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## 2009 Year-End Tax Accounting Via the Tenets of Warren Buffet

**By Doug Sayuk, Matt Fricke, Ray Naughtin, and Shamen Dugger**

*Douglas M. Sayuk, CPA, and Matthew H. Fricke, CPA, are partners with Clifton Douglas LLP, of San Jose, Calif. Ray J. Naughtin, CPA, and Shamen R. Dugger, Esq., CPA, are directors with Clifton Douglas. The authors can be reached at Doug@clifftondouglas.com, Matt@clifftondouglas.com, Ray@clifftondouglas.com, and Shamen@clifftondouglas.com. More information on Clifton Douglas is available at www.clifftondouglas.com.*

### I. Introduction

One of Warren Buffet's most well-known aphorisms is that "[I]t's not necessary to do extraordinary things to get extraordinary results."<sup>1</sup> This tenet is especially apropos with respect to 2009 year-end tax accounting wherein small adjustments could result in significant financial statement impacts.

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<sup>1</sup> *The Tao of Warren Buffet*, Mary Buffett & David Clark, 2006 Simon & Shuster, Inc.

Small adjustments to the following three key areas of tax accounting could prove most effective for year-end 2009: 1) development of salient internal controls; 2) enhancement of the tax provision preparation process; and 3) thoughtful preparation of financial statement disclosures. In tandem, these seemingly innocuous changes could have potent results.

In this article, we will explore such adjustments from the vantage points of both public and private companies, small and large companies, and profitable as well as loss companies. Our analysis will be objective, highlighting both benefits and costs associated with identified potential changes. Where applicable, we will discuss tax savings and/or improvements to the bottom line based on our past experience.

### II. Development of Salient Internal Controls

The impact of salient internal controls is perhaps best exemplified by a story titled "How to Put the World Together - A Son's Solution."<sup>2</sup> Although the story is not a Warren Buffet tenet, we believe it is in line with his emphasis on simplicity.

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<sup>2</sup> *How to Put the World Together - A Son's Solution*, peteyandpetunia.com, author unknown

A father desiring to keep his son busy while he worked on business saw a magazine with a large map of the world on the cover. The father removed the map, and then patiently tore it into small pieces. He spread the pieces on the table and explained to his son that it was a map of the world, and that by the time the son could put the map back together, his extra work would be finished, and they could both play. Surely this would keep the child busy for hours, the father thought. About half an hour later the son came to the father and said, "Okay, it's finished. Can we play now?" The father was surprised, saying, "That's impossible. Let's go see." And sure enough, there was the picture of the world all put together, every piece in its place. The father said, "That's amazing! How did you do that?" The son said, "It was simple. On the back of the page was a picture of a man. When I put the man together the whole world fell into place."

Internal controls, from a tax accounting and reporting perspective, are much like the picture of the man in the story. Once internal controls are in place, the rest of a company's tax function falls into place as well. Unfortunately, internal controls tend to be one of the last considerations at year end rather than the first, treated as a mere afterthought though truly the tax provision foundation itself.

The least expensive and perhaps the most valuable small change could be for a company to evaluate its current internal controls (and best practices) related to tax accounting and reporting before delving into year-end tax provision preparation. A review of internal controls prior to tax provision preparation would highlight potential areas of risk requiring immediate and/or more in-depth consideration. Simply stated, an internal controls evaluation prior to year-end tax provision preparation can act as a roadmap to the most critical facets of year-end accounting and reporting.

For example, although most year-end internal controls are broad from a "control objective" standpoint, detailed aspects of the control objective found within "control activities" are quite specific and delineate all material steps taken to achieve the objective. These steps should be evaluated prior to tax provision preparation to ensure no gaps exist with respect to the compilation of data that ultimately formulates the tax provision itself. If gaps exist, the tax provision data may be materially incorrect. It is better to understand and address such an issue prior to tax provision preparation rather than subsequent to the deliverable.

Similarly, although the internal controls in existence may be complete and accurate, they may nevertheless be dated without due consideration of company changes, accounting changes, and/or legislative changes. Evaluating internal controls up-front at year-end can help pinpoint areas where tax function checks and balances are not reflective of current company operations and/or new legislative and accounting developments.

