23rd Annual Health Sciences Tax Conference

Accounting for income taxes: developments and hot topics for for-profit providers

December 9, 2013
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Agenda

► Developments
  ► Legislative and regulatory developments
  ► PCAOB considerations
  ► Income tax review controls
  ► New COSO internal control framework
  ► Accounting Standards Update

► Tax provision challenges and best practice responses
  ► Restatement trends and root causes
  ► Outside basis differences
  ► Reduce risk in accounting calculations
Changes in tax laws or rates continue

- Approximately 30 countries (e.g., US, UK, Mexico) and 16 states (e.g., CT, TX, NC) enacted tax law changes in the first three quarters of 2013.
- Approximately eight jurisdictions are considering tax law changes that could be enacted by December 31, 2013.
The American Taxpayer Relief Act extended expired 2011 tax provisions through December 31, 2013.

- Research and experimentation tax credit
- Work opportunity tax credit
- 50% bonus depreciation
- Subpart F exception for active financing income
- Controlled foreign corporation look-through provision for Subpart F
- Renewable energy tax credits
- Incentives for biodiesel and renewable diesel
- New markets tax credit

Key reminders

- Fiscal year estimated annual effective tax rate (EAETR) does not include extenders for portion of year after December 31, 2013.
- Deferred taxes should also be measured consistent with enacted tax law (extenders are not extended beyond December 31, 2013).
Final tangible property regulations
Tax accounting considerations

- Tax accounting method changes that are effective for taxable years beginning on or after January 1, 2014, where a Section 481(a) adjustment is required:
  - Two temporary differences (Accounting Standards Codification (ASC) 740-10-55-59 through 61)
  - Can affect the tax basis of an asset or liability and the associated temporary difference for capitalized assets and/or amounts paid in periods prior to 2014
  - Section 481(a) adjustment is deferred income for tax purposes and a temporary difference
Final tangible property regulations
Tax accounting considerations

- Accounting method changes effective for amounts paid or incurred in taxable years beginning on or after January 1, 2014, and exceptions to the above methods for amounts paid or incurred in taxable years beginning on or after January 1, 2014:
  - There is no financial statement implication for the reporting period that includes September 13, 2013, as transactions have not yet occurred.
PCAOB considerations
Balance sheet reclassification adjustments

- Public Company Accounting Oversight Board (PCAOB) guidance has increased the focus on balance sheet classification adjustments, requiring auditors to disclose to audit committees identified misstatements related to balance sheet classifications, consistent with reporting other identified misstatements.

- The auditor should accumulate misstatements identified during the audit, other than those that are clearly trivial:
  - “Clearly trivial” is not another expression for “not material.”
  - Clearly trivial is inconsequential, whether taken individually or in aggregate and whether judged by any criteria of size, nature or circumstances. When there is any uncertainty about whether one or more items is clearly trivial, the matter is not considered trivial.

- Are your tax provision processes and controls designed and operating to identify and address balance sheet classification and disclosure matters at a level consistent with other areas of the tax provision?
PCAOB considerations
Internal control over financial reporting (ICFR)

- Income taxes have been selected as a focus area by the PCAOB and we continue to see an increase in the focus on income taxes.
- The PCAOB has found deficiencies in auditors’ reviews of internal controls related to income taxes.
  - Failed to understand the likely sources of potential misstatement (i.e., identify what could go wrong (WCGW))
  - Failed to obtain an understanding of the review procedures performed
    - Scope of review activities
    - Level of precision at which the review is performed
    - Source and reliability of information used to perform the control
  - Failed to sufficiently test the operating effectiveness of review controls
    - Testing limited to management inquiries and observation of sign-offs
  - Failed to test controls separately outside of substantive testing
Income tax review controls
Auditor considerations

- Review controls typically are a significant component of the suite of controls over the income tax accounts.
- There should be use of a mix of procedures to test the operating effectiveness of tax review controls (e.g., inquiry, observation, inspection and reperformance).
  - Inspecting that an effective tax rate reconciliation or analysis was “signed off” is not adequate evidence that the control functioned as designed; examining the signature only provides evidence that the analysis was signed, rather than evidence of the level of review that actually took place.
- Example review controls
  - The US federal provision is reviewed and approved for accuracy and completeness by the Tax Director on a quarterly basis.
  - The Manager of Tax Reporting reviews and approves the uncertain tax position analysis.
Income tax review controls
Auditor considerations

Work papers that include appropriate evidential support to document both the design and operating effectiveness of review controls

- Precision of the control
  - Precision of the control is the sensitivity to which it functions (i.e., is the control sensitive enough to prevent or detect errors or fraud that could result in a material misstatement in the financial statements)
  - Qualitative and quantitative thresholds established by the reviewer for follow up

- Completeness and accuracy of the underlying data
Income tax review controls
Example procedures: evidence of precision

► **Control**: On a quarterly basis, the current income tax payable account is reviewed by the federal income tax manager to determine that all activity has been properly recorded.

