfectant" for cleansing financial statements of aggressive interpretations of tax accounting rules.

Purveyors and purchasers of tax strategies that affect financial accounting income must now consider not only the costs and cashflow benefits of implementing such a strategy, but also whether and how the transaction must be disclosed to both investors and the Service. This would include Schedule M-3, Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More (requiring detailed book and tax differences to be reported on the corporate income tax form); Form 8858, Information Return of 115 Persons With Respect to Foreign Disregarded Entities (requiring detailed information on "check-the-box" entities); mandatory electronic filling; internal controls (Sarbanes-Oxley Act of 2002 (SOX) Section 404); tax controversies; material advisor lists and disclosure; reportable transactions; and tax accounting (FAS No. 109).

These new rules have had a dramatic effect on tax departments in professional service firms and their clients. Tax directors, once evaluated by their knowledge of the Code, are now being evaluated by their knowledge of GAAP as it applies to tax accounting. Their constituency, once confined to the IRS, now includes the Financial Accounting Standards Board (FASB), PCAOB, SEC, and investors and creditors.

Reinforcing this change in expectation of the tax function was a Tax Council Policy Institute (TCPI) survey of tax directors, in which 83% of the respondents stated that "avoiding a financial statement error" was among their most important priorities; see TCPI 7th Annual Tax Policy and Practice Symposium, "The Corporate Tax Practice in the Age of Transparency: A Path Forward," 84 Taxes 33 (June 2006). About 50% of the respondents cited "reduced effective tax rate"; only 39% cited "achieving cash tax savings."

The Glass Half Full
The good news is that individuals who understand the accounting-for-income-tax rules have never been in higher demand, by both public accounting firms and corporations. A recent article labeled specialists in FAS No. 109 as the "new rock stars in tax"; see Fieswick, "Too Taxing," CFO Magazine (11/1/05), p. 101, available at www.cfo.com/article.cfm/5077959/c_51010832?m=magazine_alsoinside. The numbers of accounting majors have not increased fast enough to keep up with this demand. Many corporations have created new positions within their tax departments dealing strictly with FAS No. 109 issues. These individuals are commanding salaries comparable to those paid to new partners at international CPA firms.

In the post-Enron SOX world, the outside auditors can no longer do the income tax provision work for their clients. As a result, tax professionals from public accounting firms are doing significant amounts of provision work for the non-attest clients (sometimes referred to as "co-sourcing" these activities between the corporation and the CPA firm). This creates a bifurcation of duties within the firm, with the auditors being asked to audit the provision work of professionals from another firm. This puts pressure on an auditor to know how the tax rules affect the financial reporting of tax strategies, and on the tax professional to understand how the financial reporting rules may affect a tax strategy. All of the international CPA firms have made

on Feb 9, 2006, are available on the SEC website, at www.sec.gov/news/speech/ sphr020906sec.htm. Many Fortune 500 companies have been cited as having material weaknesses in their tax accounting function; several have had to restate their financial statements. More than one practitioner has noted that the tax function, which used to be called an "art," has now been transformed into a "science." Others have lamented that tax practice has become more complex than tax law.
knowledge of FAS No. 109 a "core competency" in their internal tax education programs.

New Opportunities

Tax accounting educators today have an opportunity to provide their students with a comparative advantage in practice: a working knowledge of FAS No. 109. The recommendation by the AICPA MTC Task Force, that taxation should be taught within a financial accounting framework, has never been more timely. As always, the details as to how this objective should be achieved and by whom is key. Educators struggle, as do public accounting firms, with assigning the responsibility for integrating the financial-accounting-for-income-tax rules into their curricula (several CPA firms now refer to their professional education function as a "university").

Because this topic deals with financial accounting standards, it is natural to assume that the financial accounting faculty will take on this responsibility. Most intermediate accounting instructors cover a chapter on the basics of income tax accounting, at least introducing the concepts of current and deferred taxes. At the MBA level, most financial-statement-analysis textbooks also have a chapter on the rudiments of FAS No. 109 as it applies to the balance sheet and income statement. The drawback to this cursory approach is that most of the students in these classes will not have had a corporate tax class, so that their understanding of the transactions that create book and tax differences will be lacking.

A second philosophy is that this topic should be taught in an auditing class. This has some conceptual appeal. The majority of accounting majors will begin their careers as auditors, which will involve auditing the tax provision. AU Section 9326 of the AICPA Professional Standards, Evidential Matter: Auditing Interpretations of Section 326, focuses on obtaining "sufficient competent evidential matter" to provide a reasonable basis for forming an opinion as it relates to the tax provision. Given the importance of the tax provision and its prominence in material weaknesses statements, it would seem critical that students be exposed to this auditing pronouncement. Few (if any) auditing texts devote space to auditing the tax provision; as a result, few (if any) auditing professors devote time to this topic.

