Intelligence from **The Analyst's Accounting Observer**

- News and observations about accounting events affecting investment management

June, 2009

On The Horizon: Heavier U.S. Taxation Of Multinationals

In early May, the Obama administration released its fiscal year 2010 budget proposals. Among them: a reduction in the tax benefits available to U.S. multinationals who invest overseas. **Revenue expected to be raised from various changes: $210 billion.** Companies reinvesting their profits earned in foreign countries do not normally pay U.S. income taxes on those profits - nor do they accrue deferred taxes on them. If the changes come to pass in 2010, some companies may find their profits severely crimped. There are ways investors can evaluate the risks:

• Evaluate the level of cumulative untaxed foreign earnings (UFE). This is probably the most overlooked figure in the tax footnote. Comparing the figures from year to year shows an investor how much the UFE contributes to net earnings - and it can be substantial. For some firms in the S&P 500, the untaxed foreign earnings accounted for substantially all of their 2008 net income.

• Look at the effect of foreign tax rates on the effective tax rate. The tax footnote shows a reconciliation of the statutory rate to the effective rate in the income statement. The more the foreign tax exposure reduces the overall effective rate, the more exposure a firm has to changes in foreign taxation.

• Consider the source (of pretax earnings). This is another overlooked disclosure. Firms are required to show the pretax income from domestic and foreign sources each year in the tax note. A firm with the bulk of its pretax earnings overseas will face the most tax change exposure.

An analysis of the S&P 500 firms' exposure, along with other ways to assess the tax change risk of individual firms, is in *The Analyst's Accounting Observer's* May report "International Taxes: Follow The Money." *(Subscribers only.)*

New FASB Standards: Business Combinations/Non-Controlling Interests

Effective in 2009, **FASB's Statement 141(Revised), "Business Combinations,"** changes many past tenets. Among many changes, one of them is already showing up directly in earnings: firms can no longer capitalize the costs of making an acquisition, like legal, accounting and investment banker fees. Other changes:

• In-process research & development charges are a thing of the past: they'll now be capitalized.

• Bargain purchases of companies for less than their fair value will result in *immediate* gains recognized in income, rather than the gerrymandering of asset values.

• Firms will no longer be able to concoct restructuring reserves at acquisition date; they'll have to expense them as charges are incurred.

• "Earn-out" provisions must be recorded at their fair value at acquisition date.

• "Step acquisitions" will result in much more goodwill being recognized, and sooner than in the past.

"You have to know accounting. It's the language of practical business life. It was a very useful thing to deliver to civilization." - Charlie Munger

The Analyst's Accounting Observer monitors accounting practices *and* standards: both affect the way investors view any company. The Analyst's Accounting Observer gives investors a heads-up on changing accounting practices, whether it's related to pension discount rates, international reporting or upcoming writedowns. And it informs investors about changes coming from the SEC and the FASB that will affect the way investors view and value companies.

Find out more about The Analyst's Accounting Observer and its publisher, Jack Ciesielski, at www.accountingobserver.com . Take the trial offer on the site - or just call Jack at (410)783-0672.

New FASB Standards: Business Combinations/Non-Controlling Interests *(cont'd.)*

That's only a sample of the changes in store for firms making acquisitions; many more aspects will be different. Statement 160, a companion standard to Statement 141(R), became effective at the same time and will result in changes of its own, such as:

• Balance sheet reclassification of minority interest as an element of stockholders' equity, instead of inhabiting a space between liabilities and equity.

• Income statement elimination of minority interest as an single-line expense or income item. In other words, the income statement will now show performance results *gross* of any minority interest.

• Gains or losses will now be recognized in income only when a change in minority interest ownership levels result in a change in control.

• When changes in minority interest ownership levels occur, a revaluation of the entire holding will be made at the current fair value.

These changes to business combination and minority interest accounting will become more noticeable as acquisitions occur - and they'll result in unfamiliar presentations for investors and analysts. The nuances of Statement 141(R) are addressed in *The Analyst's Accounting Observer's* August 2008 report "Statement 141(R) Begins - With A Big Broom." Statement 160's quirks are covered in the September 2008 report, "Statement 160: Getting Your (Minority) Interests In Line." *(Subscribers only.)*

S&P 500 Pension Funding: Riches To Rags In One Year

At the end of 2007, the first year of the market crisis, pension plans were remarkably well-funded. For the S&P 500, the median funded balance (assets/projected benefit obligation) of pension plans was 94.2% at the end of 2007. One year later, the funding level had dropped to 72.3%. Because the funded status of pension plans has been directly embedded in balance sheets since Statement 158 became effective several years ago, firms experienced increased financial leverage from the pension funding shortfalls.

*Increased funding requirements demanded by the **Pension Protection Act of 2006** will require 158 of the S&P 500 firms to increase their pension funding by $20.4 billion in 2009. At least 87 firms in the S&P 500 expect higher pension cost in 2009, as well.*

A survey of the pension plans - and other post-employment benefit plans - for the S&P 500 covers the funding, cash flow effects and earnings quality considerations generated by the market slide in The Analyst's Accounting Observer's April report, "Benefit Plans Without Bounty: The S&P 500 In 2008." *(Subscribers only.)*

Upcoming Comment Deadlines

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• The FASB and the IASB have issued a joint Discussion Paper on **revenue recognition,** with comments due by June 19. The project's goal is to revamp US accounting standards so as to eliminate the need for more than 100 different pieces of accounting literature related to revenue recognition, while greatly amplifying the minimal guidance found in international financial reporting standards.

One potential effect of the principles in the Discussion Paper: if the two boards go down this road, it could become much simpler for software firms and others that sell "bundled services" to recognize revenue sooner than at present. The Discussion Paper can be downloaded at http://fasb.org/revenue_recognition.shtml .

• The twin boards also have issued a joint discussion paper on **lease accounting,** with the same purpose of improving ineffective US accounting standards while making a unified standard under both sets of accounting standards. The emphasis in the document is on lessee accounting, where investors have often observed the most need for improvement. Comments are due by July 19.

The principles put forth in the Discussion Paper would most likely eliminate the current "operating lease" treatment that results in non-capitalization of leased equipment. The most likely sectors to be affected would be retail and restaurants. The Discussion Paper can be downloaded at http://fasb.org/leases.shtml .