► **Examples of procedures that auditors may perform:**
  ► Inquiries of the federal income tax manager regarding prior history of errors identified through the manager’s review
  ► Discussion of what the manager considers to be a material adjustment
  ► Inspection of email correspondence with other tax managers (state and local, international and compliance) regarding estimated tax payments recorded
  ► Observation of the manager’s review of detailed accruals as compared with the quarterly tax projections
  ► Inquiries and discussion of the quarterly review control with two other tax managers, confirming the types of inquiries they receive as a result of the federal income tax manager’s review
ICFR — other observations

- Process flowcharts are being requested, if not required, by some auditors; can you supply those?
- How precise are your review controls?
- Can you document the level of precision at which your controls operate?
- Have all risks and WCGWs been identified?
- As tax footprints and business operations change, it is also important to refresh internal controls, processes and documentation, have you done so?
Best practices responses
Internal controls refresh

► Evaluate effectiveness of internal controls design and operation based on current business and procedures
► Walk-through procedures and assess process narrative/flowchart is up to date
  ► Will a flowchart be required?
► Current procedures should be designed to minimize risk today
► Document performance of review controls (signature is not sufficient)
  ► Document the precision of review controls — frequency, nature and extent of issues identified
  ► Retain evidence of issues identified and resolution of those issues
  ► Document the review thresholds and procedures that support manual controls (e.g., quantitative and qualitative)
► Understand and document effectiveness of controls related to source data and report inputs to tax provision calculations/processes
► Perform internal self-assessment of control execution and testing
In May 2013, the Committee of Sponsoring Organizations (COSO) released the Internal Control — Integrated Framework: 2013 (2013 framework) to provide additional guidance and reflect changes in the business environment since the 1992 Internal Control — Integrated Framework (the original framework).

The original framework is valid through December 15, 2014, after which it will be superseded by the 2013 framework.

Implementing the 2013 framework will be another opportunity for tax departments to engage their organizations for budget and closure of gaps while company-wide changes may be occurring.
Appendix — COSO Framework

**What is not changing?**

- Retains the core definition of internal control
- Retains the five components of internal control (control environment, risk assessment, control activities, information and communication, and monitoring)
- Retains the requirement of five components for an effective system of internal control
- Retains importance of judgment in designing, implementing and conducting internal control, and in assessing effectiveness of internal control

**What is changing?**

- Formalizes fundamental concepts underlying the five components as principles
- Considers changes in business, operating and regulatory environments
- Expands financial reporting objective to include other important forms of reporting (operations, compliance, nonfinancial)
- Provides additional approaches and examples relevant to operations, compliance and nonfinancial reporting objectives
# Appendix — COSO framework

## Principles of effective internal control

| Control environment | 1. Demonstrates commitment to integrity and ethical values  
| 2. Exercises oversight responsibility  
| 3. Establishes structure, authority and responsibility  
| 4. Demonstrates commitment to competence  
| 5. Enforces accountability  |

| Risk assessment | 6. Specifies suitable objectives  
| 7. Identifies and analyzes risk  
| 8. Assesses fraud risk  
| 9. Identifies and analyzes significant change  |

| Control activities | 10. Selects and develops control activities  
| 11. Selects and develops general controls over technology  
| 12. Deploys through policies and procedures  |

| Information and communication | 13. Uses relevant information  
| 14. Communicates internally  
| 15. Communicates externally  |

| Monitoring activities | 16. Conducts ongoing and/or separate evaluations  
| 17. Evaluates and communicates deficiencies  |
## Overview of ICFR