That leaves the tax accounting professor with the challenge (or unenviable task) of integrating FAS No. 109 into the tax curriculum. Allocating two hours to the topic, as suggested in the MTC, is woefully inadequate. A thorough introduction to FAS No. 109 requires 10 to 20 classroom hours, depending on how detailed the instructor wants to get. At a minimum, he or she needs to discuss the pronouncement's balance-sheet approach to how the current and deferred tax provisions are calculated, differentiating the types of temporary differences (taxable and deductible) from permanent differences. How these components of the provision calculation are disclosed, both on the balance sheet and in notes to the financial statement, is essential (e.g., students should understand the components and calculation of the company's effective tax rate reconciliation in the tax footnote). The management-judgment aspects of FAS No. 109 (in particular, the creation of valuation allowances and determination of the tax contingency reserve under new FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes) should also be discussed.

Learning how to interpret financial statement tax information is another critically important skill. For examples of such analyses, see McGill and Outslay, "Lost in Translation: Detecting Tax Shelter Activity in Financial Statements," 57 Nat'l Tax Journal 739 (September 2004), and McGill and Outslay, "Did Enron Pay Taxes?: Using Accounting Information to Decipher Tax Status," 96 Tax Notes 1125 (8/19/02). The classroom use of Enron's tax information was illustrated in McGill and Outslay, "Case Study: The JCT's Enron Report Sheds Light on the Book vs. Tax Debate," TTA, August 2003, p. 500.

How much, and the extent to which, instructors want to delve into the tax accounting aspects of specific transactions (e.g., the issuance and exercise of stock options, business combinations, cross-border transactions) is a personal decision. One benefit of integrating the FAS No. 109 consequences of specific components of the corporate tax return into a tax course is the opportunity to have the students take an income statement and convert it into a tax return, after which they can calculate the company's tax provision and prepare its Schedule M-3 reconciliation in Form 1120.

How dispersed or concentrated the focus on FAS No. 109 should be depends on the structure of the tax curriculum. For the first undergraduate course, an introduction to the nature of book and tax differences and the preparation of a basic Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return, to Form 1120 seems sufficient (warning the students, of course, that the tax accounting process is extremely complex). At the masters level, the basic components of the provision computation should be introduced in the tax class that deals with corporations and shareholders. The accounting rules that apply to more complex transactions (e.g., business combinations and cross-border transactions) can better be discussed in conjunction with the technical tax rules that apply to them.

Challenges

The greatest challenges to creating the new school of tax accounting are, not surprisingly, time and resources, which directly correlate with instructor familiarity with the material. Most tax educators today lament the lack of time to cover all of the technical tax rules imposed by the Code's 1,900-plus pages. The thought of finding two (much less 20) hours to devote to FAS No. 109 likely would be viewed as infeasible. Embracing a financial accounting approach to teaching the
Corporate tax class means reducing the time spent with tax technical topics traditionally taught. For example, it may no longer be possible to cover all of the nuances related to incorporations, dividends, redemptions, reorganizations and liquidations. Although these technical tax topics are an essential part of the tax practitioner's toolbox, implementation is usually at a high level (manager or partner), and the rules are taught to tax staff in their second or third year (associate or senior). Entry-level tax and auditing staff likely will encounter FAS No. 109-related issues much earlier in their careers than the intricacies of these tax transactions.

The second challenge, assuming the time issue can be overcome, is the lack of resources related to accounting for income taxes. Tax textbooks traditionally have not addressed FAS No. 109, although this is changing. The public accounting firms have extensive FAS No. 109 libraries, most of which are restricted to their professional staff. Some of the firms have made these materials available on their websites and through webcasts. All of the international firms have recognized the importance of helping university educators understand the tax accounting rules and have offered seminars at conferences. These seminars are invaluable to tax educators trying to understand the rules and the relevance of these accounting principles to the tax practice community. (Note: The American Taxation Association will devote part of its February 2007 midyear meeting program to teaching FAS No. 109; materials presented at this conference will be available at the association's website, at http://aatax.org/ata/index.htm.)

As with all satisfying endeavors, the rewards of developing a tax curriculum centered around financial accounting are not achieved without significant time and emotional commitment by faculty members. For beginning faculty, there are many synergies to this teaching approach and research. A growing body of tax research — much of which is being done through collaboration between accountants, economists and lawyers — is devoted to how companies react (or are likely to react) to changes in tax legislation that have financial accounting implications. Such integrative research often finds its outlet in the major accounting and economics journals, further enhancing the author's chances for promotion and tenure. Much like in practice, the senior tax accounting professor may find this new approach uncomfortable. At the same time, however, today's tax environment demands that such a shift may be necessary.