

# Income Tax Provision: What's the Rush About?

Michael Cavanaugh

June 2021



CrossBorder  
Solutions

The World's AI Tax Expert

## INCOME TAX PROVISION: WHAT'S THE RUSH ABOUT?

The clock starts ticking at the end of every quarter. Investors, analysts, bankers, the media, they all want to know how your company has fared—and your stock price depends on the answer. Once the finance department has processed the data collected from every corner of the company, there is one last piece of the puzzle to put in place: the income tax provision.

Taxes are not generally front of mind for investors. Your company's quarterly performance will be judged on the three parts of its financial report: the income statement, the balance sheet, and the cash flow statement. But the single most eagerly awaited number, and the number mostly likely to determine the short-term direction of your stock, is found at the bottom: earnings per share (EPS). The last calculation to get to that all-important number is the effective tax rate. The tax rate expense you calculate will impact the company's EPS and affect its assets and liabilities profile. Your CFO will be keenly interested.

Investors will of course want to know how much money their investment has made each quarter. But tax returns are not finalized until months after the end of each fiscal year. An accurate and timely tax provision—an estimate of what the company's final tax bill for the year will be—therefore serves as a placeholder for the company's finalized results. That estimate allows companies to keep all stakeholders current on how things are going.

---

**“The provision is an estimate of what the company's final tax bill for the year will be. That estimate allows companies to keep all stakeholders current on how things are going.”**



Publicly traded companies start releasing their earnings reports just weeks after the end of each quarter. But a corporate tax department requires complete financial statement data (a full income statement and balance sheet, excluding the income tax pieces) before it can perform the annual tax provision calculations. So, you will inevitably be left waiting for your colleagues in accounting to close the pre-tax books to begin your work. The tax provision is the much-anticipated grand finale of the accounting process, but you're not likely to be given much time to perform it.

### **The XBS Takeaway: Defining Tax Provision**

- The annual tax provision is an estimate of what a company will owe in tax for a given year
- The tax provision serves as a placeholder for earnings results that will be finalized with a tax return
- The tax provision allows stakeholders to evaluate the efficacy of an entity's management of its tax function through the effective tax rate (ETR)



## Playing by the Rules: Accounting vs. Tax

A tax provision is not just a sneak-peek of the tax return, however. Because accounting rules differ from tax rules, the profit that a corporation reports on its financial statement differs from the taxable profit it reports on its annual tax return. This discrepancy arises because of the way in which tax authorities account for a corporation's profit and loss versus the way in which the corporation does. Accounting rules (GAAP in the U.S. and IFRS internationally) are accrual based, with expenses and revenue recorded to the income statement when earned or incurred. Tax rules, in contrast, are generally cash-based, calling for expenses to be deducted when cash is spent and revenue to be included as income when cash is collected. Through the use of tax adjustments, the provision calculation bridges the gap between GAAP and the Internal Revenue Code.

---

**"The provision calculation bridges the gap between GAAP and the Internal Revenue Code."**

This bridge is formally known as a book-to-tax reconciliation: the act of reconciling the income on a company's accounting books to the taxable income reported in its tax return by adding and subtracting the non-tax items. In the U.S., these adjustments are reported to the IRS on the corporate tax return's Schedule M-1.

Why do these differences exist? Because the two sets of rules, accounting and tax, are designed with opposing goals in mind. Accounting rules are intended to slow down income and speed up expenses, producing a more conservative depiction of a company's financials. Accounting authorities have our best interests in mind—the rules are meant to deter companies from misleading investors by reporting inflated earnings. Tax rules, in contrast, aim to do the opposite: they increase taxable income and slow down deductible expenses. The intentions here are also good—lawmakers seek to prevent companies from avoiding taxes by understating income and overstating expenses.