### Entity-level control assessment

<table>
<thead>
<tr>
<th>Area</th>
<th>Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Control environment</strong></td>
<td>The control environment reflects the tone set by top management and the overall attitude, awareness and actions of the board of directors, management, owners and others concerning the importance of internal control and the emphasis placed on control in the company’s policies, procedures, methods and organizational structure. It is the foundation for all other components of internal control, providing discipline and structure.</td>
</tr>
<tr>
<td></td>
<td><em>Focus/pressure on effective tax rate (attitudes, control consciousness)</em></td>
</tr>
<tr>
<td><strong>Risk assessment</strong></td>
<td>Risk assessment is the entity’s identification and analysis of relevant risks (both internal and external) to the achievement of its objectives, forming a basis for determining how the risks should be managed.</td>
</tr>
<tr>
<td></td>
<td><em>Ability to anticipate, identify and react to late changes in profit before tax (PBT) (risk assessment)</em></td>
</tr>
<tr>
<td><strong>Information and communication</strong></td>
<td>Information and communication systems support the identification, capture and exchange of information in a form and time frame that enables management and other appropriate personnel to carry out their responsibilities.</td>
</tr>
<tr>
<td></td>
<td><em>Quality and frequency of tax-sensitive data elements received from outside Tax Dept.</em></td>
</tr>
<tr>
<td><strong>Control activities</strong></td>
<td>Control activities are the policies and procedures that help facilitate that management’s directives are carried out.</td>
</tr>
<tr>
<td></td>
<td><em>Integration of tax controls throughout provision process</em></td>
</tr>
<tr>
<td><strong>Monitoring</strong></td>
<td>Monitoring is a process that assesses the quality of internal control performance over time.</td>
</tr>
<tr>
<td></td>
<td><em>Role and integration of internal audit in test of controls of tax accounts</em></td>
</tr>
</tbody>
</table>
In July 2013, the Financial Accounting Standards Board (FASB) issued ASU 2013-11, Presentation of an Unrecognized Tax Benefit (UTB) When a Net Operating Loss (NOL) Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists.

It provides that a liability related to a UTB would be offset against a deferred tax asset for an NOL carryforward, a similar tax loss or a tax credit carryforward if such settlement is required or expected in the event the uncertain tax position is disallowed (i.e., net presentation).

The determination of whether a deferred tax asset is available is based on the unrecognized tax benefit and the deferred tax asset that exist at the reporting date and presumes disallowance of the tax position at the reporting date.

It is effective for fiscal years, and interim periods within those years, beginning after December 15, 2013, for public entities and December 15, 2014, for nonpublic entities. Early adoption is permitted.

It is applied prospectively to unrecognized tax benefits that exist at the effective date. Retrospective application is permitted.
Emerging Issues Task Force (EITF)
Issue 13-B

- Issue 13-B: Accounting for Investments in Qualified Affordable Housing Projects

- At the September 13, 2013, meeting, the Task Force tentatively decided to amend the prior consensus-for-exposure, including to:
  - Change the method of amortizing the Low Income Housing Tax Credit (LIHTC) investments to a proportional amortization method (i.e., amortization would be proportional to the tax credits and tax benefits received)
  - Present LIHTC investment as a tax asset on the statement of financial position — not as an investment
  - Evaluate the LIHTC investment for impairment when it is more likely than not that the tax credits and other benefits will not be realized
  - Change one of the control conditions to apply the proportional amortization method

- Status
  - No conclusion reached at the September meeting
  - Next meeting scheduled for November 14, 2013
Tax provision challenges and best practice responses
## Restatement trends — top three topics

<table>
<thead>
<tr>
<th>Restatement topics</th>
<th>Number</th>
<th>Percent</th>
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</thead>
<tbody>
<tr>
<td>2012:</td>
<td></td>
<td></td>
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<tr>
<td>1. Income taxes</td>
<td>22</td>
<td>21%</td>
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<tr>
<td>2. Revenue recognition</td>
<td>8</td>
<td>8%</td>
</tr>
<tr>
<td>3. Statement of cash flows</td>
<td>6</td>
<td>6%</td>
</tr>
<tr>
<td>2011:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Income taxes</td>
<td>18</td>
<td>20%</td>
</tr>
<tr>
<td>2. Revenue recognition</td>
<td>9</td>
<td>10%</td>
</tr>
<tr>
<td>3. Statement of cash flows</td>
<td>5</td>
<td>6%</td>
</tr>
<tr>
<td>2010:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Revenue recognition</td>
<td>21</td>
<td>17%</td>
</tr>
<tr>
<td>2. Income taxes</td>
<td>15</td>
<td>12%</td>
</tr>
<tr>
<td>3. Derivatives</td>
<td>9</td>
<td>7%</td>
</tr>
</tbody>
</table>
Income tax restatements — root causes

- Application of tax technical rules
  - Incorrect identification or calculation of tax basis and carryback/carryforward periods
- Realizability of deferred tax assets (DTAs)
  - Improper consideration of naked tax credits as a source of taxable income
- Business combinations
  - Failure to recognize deferred taxes on temporary differences in purchase accounting
- Accounting for outside-basis differences
  - Inappropriate application of exceptions to deferred tax liability recognition for outside-basis differences
  - Not providing taxes for basis differences related to investments in partnerships and equity method investments
Tax provision challenges

Tax basis

- Maintaining a detailed and accurate record of the tax basis of all assets and liabilities, including those without a book basis, is an essential starting point in accounting for income taxes.