It is important to note that private companies are not required to adopt Sarbanes-Oxley Section 404 internal controls; however, many of the SOX 404 provisions have become private company "best practices" and "industry standards."<sup>3</sup> Therefore, the beneficial and relatively inexpensive impact of accurate and complete internal controls on private company tax functions is, for the most part, the same as that for public companies.

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<sup>3</sup> *SOX Impact on Private Companies*, Foley & Lardner LLP, 2005

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In evaluating the completeness and accuracy of current internal controls (and best practices) at year-end, a company may find it helpful to review internal controls in place in light of the following "Tax Function Effectiveness Best Practices Checklist" prepared by PricewaterhouseCoopers:<sup>4</sup>

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<sup>4</sup> *Tax Function Effectiveness Best Practices Checklist*, PricewaterhouseCoopers Tax Function Effectiveness book, 2008

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### Tax Functions Effectiveness Best Practices Checklist

<b>Enablers</b>	<b>Statement</b>
<b>Tax Strategy</b>	We know what taxes we pay/collect (our total tax contribution).
	We have agreed our approach to corporate responsibility in relation to tax.
	We understand our overall attitude to tax planning.
	We have a documented tax strategy.
	The tax strategy is discussed/agreed at board level at least once a year.
	We know our key areas of focus for managing tax.
	We have SMART (Specific, Measurable, Achievable, Relevant, Time-Bound) objectives for each area of focus.
<b>Structure of the Tax Function</b>	The structure of the tax function supports the implementation of the tax strategy.
	The structure of the tax function is aligned with the business.
	It is clear what the tax function is responsible for – which taxes and which enablers/deliverable.
	It is clear what the 'shadow' tax function is responsible for.
	It is clear when we use external advisors.

	The structure is flexible enough to cope with ongoing change.
<b>People</b>	We have sufficient tax resources to deliver the tax strategy.
	Tax function staff have the appropriate skills to deliver the tax strategy.
	Tax staff are continuing to develop their skills.
<b>Leadership</b>	The head of tax has access to the board.
	The head of tax is an effective ambassador for tax within the business.
	The head of tax is good at managing change.
	The head of tax is an effective manager of the tax function.
<b>Control/risk management</b>	Those involved in managing tax risk understand our attitude to tax risk.
	We have a documented tax risk policy.
	We understand where the major tax risks are in the business.
	We have evaluated the tax controls around the major risks.
	We have put in place appropriate controls to manage these risks.
	We monitor the operation of the key controls.
	The tax function knows the position on corporate income tax compliance around the whole group.
<b>Process</b>	We have a process for evaluating tax planning ideas.
	We have mapped the key processes for managing tax (including tax accounting and compliance processes).
	We have reviewed the processes for inefficiencies.
	We have implemented new processes where there were inefficiencies.
	We have people with the right skills to operate the processes.
	We monitor and review our processes on a regular basis.
<b>Data</b>	We have good data for tax forecasting.
	We can easily obtain the data we need for tax accounting.
	We can easily obtain the information we need for tax compliance.
	We receive data in a standardized format.
	There is a proper audit trail from the accounts to the tax returns.
	We validate the data to ensure correctness.
<b>Technology</b>	We use tax technology systems to prepare our tax figures.
	Our tax technology systems are integrated with the financial systems.
	Our tax technology systems are integrated with each other.
	We do not use spreadsheets/email as a way of collecting tax data.
	We do not spend a lot of time re-keying information.
	We store information in an electronic data management system.
	We have someone specifically responsible for tax information technology matters.
<b>Communication</b>	We know who the key internal and external stakeholders in tax are.
	We have a formal plan for communication with the stakeholders.
	The stakeholders understand the tax strategy as it affects them.
	We understand what the stakeholders need from the tax function and what the tax function needs from them.

We are in regular contact with our stakeholders (including revenue authorities).
We are aligned and integrated with the overall financial reporting team.
Source: PricewaterhouseCoopers Tax Function Effectiveness book, 2008

If your company, be it public or private, has implemented many of these tax internal controls/best practices, then your company likely already has a solid foundation in place upon which to build the 2009 year-end tax provision. Alternatively, if your company lacks many of these internal controls/best practices, then we recommend reviewing your tax function prior to 2009 year-end tax provision preparation to ensure no material areas of risk exist. We also recommend updating your internal controls/best practices as part of the 2009 year-end tax provision preparation and financial reporting process.<sup>5</sup>

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<sup>5</sup> It is important to note that company size often will dictate the extent to which a company must apply internal controls/best practices. Risk associated with the tax function of a ten employee loss company typically is much lower than the risk associated with a hundred employee profitable company.

