

Assessing The Internal Control Structure For Income Tax Account Balances And Their Related Disclosures

Jeff Decker, California State University, Chico, USA
Richard Ray, California State University, Chico, USA
Tim Kizirian, California State University, Chico, USA

ABSTRACT

We provide practical considerations to guide auditors in performing a preliminary assessment of the design of the auditee's control structure related to income tax account balances and their related disclosures which should contribute to more reliable financial reporting. While our process is specifically designed for use in performing an integrated audit under PCAOB Auditing Standard No. 5 (PCAOB, 2007), the internal control objectives and related control activities we present are also useful in performing other types of audits or limited engagements.

Keywords: Income Tax; Internal Control; Control Objective; Control Activity; PCAOB

INTRODUCTION

*F*inancial statement auditors are responsible to assess internal control systems and procedures over the production of tax account balances and their related disclosures. Many young emerging accounting professionals erroneously believe the focus on income tax balances and disclosures is the responsibility of the tax professionals in a large CPA firm as opposed to the auditors. It is the financial statement auditor who is responsible to assess internal control for all balances on all financial statements when conducting a PCAOB integrated audit.

Our study proceeds as follows. First, we discuss the importance of internal controls, then we outline the principle account balances and disclosures for processing income tax information. The remainder of the paper outlines overall control objectives for income tax account balances and disclosures with the related management assertions, whether stated or implied. We then link control activities with control objectives for related account balances and financial statement disclosures.

Importance of Internal Controls

The effectiveness of an organization's internal controls plays a critical role in ensuring that the financial statements are accurate and free of material error and bias. One of the purposes of financial reporting is to provide useful information to decision makers. A primary characteristic of useful information is the reliability of this information. Decision makers should be able to know the accounting information provided is accurate and free of material error and bias. Since decision makers neither have the time nor the expertise to determine the factual content of the accounting information themselves, they rely on the auditor to make that determination. Therefore, it is essential that the auditor assess the effectiveness of the organization's internal controls.

“Effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes. If one or more material weaknesses exist, the company's internal control over financial reporting cannot be considered effective” (PCAOB, 2007). Additionally, Doyle, Ge and McVay (2007) finds that weaker internal controls lead to poorer accrual quality estimates which can be the result of either (1) intentionally biased accruals through earnings management, (2) unintentional errors in

accrual estimation, or (3) both. Strong internal controls can help mitigate aggressive reporting outlined in Kadous, Kennedy and Preecher (2003). Finally, an ineffective internal control system will decrease the probability of detecting fraud AICPA (2002). An effective internal control system increases the reliability of the financial statements which makes information more useful to decision makers.

Principle Account Balances and Disclosures for Processing Income Tax Information

Income tax information needs to be captured and processed for the following accounts: Income Taxes Receivable, Income Taxes Payable, Deferred Income Taxes, and Income Tax Expense. Further, the Income Tax Disclosures need to be prepared and reviewed.

Control Objectives for Income Tax Account Balances and Disclosures by Management Assertion

Balances

The application and interpretation of generally accepted accounting principles (GAAP) is an essential part of appropriately recording the income tax provision and related income tax accounts. If appropriate accounting treatment is not applied to the income tax provision and related income tax accounts, the related account balances could be inaccurate, which could cause the financial statements to be misstated. In addition, some empirical evidence suggests that tax account balances have been negotiated between a firm and an auditors to meet earnings' targets (Dhaliwal, Gleason & Mills, 2004). The proper application and interpretation of GAAP should be built into the entity's accounting policies for each of the steps in performing income tax calculations. In addition to having accounting procedures for current, ongoing transactions and events affecting income taxes, management's policies should embrace continuous review and improvement for new authoritative guidance.

A critical control objective for the income tax balances is that appropriate accounting treatment is specified for the income tax provision and related income tax accounts, including those aspects requiring the use of accounting estimates and judgment in the selection and application of GAAP. This control objective will typically support management's Recording and Valuation assertions for income tax expense, deferred income taxes, and income taxes receivable/payable.

Two key control activities support the above control objective. First, the financial statement accounting treatment for new kinds of transactions, planning strategies, and tax entities or jurisdictions affecting income tax - including those requiring the use of significant estimates and judgment - in the selection and application of GAAP is researched, analyzed, documented, updated, and communicated to responsible parties on a continuous basis. Second, knowledgeable personnel should monitor changes in GAAP and income tax promulgation that affect the financial statements. The financial statement accounting effect of such changes should be researched, analyzed, documented, and incorporated into the accounting policies, and again, communicated to responsible parties on a continuous basis.