- Restatements have been caused by not properly identifying a tax basis or attribute, or not appropriately recording and tracking the tax basis or attribute in subsequent periods.

  - Requires technical understanding of tax law
    - Often for multiple taxing jurisdictions
    - May be simple or complex
Tax provision challenges
Realizability of deferred tax assets

- Restatements generally occurred due to errors in assessing the four sources of taxable income.

- Examples include:
  - Inappropriately considering a projection of future taxable income to be a tax planning strategy
  - Evaluating deferred tax assets for realizability on a net vs gross basis
  - Inappropriate consideration of taxable temporary differences (e.g., taxable temporary differences related to indefinite-lived intangibles) as a source of future taxable income
Tax provision challenges
Outside basis — partnership investments

- Investments in partnerships may be accounted for under the cost, equity or consolidation method.
- Partners/investors need to consider future tax consequences of recovering their financial reporting basis of the investment in the partnership.
  - Represents outside-basis differences
  - Outside basis may be different from the partner’s share of inside basis
    - Optional basis adjustments
    - Asset/partnership interest transfers
- The outside basis difference related to a partner’s investment in a partnership is recognized as a deferred tax asset or liability.
Tax provision challenges
Outside basis — partnership investments

- ASC 740-30-25-9 prohibits recognition of a deferred tax asset for an investment in a subsidiary or corporate joint venture unless it is apparent the temporary difference will reverse in the foreseeable future.
- Because the tax attributes of partnerships and other flow-through entities are taxed at the investor/partner level, this limitation should not apply to deferred tax assets attributable to partnerships’ outside basis differences.
- Valuation allowance considerations should still be considered for any deferred tax asset based upon the provisions of ASC 740-10-30-5:
  - Limitations based upon jurisdictional income
  - Limitations based on character of income
Tax provision challenges
Outside basis — partnership investments

Because partnerships are pass-through entities, there is no ability to indefinitely reinvest the earnings in jurisdictions where earnings are taxed directly to partners.

Special issues with respect to hybrid entities (foreign corporations treated as partnerships for US):
  ► Withholding taxes on distributions
  ► Deferred taxes on cumulative translation adjustments
  ► Deferred tax asset for tax basis > book basis
Tax provision challenges
Outside basis — partnership investments

Provisions related to the consolidation of partnership interests are provided in ASC 810.
The requirements of consolidation of a partnership can be very complex.
If required, consolidation requires the full inclusion of 100% of the income, assets and liabilities of the partnership, with separate designations for amounts attributable to non-controlling interests (NCIs).

- Balance sheet — separate component of equity
- Income statement — separately shown on the face of the income statement
Tax provision challenges
Outside basis — partnership investments

- Consolidation of partnership interests presents unique tax accounting issues.
  - 100% of the net assets and liabilities (inside book basis of assets) are included in the consolidated financial statements.
  - Deferred taxes are calculated based on the outside basis difference in the partnership interest.
Best practice responses
Reduce risk in accounting calculations

Uncertain tax positions
- Automate unrecognized tax benefit calculations and roll-forwards, including interaction with other tax attributes, interest and penalty calculations, and cumulative translation adjustments

Fixed assets
- Improve reporting of tax return deductions and deferred taxes
- Reconcile sub-ledgers and general ledgers to source data and tax systems to uncover areas for improvement

Share-based payments
- Support balances for deferred tax assets, additional paid-in capital (APIC) pool, Section 162(m) adjustments, and unrecognized tax benefits by entity; consider deductibility of payments to foreign employees

Tax basis balance sheets
- Support cumulative temporary differences by entity with book and tax basis balance sheets that reconcile to tax returns and general ledgers; automate inputs and calculations

Legal entity calculations
- Improve legal entity data and engage Finance for items outside the Tax Department’s direct control (e.g., forecasts, legal entity reporting, intercompany profit elimination)
Best practice responses
Reduce risk in accounting calculations

- Intercompany transactions
  - Review intercompany transactions for compliance with tax accounting rules
- Improve spreadsheets and tools to minimize risk of errors, reduce hours and manage risk. Consider implementing a standardized process and/or tool for:
  - Tax basis balance sheets to validate deferred taxes
  - Unrecognized tax benefit computations and tracking
  - NOL tracking
  - Indefinite reinvestment assertion documentation and outside basis difference calculations
  - Share-based payment tax accounting, APIC pools and deferred tax proofs
  - Section 162(m)(6) deferred tax computations
  - Fixed asset deferred tax reconciliations
- More than 50% of Fortune 1000 companies use Excel spreadsheets to compute global income tax provision.
  - Consider a third party to test and improve Excel spreadsheets for enhanced efficiency, accuracy and controls
Questions?