

SEC Regulations Committee
April 17, 2007 - Joint Meeting with SEC Staff
SEC Offices – Washington DC

Discussion Document F

Topic: Determining the Amount of Interest on FIN 48 Liabilities to be Included in Fixed Charges for Purposes of Calculating the Ratio of Earnings to Fixed Charges

Issue: How should interest related to uncertain tax positions be reflected in the calculation of ratio of earnings to fixed charges?

Background: Item 503(d) of Regulation S-K defines fixed charges as:

... the sum of the following: (a) interest expensed and capitalized, (b) amortized premiums, discounts and capitalized expenses related to indebtedness, (c) an estimate of the interest within rental expense, and (d) preference security dividend requirements of consolidated subsidiaries.

The definition does not, however, specifically address how interest related to uncertain tax positions should be considered in the calculation.

Consider the following example:

Company X and Company Y are unrelated SEC registrants. The companies are direct competitors in the heavy equipment manufacturing sector. Because of the capital intensive nature of their businesses, both Company X and Company Y frequently use registered debt offerings to finance their operations. Company X and Company Y's 2006 income statements are as follows:

	Company X	Company Y
Net sales	\$100,000	\$100,000
Cost of sales	<u>(80,000)</u>	<u>(80,000)</u>
Gross profit	20,000	20,000
Interest expense	<u>(6,000)</u>	<u>(4,000)</u>
Pre-tax income	14,000	16,000
Provision for income taxes	<u>(5,600)</u>	<u>(7,600)</u>
Net income	<u>\$ 8,400</u>	<u>\$ 8,400</u>

Each company had \$2,000 of interest expense relating to uncertain tax positions. Company X's policy presents interest expense relating to uncertain tax positions as a component of interest expense (i.e., a deduction in arriving at pre-tax income). Company Y presents interest expense relating to uncertain tax positions as a component of its provision for income taxes. Therefore, the only difference between Company X and Company Y's financial statements is that Company X included the \$2,000 of interest expense related to its uncertain tax positions as a reduction in arriving at pre-tax income and Company Y recorded \$2,000 of interest related to its uncertain tax positions as a component of its income tax provision.

Question: How should each company consider the \$2,000 interest expense relating to its uncertain tax positions when calculating the 2006 ratio of earnings to fixed charges?

Note: Assume neither company has any rent expense/operating leases, capitalized interest, guarantees of other parties' obligations, preference security dividend requirements of consolidated subsidiaries, minority interests or equity method investees.

View A: All interest should be included in the calculation of the ratio of earnings to fixed charges, without regard to where it is classified on the income statement. Accordingly, Company X and Company Y should each include the \$2,000 interest expense relating to its uncertain tax positions as a component of "fixed charges". However, when calculating "earnings" for purposes of the ratio of earnings to fixed charges, Company Y should not add back the \$2,000 to pre-tax income because it was not deducted in arriving at pre-tax income for financial reporting purposes. The two companies' calculations would be as follows:

	<u>Company X</u>	<u>Company Y</u>
Fixed charges:		
Interest per income statement	\$6,000	\$4,000
Interest included in income tax provision	_____	<u>2,000</u>
Total fixed charges	<u>\$6,000</u>	<u>\$6,000</u>
Earnings:		
Pre-tax income	\$14,000	\$16,000
Fixed charges	6,000	6,000
Portion of fixed charges included in income tax provision	_____	<u>(2,000)</u>
Total Earnings	<u>\$20,000</u>	<u>\$20,000</u>
Ratio of Earnings to Fixed Charges	<u>3.33</u>	<u>3.33</u>

View B: The interest to be included in "fixed charges" should only be interest on third party indebtedness, however, any expenses (other than income taxes) that are reported as a component of the income tax provision should be deducted in arriving at "earnings" for purposes of the ratio calculation. Accordingly, Company X and Company Y should each exclude the \$2,000 interest expense relating to uncertain tax positions from the determination of "fixed charges". However, Company Y should deduct the \$2,000 in calculating "earnings". The two companies' calculations would be as follows:

	<u>Company X</u>	<u>Company Y</u>
Fixed charges:		
Interest per income statement	\$6,000	\$4,000
Interest included in interest expense not related to third party indebtedness	<u>(2,000)</u>	_____
Total fixed charges	<u>\$4,000</u>	<u>\$4,000</u>
Earnings:		
Pre-tax income	\$14,000	\$16,000
Interest included in income tax provision		(2,000)
Fixed charges	<u>4,000</u>	<u>4,000</u>
Total Earnings	<u>\$18,000</u>	<u>\$18,000</u>
Ratio of Earnings to Fixed Charges	<u>4.5</u>	<u>4.5</u>

View C: The interest to be included in "fixed charges" should only be interest on third party indebtedness, and any interest expense accrued on uncertain tax positions should be excluded from the calculation of "earnings" (because that amount could have been presented as a component of income taxes). Accordingly, Company X and Company Y should each exclude the \$2,000 interest expense relating to uncertain tax positions from the determination of "fixed charges". Company X should add back the \$2,000 in calculating "earnings". The two companies' calculations would be as follows:

	<u>Company X</u>	<u>Company Y</u>
Fixed charges:		
Interest per income statement	\$6,000	\$4,000
Interest included in interest expense not related to third party indebtedness	<u>(2,000)</u>	<u>-</u>
Total fixed charges	<u>\$4,000</u>	<u>\$4,000</u>
Earnings:		
Pre-tax income	\$14,000	\$16,000
Interest on uncertain tax positions included in pre-tax income	2,000	-
Fixed charges	<u>4,000</u>	<u>4,000</u>
Total Earnings	<u>\$20,000</u>	<u>\$20,000</u>
Ratio of Earnings to Fixed Charges	<u>5.0</u>	<u>5.0</u>

View D: The determination of "earnings" and "fixed charges" should follow the registrant's accounting policy for the classification of interest on FIN 48 liabilities. If the registrant classifies interest on FIN 48 liabilities within interest expense, it should treat interest on FIN 48 liabilities as a fixed charge (consistent with View A above). If the registrant classifies interest on FIN 48 liabilities within its income tax provision, it should exclude interest on FIN 48 liabilities from fixed charges (consistent with either View B or C above).

Committee Recommendation: The Committee supports View C.

SEC Staff Response: The staff did not express a view. However, the staff expressed its expectation that the computation of the ratio of earnings to fixed charges provide a transparent disclosure of the treatment of interest on FIN 48 liabilities and other types of interest on non-third party indebtedness.