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### III. Enhancement of the Tax Provision Preparation Process

Once the completeness and accuracy of internal controls are confirmed, along with the resulting data, the tax provision should be prepared. Again, with respect to tax provision preparation, extraordinary things are not required for extraordinary results. "You don't have to swing at everything - you can wait for your pitch."<sup>6</sup> If a company focuses on the following three items, the tax provision will be accurate and complete, along with minimized tax and implementation costs: 1) limit the players, but not too much; 2) understand the game; and 3) take advantage of low hanging fruit while avoiding complex tax minimization strategies.

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<sup>6</sup> *The Tao of Warren Buffet*, Mary Buffett & David Clark, 2006 Simon & Schuster, Inc.

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#### Limit the Players, but Not Too Much

As with cooking, in tax too many participants can ruin the tax provision. That is not to discount the importance of review or a "second pair of eyes." It is simply to eliminate duplication and confusion that comes with too many opinions.

Barring certain circumstances that call for specialists, the tax provision process should be limited to the preparer, internal reviewer, and the auditor. The tax provision preparer completes the tax provision itself, FIN 48 (formerly Accounting for Uncertainty in Income Taxes, now Accounting Standards Codification 740-10) analyses (or 2009 adoption in the case of private companies), and SOX 404 internal controls compliance. The internal reviewer (i.e., applicable company representative) reviews and attests to the accuracy of the preparer's work product. The auditor audits the company's work product. The process should be that simple, but oftentimes it is not.

This straightforward year-end tax provision process is often complicated by a desire to be too independent. By "too independent" we are referring to a company that engages a separate firm for each piece of year-end work, i.e., a separate firm prepares the tax provision, the FIN 48 work, SOX 404, and material supporting analyses. Though at times separate service providers are warranted, generally too many tax practitioners involved at year end leads to confusion regarding a company's overall tax picture and duplication of information gathering, not to mention the cost inefficiencies tied to duplicative efforts.

On the other hand, the process also can be complicated by a desire to be too streamlined. By "too streamlined" we are referring to a company relying too heavily on its audit firm for year-end tax provision preparation. Underlying "studies" and tax returns may be prepared by the audit firm at year-end as they are not restricted services potentially impairing independence. However, any work related to the preparation of tax provisions, FIN 48, and SOX 404 internal controls should be segregated from the audit function.

Limiting the players is a small adjustment that can be made at year end prior to tax provision

preparation, which could result in more accurate, complete, timely, and cost-effective tax compliance.

### **Understand the Game**

Once you have the best and most streamlined team in place at year-end, make sure you understand the game, that is, make sure you understand your company objectives before preparing the tax provision. The tax-related objectives of a public versus private, large versus small, and profitable versus a loss company can be very different. If you do not understand the tax-related objectives up front, your company could pay for tax services it does not require or could fail to address adequately significant tax-related issues.

For example, if your company is a small, private operation struggling to conserve cash to fund operations, costly "studies" to support tax attributes at year end such as research credits and net operating losses may not be the best use of your time and/or money as there could be uncertainty whether these tax attributes will be utilized prior to expiration. Alternatively, if you are a profitable company or one that anticipates profitability in the near future, a study may be warranted to support tax attributes soon to be utilized.

Another important factor for private companies at year end is whether they are anticipating going public. An impending initial public offering (IPO) changes a private company's objectives as it must fulfill more stringent Securities and Exchange Commission requirements, as well as the requirements of its lenders and other interested third parties. In this situation, more in-depth analyses or "studies" to support tax positions may be required at year end to prepare for the following year's SEC filings.

Valuation allowance concerns are also important factors for companies beginning to turn profitable. Careful consideration of all positive and negative evidence should be made at year end to determine whether full, partial, or no release of valuation allowance is warranted.

Finally, companies must consider the impacts of significant 2009 activities. For example, company acquisitions and restructuring require a host of considerations, such as purchase price accounting, proper carryover of tax attributes, the logistics of year end accounting, and write-off/write-down of goodwill or other intangible assets due to impairment, to name a few.

Based on these examples, understanding the game is critical at year end to ensure no significant factors are overlooked while, at the same time, preventing expenditures of time and resources in tax-related areas that are currently of little significance to the company.