The application and interpretation of GAAP should be applied consistently across the entity and across accounting periods. This requires the use of consistent accounting policies and procedures and the quality control evaluation of their consistent application. If aspects of the calculations related to the income tax provision and related income tax accounts are evaluated using inappropriate or inconsistent methodologies and assumptions, the income tax balances may not be reflected accurately causing the financial statements to be materially misstated.

A critical control objective for the income tax balances is that the income tax provision and related income tax accounts are evaluated using methodology and assumptions that are consistent across the entity and across accounting periods. After all, some empirical evidence exists to suggest that management will manipulate the Valuation Allowance Account (VAA) to meet earning targets (Schrand & Wong, 2003; Frank & Rego, 2006). This evidence suggests that the policies of management are not consistent across accounting periods but are more of a function of an earnings' target. This control objective will typically support management's Recording and Valuation assertions for income tax expense, deferred income taxes, and income taxes receivable/payable.

Two key control activities support the above control objective. First, analytical reviews of the components of the income tax provision and related income tax accounts are performed with significant exceptions being highlighted for review. Significant exceptions are investigated and resolved on a timely basis and in the appropriate accounting period. Second, management monitors the proper application of accounting policies and procedures for preparing the income tax provision and related income tax accounts.

Controls need to be in place to ensure the validity, accuracy, and completeness of the data behind the general ledger as well as other information that leads to the income tax provision and related income tax account balances. This includes controls over completeness (all transactions and events are considered), implemented tax planning strategies, intercompany transactions between tax jurisdictions, and any other matters giving rise to temporary differences, permanent differences, tax credits, and alternative taxes. If the underlying data and information necessary to prepare the income tax account balances is not complete, accurate, and relevant, information may not be accurately analyzed or may be calculated based on incorrect or incomplete data, which could cause the income tax accounts and financial statements to be misstated.

With the higher risk due to incorrect or incomplete data, a critical control objective for income tax balances is that the data to record, process, and report the income tax provision and related income tax accounts is relevant, sufficient, and reliable. This control objective will typically support management's validity, completeness and recording assertions for income tax expense, deferred income taxes, and income taxes receivable/payable.

Three key control activities support the above control objective. Management must ensure that the information used to prepare the income tax provision and related income tax accounts is relevant. Management ensures this relevance by instilling controls that support the validity, accuracy, and completeness of the information that builds the income tax provision and related income tax accounts. This includes controls over any process used to extract, summarize, and accumulate data and any other information that supports the general ledger. Second, to promote completeness, data supporting the general ledger is compared to a listing of all subsidiaries and entities that can affect the income tax provision and related income tax accounts. Third, all temporary differences, permanent differences, income tax contingency reserves, and intercompany transactions between tax jurisdictions are reviewed and compared for completeness and accuracy. Prior research has provided empirical evidence to suggest that many firms have used temporary and permanent differences, etc. to aggressively report the financial and tax positions (Frank, Lynch & Rego, 2009; Hanlon, 2005; Krull, 2004).

Supporting calculations to prepare the income tax provision and related income tax accounts should be performed and documented. The calculations should be prepared in accordance with GAAP and the entity's accounting policies. Financial statement income tax balances often require numerous different calculations and estimates. If accounting policies - including the methodologies and assumptions - relating to income tax accounts are incorrectly applied or supporting calculations are not performed, the balances for the income tax accounts may not be reflected accurately, causing the financial statements to be materially misstated.

The possibility of material misstatements due to miscalculations means that a critical control objective for income tax balances is that the application of the entity's accounting policies to the income tax provision and related income tax accounts is performed on a timely basis and appropriately documented. This control objective will typically support management's validity, completeness, recording, cutoff and valuation assertions for income tax expense, deferred income taxes, and income taxes receivable/payable.

Six key control activities support the above control objective. First, supporting calculations for the income tax provision and related income tax accounts are prepared and documented by knowledgeable and skilled personnel. The calculations include the income tax provision implications of all book-to-tax temporary and permanent differences, income tax credits, alternative income taxes, and their related adjustments to the deferred income taxes and income taxes payable/receivable accounts. The entity can utilize a checklist of policies and procedures to ensure the income tax provision and related income tax accounts are valid, complete, and properly recorded in the appropriate accounting period. Second, a calculation of income tax contingency reserves is performed by knowledgeable personnel in accordance with GAAP and the entity's accounting policies. These reserves result from identified disagreements such as pending assessments from taxing authorities as well as from potential disagreements such as unassessed claims of

reasonably estimable and probable of occurrence based on tax filing positions taken. Third, an analysis of deferred income tax asset valuation allowances should be conducted by knowledgeable and skilled personnel in accordance with GAAP. Fourth, the income taxes payable/receivable account should be reconciled to the supporting detail and differences resolved with adjusting journal entries made in the appropriate accounting period. Fifth, intercompany transactions between tax jurisdictions should be reconciled and differences resolved with adjusting journal entries made in the appropriate accounting period. Sixth, calculations to support the income tax provision and related income tax accounts are reviewed to ensure that events from all subsidiaries are included for completeness.