## The XBS Takeaway: Mind the GAAP

- Tax provision bridges the gap between a company's financial statement and its tax return
- A book-to-tax reconciliation reconciles the income on a company's accounting books with the income on its tax return
- Accounting and tax rules are written with opposing intentions (both good)

## The Big Reveal: Effective Tax Rate

The first key calculation of the tax provision is the current income tax expense (or benefit!), which is included on the income statement. Next is the calculation of the deferred expense (benefit) which is determined by the movement between the beginning of the year and end of the year deferred tax assets/(liabilities) as found on the deferred rollforward schedule. The sum of the current and deferred provision amounts are then presented as a single line item on the income statement as "Income Tax Expense".

Once the total tax provision amount has been calculated it's time to grab a calculator and compute your company's effective tax rate (ETR). An ETR's calculation will then be displayed in the supporting notes to the financial statements. An entity's ETR provides critical insight into the entity's management of its tax function and is a focal point for investors, analysts, and shareholders alike.

The ETR Reconciliation schedule starts with pretax book income, which is then multiplied by the statutory rate, currently set at 21% for US companies. Next are layered in the "rate drivers" which represent all provision adjustment items of income and expense that impact the ETR as it is translated from book to tax. The last line of the ETR Reconciliation Schedule is the sum of the current and deferred provision amounts which, when divided by the pretax book income number, produces the ETR. This walk between the book and tax income amounts is the very distillation of the entire provision process and expresses, in a percentage format, a company's competence, or lack thereof, in the management of its tax function.



The ETR is arguably the most important output of your tax provision work for one primary reason: It indicates whether your company is operating in a tax-efficient manner. That measure of efficiency is then likely to be used to judge the performance of your tax department. Performance will be benchmarked both internally (what did you pay this quarter vs. last quarter and this year vs. last year) and externally (did you pay more or less than your competitors and peers). When it comes to tax, the ETR tells your company's story.

---

**“The ETR is arguably the most important output of your tax provision work for one primary reason: It indicates whether your company is operating in a tax-efficient manner.”**

### **The XBS Takeaway: Tax in the Financial Statement**

- The income tax expense is an estimate of what tax liability was incurred for the period
- The effective tax rate (ETR) is the income tax expense divided by pre-tax income
- ETR is a measure of tax efficiency and how effective a company's tax planning is



## The Challenges

That story can have many twists and turns, however: Given the scope of the tax provision and the many stakeholders involved, the calculations come with substantial challenges.

First and foremost, the computations must be accurate. That obvious point should remain top of mind because mistakes, of either omission or commission, can be devastating.

Given the scope and complexity of financial statement reporting, errors are not uncommon. When a misstatement is found, the corresponding item(s) are corrected and in the subsequent reporting period an explanatory note may be added. However, if a “material misstatement” is discovered, then the consequences are much more severe. A material misstatement is information in the financial statements that is sufficiently incorrect that it may impact the economic decisions of someone relying on those statement. The level of materiality is expressed as a percentage which is determined by a company’s auditors.

If a material misstatement is discovered and made public, the consequences can be dire. At a minimum, there would likely be a shake-up of executives in the finance and accounting departments. At worst, the entity’s stock price would drop and lawsuits could follow.

A close second to accuracy is speed: The income tax provision must be completed expeditiously. Most publicly traded companies are required to file their quarterly and annual financial statements shortly after the end of their interim and annual reporting periods. As the income tax provision is the final step in the accounting cycle, this is generally subject to the tightest time crunch of all. For quarterly filing, it’s not unusual for companies to have just one or two days to compute the income tax provision. For year-end filing, things aren’t much easier, with many companies giving their tax department just a week or so to complete their provision calculations and book the amounts to the financials.





Late filings aren't an option for public companies. Investors will often assume the worst when a filing is late, which is likely to be reflected in a falling stock price (not something that will make the tax department popular around the office). In the case of longer or repeated delays, a company's stock could even face delisting from applicable stock exchanges—a potentially existential threat. Private companies also face pressure to file promptly, as late filings will be similarly unwelcome by management, shareholders, and creditors.