### **Take Advantage of Low Hanging Fruit; Avoid Complex Tax Minimization Strategies**

The tax world is changing and companies must adapt. Part of this change is accepting that the free flowing tax benefits of prior tax years are gone for the time being. The taxing authorities are scrutinizing everything from complex tax minimization strategies to basic statutory credits. Companies must fight "tooth and nail" for every tax offsetting opportunity of which they avail themselves. Therefore, we recommend companies focus on the "low hanging fruit" for now and steer clear of complex tax minimization strategies. Statistically speaking, the "low hanging fruit" is a much more beneficial and economical bet.

Before securing any of the tax opportunities discussed below, it is important to consider their year-end provisional impact. Depending on a company's current financial posture (e.g., valuation allowance or not, profitable or loss, etc.), securing these opportunities for the 2009 year-end tax provision could have varying impacts to current tax expense, deferred tax expense, and/or effective tax rates, to name a few. Therefore, we recommend discussing these opportunities with your tax preparer and audit team prior to inclusion in the 2009 year-end tax provision.

### **New Tax Minimization Opportunities**

In spite of much economic turmoil, both state and federal legislatures over the past couple years have managed to pass a handful of beneficial tax opportunities that generally do not involve complex tax minimization strategies and are rather straightforward to secure and sustain on audit.

#### **1) Federal Refundable Credit**

During 2008 the "Housing Assistance Tax Act of 2008" (aka Public Law No. 110-289) was passed creating a temporary refundable Alternative Minimum Tax and/or Research and Development credit (codified as IRC §168(k)(4)). Specifically, taxpayers that elected to forgo "bonus depreciation" on certain "qualified property" acquired and placed in service from April 1, 2008 through Dec. 31, 2008

were eligible for a refundable credit, subject to certain limitations (“the election”).

During 2009, the “American Recovery and Reinvestment Act” extended the refundable credit through Dec. 31, 2009 in much the same form as the 2008 Act. Specifically, the 2009 Act allows a company to choose between bonus depreciation and a refundable research/AMT credit for property placed in service during 2009. The only material difference between the 2008 election and that for 2009 is the 2008 election is available for only three quarters (i.e., April 1, 2008 through December 31, 2008) and the 2009 election is available for all quarters of that year.

Based on our experience, the federal refundable credit has been relatively straightforward to calculate and refunds are processed quickly. The primary issue has been supporting the credits as they are limited by a cap of 6 percent of research/AMT credits generated prior to January 1, 2006. It also has been extremely challenging to maximize federal bonus depreciation along with maximizing the federal refundable credit. This generally is not an issue with respect to loss companies that benefit more from a refund than a tax deduction. However, we recommend profitable companies test various scenarios to determine the optimal combination of the two opportunities.

## **2) Federal Bonus Depreciation**

For those companies that do not have requisite federal credits to monetize or significant prior year profits (see section regarding five-year NOL carryback below), bonus depreciation offers an opportunity for tax savings. The federal Economic Stimulus Act of 2008 and the American Recovery and Reinvestment Act of 2009 allow taxpayers to claim 50 percent of an asset's basis as “bonus depreciation” in the year the asset is placed in service. Taxpayers may then claim the regular depreciation amount on the remaining 50 percent of the asset's basis. This provision applies to assets placed in service after Dec. 31, 2007, and before Jan. 1, 2010, for qualifying property.

## **3) Accelerated Amortization for Leasehold Improvements**

Non-residential real property qualified leasehold improvements continue to be allowed accelerated depreciation. Previously, these leasehold improvements were required to be depreciated using straight-line depreciation over 39 years. However, for the past few years the legislature has accelerated the depreciation for these assets using straight-line depreciation over 15 years. This allows companies to expedite tax deductions that would generally require substantial time to realize.