The analyses and calculations supporting the balances for the income tax provision and related income tax accounts should be reviewed by someone independent of the preparer. These independent reviews should occur prior to recording amounts in the general ledger. If amounts related to income tax accounts are not independently reviewed for appropriateness and for proper judgment or if exceptions are not properly resolved, the financial statements could be materially misstated.

A critical control objective related to an independent review is that a person with appropriate level of authority, knowledge, skills and experience carries out an independent review to ensure appropriate accounting and judgment on the income tax provision and related income tax accounts. Exceptions are identified, always investigated, and properly resolved with adjusting journal entries made in the appropriate accounting period. This control objective will typically support management's validity, completeness, recording, cutoff and valuation assertions for income tax expense, deferred income taxes, and income taxes receivable/payable.

The key control activity to support the above control objective is management's regular review of the income tax provision and adjustments to related income tax accounts. Any issues identified as part of the review of the income tax calculations are resolved by means of adjusting journal entries made in the appropriate accounting period.

Once the calculations supporting the balances for the income tax provision and related income tax accounts have been approved by management, these amounts must be appropriately recorded in the general ledger. If the balances related to the income tax provision and related income tax accounts are not recorded in an accurate and timely manner at the amounts approved by management, the related account balances could be inaccurate, causing the financial statements to be materially misstated.

A critical control objective that addresses management approval is that the management-approved income tax provision and related income tax account balances are recorded in the general ledger at the approved amounts and in the appropriate accounting period. This control objective will typically support management's recording and cutoff assertions for income tax expense, deferred income taxes, and income taxes receivable/payable.

The key control activity to support the above control objective is to ensure that journal entries relating to the income tax provision and the related income tax accounts have adequate supporting documentation and are reviewed and approved independently prior to posting to the general ledger.

Significant estimates and judgments related to the income tax provision and related income tax accounts should be reviewed by senior management for appropriateness and should also be discussed with the audit committee. This includes a review of estimates such as income tax contingency reserves and valuation allowances. The review must also be reflective to prior year information. If significant accounting estimates and judgments are not carefully reviewed and validated by management on a timely basis, the income tax account balances could be inaccurate and cause the financial statements to be materially misstated.

In the case of estimates and judgments, that a critical control objective is that significant accounting estimates and judgments associated with the income tax provision and related income tax accounts are based on valid information and reviewed by management. Significant estimates and judgments are communicated to the audit committee on a timely basis. This control objective will typically support management's validity, completeness, cutoff and valuation assertions for income tax expense, deferred income taxes, and income taxes receivable/payable.

Two key control activities support the above control objective. First, the audit committee should be informed on a timely basis of significant estimates and judgments related to the income tax provision and related income tax accounts. Second, an independent review of significant income tax judgments and estimates is performed at the end of every accounting period by knowledgeable, skilled, and experienced personnel. Income tax contingency reserves and valuation allowances are reviewed, including a retrospective review to prior year information.

Disclosures

There should be GAAP-based analyses to support the procedures leading to the overall financial statement income tax disclosure information. If the GAAP-based analyses regarding the income tax disclosure are not accurately performed on a timely basis, the financial statement income tax disclosures may be materially misstated.

A critical control objective is that the financial statement income tax disclosure is prepared in accordance with GAAP. This control objective will typically support management's validity, recording, completeness, cutoff, valuation and presentation assertions for income tax disclosures.

One primary control activity supports the above control objective. Calculations that support the GAAP income tax disclosure are prepared by personnel who have proper knowledge, skills and experience. An entity-specific checklist, a GAAP disclosure checklist, or other suitable mechanism is used to ensure the financial-statement income tax disclosure is valid, complete, and appropriately presented in the appropriate accounting period.

The analyses supporting the income tax disclosure information should be reviewed by someone who is independent of the preparer to ensure the disclosure is accurate, complete, and prepared in accordance with GAAP. If the analyses supporting the income tax disclosure is not independently reviewed, errors in judgment made by the original preparer of the disclosure may cause the disclosure and the financial statements as a whole to be materially misleading.

A critical control objective is that the income tax disclosure is independently reviewed and validated for appropriate and unbiased assumptions, methodology, and presentation in accordance with GAAP. This control objective will typically support management's validity, recording, completeness, cutoff, valuation and presentation and disclosure assertions for income tax disclosures.

One primary control activity supports the above control objective. Personnel who have the proper knowledge, skills and experience independently review the income tax disclosure using a disclosure checklist to determine compliance with GAAP. All exceptions identified through the review are resolved.