---

**“The ETR is arguably the most important output of your tax provision work for one primary reason: It indicates whether your company is operating in a tax-efficient manner.”**

It's not all gotchas and pitfalls, however: Your tax work can provide value for a company above and beyond merely providing the required outputs. Thorough tax provision planning has the potential to offer insights into your company's past performance and future planning. These positive outcomes may seem less salient than the negative ones. But opportunity costs, while easily overlooked, are real: A tax department that fails to identify revenue opportunities or spot emerging trends, is, at best, missing an opportunity to wow the C-suite and, at worst, causing the company and its investors to leave money on the table.

### **The XBS Takeaway: Get it Right. Quickly.**

- Precision is paramount. Errors risk re-statement of financials.
- Speed is a close second. Tax departments have just days to do their quarter- and year-end work.
- Tax provision data can offer strategic insight and assist future planning.





## Technology for Your Toolbox

You may by now be asking yourself exactly how to meet this daunting challenge of producing a tax provision that will both pass an auditor's review and add value to your company. And how to do it all accurately in a short amount of time. Previously, the only technology tool in your toolbox was Microsoft Excel—and that's where most tax professionals still feel most comfortable. However, using Excel in today's tax provision world is increasingly analogous to entering a chariot into a NASCAR race. By its nature, Excel is highly manual and therefore prone to error. With dozens of tabs, thousands of rows, and tens of thousands of cells, there is vast scope for your company's data to get scrambled, no matter how careful and diligent your data entry may be.

Excel cannot automate your repetitive tasks—even Microsoft now admits Visual Basic is not much use to anyone. A static spreadsheet will lack the flexibility needed to adjust to changes in your company's structure or accounting records, making tax provision work in Excel highly inefficient and time-consuming. Lastly, Excel doesn't easily lend itself to analytical insight. You are not liable to spot any emerging trends in a spreadsheet. Opportunities will likely be missed, taxes may be overpaid, and management will be unimpressed.

---

**“AI-driven software will therefore help bring efficiency and accuracy to tax provision work—and move tax departments further up the value chain.”**



In contrast, artificial-intelligence-driven, tax-provision software can save time, sharpen accuracy, and identify opportunity. AI is dragging the tax function out of the past and into the future. An AI-software solution offers transparency to auditors, vastly improving their understanding of your business. Management will similarly benefit, gaining a more granular view of key metrics by entity, jurisdiction, and function. That enhanced transparency lends itself to analytic insights, allowing tax departments to produce trend analysis and sensitivity studies that will help plan for the future. AI-driven software will therefore help bring efficiency and accuracy to tax provision work—and move tax departments further up the value chain.

### **The XBS Takeaway:**

- Most tax departments still rely on Excel for their tax provision work.
- AI-driven software makes the tax provision process faster, more reliable, more transparent, and more insightful.
- Tax departments still on Excel are missing an opportunity to move themselves up the value chain.





**Michael Cavanaugh** | Senior Tax Manager

Michael Cavanaugh is a senior manager in CrossBorder Solutions' product group, where he focuses on the company's tax provision software solution. Cavanaugh worked as a tax provision manager at the original iteration of CrossBorder Solutions and continued to develop and implement the ONESOURCE tax provision tool after the company's purchase by Thomson Reuters. Before joining CrossBorder Solutions again in 2020, Cavanaugh was part of the Tax Technology and Transformation group at KPMG. He holds a CPA license in New York and a master's in taxation and MBA from Fordham University.



# CrossBorder Solutions: The world's AI tax expert

CrossBorder Solutions is the global leader in technology-driven tax solutions. The company develops software powered by advanced AI to help taxpayers accurately comply with jurisdiction-specific requirements, and dramatically lowers the fees associated with this type of work. Today, thousands of companies worldwide rely on CrossBorder Solutions for their transfer pricing, R&D tax credit, and tax accounting (tax provision) needs.

CrossBorder Solutions is backed by Insight Partners, the leading private equity firm in the world. We have achieved a billion-dollar valuation and raised over \$100M in growth capital to date. These investments are leveraged to continue to develop and maintain Fiona, our proprietary AI engine, and expand global operations to serve a diverse and growing client base.

For more information on CrossBorder Solutions and its AI-powered tax solutions, visit [www.xbs.ai](http://www.xbs.ai) or call **646.767.7342**