## **4) Federal Five-Year Extended Net Operating Loss Carryback**

The Worker, Homeownership, and Business Assistance Act of 2009 (the “Act”) was enacted Nov. 6, 2009 creating an opportunity for most businesses to elect to carry back either a 2008 or 2009 federal net operating loss (NOL) for three, four, or five years.<sup>7</sup> The typical federal carryback period is only two years, so this legislative change allows companies generally to monetize 2008 or 2009 NOLs over a longer period of time. The Act also suspends the 90 percent limit on the utilization of alternative minimum tax (AMT) losses, effectively permitting AMT taxpayers to elect to carry back their entire applicable NOL.<sup>8</sup>

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<sup>7</sup> Pub. L. No. 111-92, 123 Stat. 2984, Section 13 amending §§172(b)(1)(H) and 810(b) of the Internal Revenue Code

<sup>8</sup> Ernst & Young, Hot Topic No. 2009-44, Nov. 6, 2009

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There may exist similar extended NOL carryback opportunities at the state level; however, it is currently unclear which states, if any, will conform to the federal extended NOL carryback. We believe the number of conforming states will be low because of state fiscal issues and state statutes that generally do not allow NOL carrybacks.

## **5) Jurisdiction Domiciled Incentives**

Various states have continued to pass legislation to attract or maintain state domiciled businesses. For example, California enacted a host of incentives via A.B. 1452 and S.B. 15 that provide, among other opportunities, combined companies to share credits, extended NOL carryforwards from 10 to 20 years, and a single sales factor apportionment election.<sup>9</sup> New Jersey's governor signed into law A.B. 2722, which repeals the sales “throwout” and “the regular place of business” provisions for privilege periods beginning on or after July 1, 2010. This prospective relief is a welcome change for New Jersey taxpayers frustrated with New Jersey rules that penalize New Jersey based businesses.

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<sup>9</sup> In general, there appears to be a move toward single sales factor apportionment by state jurisdictions attempting to encourage the locating of property and/or payroll within their state.

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Foreign jurisdictions also are attempting to incentivize companies to locate within their borders by offering tax holidays for a specific time period, among other incentives.

## **6) Reduced State and Foreign Tax Rates**

A simple way of reducing 2009 corporate income taxes is to take advantage of reduced tax rates. For example, effective Jan. 1, 2010, the Massachusetts' corporate tax rate will drop from 9.5 percent to 8.75 percent, while the financial institution tax rate will drop from 10.5 percent to 10 percent. It is important to note that although tax rate changes effective after 2009 do not impact taxes currently payable in 2009, they may impact the rate at which 2009 deferred tax is calculated.

Various foreign jurisdictions have also reduced corporate income tax rates or are in the process of approving such reductions. For example, the United Kingdom recently reduced its top corporate income tax rate from 30 percent to 28 percent.

## **7) Tax Amnesty**

State tax amnesty programs are another relatively simple and risk-free means of reducing tax expense. Generally, these programs offer a limited-time opportunity for a specified group of taxpayers to pay a defined amount of tax in exchange for forgiveness of penalties relating to a previous tax period or periods. Assuming these failure to file penalties have been booked as FIN 48 liabilities, amnesty programs may assist companies in releasing such FIN 48 liabilities.

## **Old, but Still Good, Simple Tax Minimization Opportunities**

It is important not to forget tried and true basic tax planning opportunities that have withstood time and audit scrutiny. Such opportunities are relatively easy to implement as well as sustain on audit.

### **1) Pay Out Accruals**

One of the simplest ways of reducing current tax is to reduce temporary differences by paying out accruals (which are generally added back in the calculation of taxable income). For example, accrued salaries, bonuses, and vacation can be paid out within 2 1/2 months of year-end to avoid addback.

This planning opportunity is especially beneficial to AMT taxpayers that are limited in their use of credits and net operating loss deductions to reduce AMT tax liability.

### **2) Tax Credits**

There are various federal and state statutory credits that a company may secure to reduce tax (e.g., research credits, targeted zone credits, etc.). These are relatively simple opportunities, but oftentimes made complicated by not gathering adequate support on an annual basis and being too aggressive with respect to credit generation. At year end a company should evaluate its qualifying activities in light of what it believes will be sustained on audit based on federal/state audit guidelines. A company should also gather at year end requisite support for the credits claimed based on federal/state audit guidelines.

### **3) Domestic Production Activities Deduction**

A business engaged in a qualifying production activity is eligible to take a federal tax deduction of 6 percent in tax year 2009. The deduction increases to 9 percent in year 2010. Based on our experience, many companies fall within the definition of "engaged in a qualifying production activity," though sufficient supporting data is necessary to validate such qualification. The primary catch to this opportunity is that a company must be profitable after federal net operating loss application to utilize the deduction. However, the deduction may be applied against AMTI, which can further reduce the ten percent of AMTI that may not be offset by net operating losses.