The income tax disclosure is prepared using information obtained from the general ledger or from other sources. Controls over the accuracy of the data and other information used in preparing the disclosure need to be in place and operating effectively. This includes controls to ensure that all relevant information is considered in preparing the disclosure (completeness). If the underlying data and information necessary to prepare the income tax disclosure is not complete, accurate, and relevant, the resulting disclosure may not be accurately prepared which could cause the disclosure and the financial statements as a whole to be materially misleading.

A critical control objective is that the data and information used to prepare the income tax disclosure is relevant, complete, and reliable. This control objective will typically support management's validity, recording and completeness assertions for income tax disclosures.

One primary control activity supports the above control objective. Internal controls need to be in place and operating effectively to ensure the validity, accuracy, and completeness of the data and other information used in preparing the income tax disclosure. This includes internal controls over any process used to extract, accumulate, summarize, and classify data and information for presenting the income tax disclosure. All data and information leading to the tax disclosure is reconciled to supporting documentation.

CONCLUSION

Effective internal controls can mitigate aggressive reporting (Kadous et al. 2003), manipulation of earnings targets (Dhaliwal et al. 2004; Schrand & Wong, 2003; Frank & Rego, 2006), and the use of temporary and permanent differences to aggressively report financial and tax positions (Frank et al. 2009; Hanlon, 2005; Krull, 2004). Financial statement auditors are responsible to assess internal control systems and procedures over the production of tax account balances and their related disclosures. By outlining critical control objectives with the related management assertions and control activities, we provide practical considerations to guide auditors in performing a preliminary assessment of the design of the auditee's control structure relating to income tax account balances and disclosures. The practical considerations we provide should contribute to more reliable financial reporting and more accurate accrual accounting estimates as outlined in Doyle et al. (2007).

AUTHOR BIOGRAPHIES

Jeff Decker, Ph.D., CPA is an Associate Professor of Accounting at CSU, Chico. He has taught Managerial, Financial, Auditing and MBA accounting. His research focuses on issues relating to management's use of internal controls. E-mail: jldecker@csuchico.edu

Richard Ray, Ph.D., CPA is an Assistant Professor of Accounting at CSU, Chico. He has taught both Individual and Business Entity Taxation at CSU, Chico. His research typically focuses on issues in Corporate Taxation, Real Estate Investment Trusts and Regulated Investment Companies. E-mail: rwrap@csuchico.edu

Tim Kizirian, Ph.D., CPA is a Professor of Accounting and Department Chair at CSU, Chico. He has taught Auditing, Forensic Accounting, and Financial Accounting. His research typically focuses on issues in auditing and internal controls. E-mail: tkizirian@csuchico.edu (contact author)

REFERENCES

- American Institute of Certified Public Accountants (AICPA). (2002). Consideration of Fraud in a Financial Statement Audit. *Statement on Auditing Standards No. 99*. New York, NY: AICPA.
- Dhaliwal, D., Gleason, C. & Mills, L (2004) Last-Chance Earnings Management: Using the Tax Expense to Meet Analysts' Forecasts. *Contemporary Accounting Research*, 21(2), 431-459.
- Doyle, J.T., Ge, W. & McVay, S (2007). Accruals Quality and Internal Control over Financial Reporting. *The Accounting Review*, 82(5), 1141-1170
- Frank, M. & Rego, S. (2006). Do Managers Use the Valuation Allowance Account to Manage Earnings around Certain Earnings Targets? *Journal of the American Taxation Association*, 28(1), 43-65
- Frank, M., Lynch, L. & Rego, S. (2009). Tax Reporting Aggressiveness and Its Relation to Aggressive Financial Reporting. *Accounting Review*, 84(2), 467-496.
- Hanlon, M. (2005). The Persistence and Pricing of Earnings, Accruals, and Cash Flows When Firms Have Large Book-Tax Differences. *Accounting Review*, 80(1), 137-166.
- Kadous, K., Kennedy, J. & M. Peecher. (2003.) The effect of quality assessment and directional goal commitment on auditors' assessment of client-preferred accounting methods. *The Accounting Review*, 78, 759-778.
- Krull, L. (2004). Permanently Reinvested Foreign Earnings, Taxes, and earnings management. *The Accounting Review*, 79(3), 745-767.
- PCAOB. (2007). An Audit of Internal Control over Financial Reporting that is integrated with an Audit of Financial Statements. Retrieved from: http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_5.aspx
- Schrand, C. & Wong, F. (2003) Earnings Management Using the Valuation Allowance Account for Deferred Tax Assets under SFAS. No. 109, *Contemporary Accounting Research*, 20(3), 579-611.