### **4) Perfecting State Net Operating Losses**

For many profitable companies, at year end a large portion of the tax provision consists of state income/franchise tax due to insufficient offsetting tax attributes. A widely used planning opportunity that is rather straightforward and easily implemented is to create nexus in a state at an earlier date. This oftentimes results in the generation of net operating loss carryforwards that may be used to

offset 2009 state income/franchise taxes.

### 5) Perfecting State Apportionment

In addition to perfecting state NOLs, another simple way to limit state tax liabilities is to review a company's state apportionment factors. High state apportionment rates may be reduced by certain favorable apportionment elections (e.g., single sales factor), preventing sales throwback by creating nexus in another state, and creating "nowhere sales" by establishing international nexus.

### IV. Thoughtful Preparation of Financial Statement Disclosures

Another often quoted Warren Buffet tenet is that "what the wise man does in the beginning, the fool does in the end."<sup>10</sup> From this perspective, it is crucial that accounting and financial reporting rules regarding tax are followed. But more than that, it is important that companies go beyond legalities and ask themselves a simple question: "what information would impact an investor's decision whether to invest in my company?"

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<sup>10</sup> *The Tao of Warren Buffet*, Mary Buffett & David Clark, 2006 Simon & Schuster, Inc..

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### Private Company

From a private company perspective, FIN 48 adoption at year end 2009 will be of primary importance. Along these lines, as Buffet emphasizes, it is important to adopt and disclose "wisely" in the beginning rather than patching holes in subsequent years. Therefore, a complete FIN 48 analysis including 1) certain tax position inventory; 2) material tax position memoranda; 3) pertinent supporting data and calculations; and 4) a capstone memorandum outlining processes applied and conclusions reached will be imperative. Once a thorough adoption is made, subsequent updates are less timely and costly on a quarterly or annual basis.

It is also important for private companies to recall that FIN 48 adoption financial statement disclosures are the same as their public company counterparts, except for two key omissions. Disclosures required by paragraphs ASC 740-10-50-15 (a) through (b) for public entities are eliminated for nonpublic entities. This means a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented as well as disclosure of the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate are not required for private company FIN 48 disclosures.<sup>11</sup> In addition, because private company financial statements do not contain a "Management's Discussion and Analysis" (MD&A) section, the pronouncement adoption will likely appear within the following two sections of the "Summary of Significant Accounting Policies:" 1) Income Taxes and 2) Recent Accounting Pronouncements.

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<sup>11</sup> Accounting Standards Update No. 2009-06, Income Taxes (Topic 740), Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities

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### Public Company

From a public company perspective, the question is more than simply "what must I do," incorporating "what should I do?" as well. A review of tax-related disclosures in historical financial reporting indicates there are various instances where U.S. GAAP requirements have not been followed to the letter of the pronouncement. Generally, this is not an overt deviation from the rules but rather a tendency to follow industry standards and/or reduce complexity of financial statement disclosures. Nevertheless, at year end, it is prudent to review U.S. GAAP tax-related disclosure requirements to validate the accuracy of your company's disclosures in light of your specific industry and organizational size and structure.

At year-end 2009, we recommend that companies compare their current tax-related disclosures to U.S. GAAP requirements to ensure all necessary information has been provided to investors in the most clear and concise manner possible. A chart of required U.S. GAAP tax related disclosures is available within Ernst & Young's International GAAP Disclosure Checklist<sup>12</sup> and should assist in this evaluation.

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<sup>12</sup> Ernst & Young International GAAP Disclosure Checklist, Effective for Entities with Year Ends of 31 December 2009 or Thereafter

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## V. Conclusion

We believe companies that apply Warren Buffet's tenets of simplicity to their 2009 year-end tax provision processes will benefit from a cost, resource, and quality standpoint. To paraphrase Buffet, at year end a company does not have to do a lot to get a lot. If a company begins with ensuring internal controls/best practices are in place, then half the battle is won. Add to that accomplishment limited players, a well-understood game, and the utilization of "low hanging fruit" to offset tax liabilities, and a company's tax function is operating at an optimal level without significant cost, time, or resources. All that optimization is futile without thoughtful preparation of financial statement tax disclosures, which can be achieved by reviewing past company disclosures in light of U.S. GAAP required tax disclosures and company size and structure.

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