

# Post-Implementation Review of FIN 48

September 30, 2011

On September 30, 2011, Tax Executives Institute filed the following comments with the Financial Accounting Foundation in connection with the FAF's post-implementation review of FASB Interpretation No. 48. The comments, which took the form of a letter from TEI President David M. Penney to Theresa S. Polley, President and Chief Executive Officer of the Financial Accounting Foundation, were prepared under the aegis of TEI's Financial Reporting Committee, whose chair is Donald J. Rath of Synopsys, Inc. Contributing substantially to the development of TEI's comments were: Janice Lucchesi of Akzo Nobel Inc.; James C. Parent of Tyco International; Audrey Sherman of Allergan, Inc.; and Tavin Skoff of SAIC. Also contributing were Robert L. Howren of BlueLinx Corporation; Jocelyn Krabbenschmidt of Amazon.com; and Gary J. Wenzel. Jeffery P. Rasmussen, TEI Senior Tax Counsel, coordinated the preparation of the comments.

The Financial Accounting Foundation has established a post-implementation process to review the guidance issued by the Financial Accounting Standards Board. The inaugural project is a review of FASB Interpretation No. 48 (FIN 48) on *Accounting for Uncertainty in Income Taxes*, which is now incorporated in Accounting Standards Codification (ASC) 740-10. On behalf of Tax Executives Institute, I am pleased to submit the following comments for your consideration.

## TEI Background

Tax Executives Institute is the preeminent global association of corporate tax executives. Our nearly 7,000 members are accountants, attorneys, and other business professionals employed by approximately 3,000 of the leading companies in the United States, Canada, Europe, and Asia. TEI represents a cross-section of the business community, and is dedicated to the development and implementation of sound tax policy and to promoting the uniform and equitable enforcement of the tax laws. The Institute is proud of its record of working with congressional committees, government agencies, and other policy-making bodies (including the Public Company Accounting Oversight Board and the Securities and Exchange Commission) to minimize the cost and burden of tax administration and compliance to the mutual benefit of the

government, business, and ultimately the public. We also support efforts to ensure that companies fairly present their financial position in financial statements prepared for investors and in documents filed with the SEC.

TEI members are responsible for conducting the tax affairs of their companies and ensuring their compliance with the tax laws. Thus, members deal with the tax code in all its complexity, as well as with the Internal Revenue Service, on a daily basis. Most of the companies represented by our members issue financial statements that are governed by the FASB's pronouncements and, of those, most are SEC registrants. For companies governed by other accounting standards, such as International Financial Reporting Standards (IFRS), the FASB's work is also critical since FASB pronouncements are often referenced by other accounting standards boards. In addition, they are subject to scrutiny by the IRS and various other agencies in the United States and foreign jurisdictions on a continual basis.

As a professional association of in-house tax executives, TEI offers a different perspective on the issues from other organizations. TEI's members work directly for corporations that routinely enter into business transactions requiring an analysis of their tax benefits and burdens. These companies have professional staffs dedicated to ensuring compliance with the tax law while min-

imizing their tax liability. TEI members and their staffs are also responsible for ensuring the quality, reliability, and documentation of their companies' internal controls for the proper financial accounting and reporting of tax expense, tax assets, and tax liabilities under section 404 of the *Sarbanes-Oxley Act of 2002* (SOX).

Hence, we believe that the diversity, background, and professional training of TEI's members place us in a uniquely qualified position from which to comment on the implementation of FIN 48. Along with the government and the investing public, our members have the most at stake in trying to craft a financial reporting system that fairly presents the results of company operations and is as administrable and efficient as possible. We are pleased to submit the following comments.

## General

Tax Executives Institute commends the Financial Accounting Foundation for instituting a post-implementation review (PIR) process. We believe that financial accounting guidance will be improved by systematically collecting feedback on the benefits, challenges, and burdens of implementing the accounting pronouncements issued by the Financial Accounting Standards Board. The data will provide a useful filter through which the FAF and FASB can evaluate what worked — and what did not — by com-

paring expected outcomes of the guidance with actual results. Finally, we also commend the FAF for selecting FIN 48 for its initial project. The guidance has resulted not only in significant implementation and interpretation challenges, but also engendered ancillary developments and burdens for financial statement issuers, taxpayers, and government regulators. TEI appreciates the opportunity to provide its input on the FAF's PIR for FIN 48.

### **Purpose of FIN 48**

FIN 48 altered the financial statement treatment of accounting for uncertain income tax positions by shifting the focus from the contingent liability approach of FAS 5 to a modified gain contingency approach. Thus, under FAS 5 companies reported their income tax liabilities on the basis of their tax returns "as filed" so long as they and their auditors were satisfied that additional tax liabilities were not "probable." If a loss contingency from an assessment by the tax authorities was "probable" and the amount could be reasonably estimated, a liability for the assessment was accrued.<sup>1</sup> In contrast, FIN 48 treats each tax position as though it might create a tax asset rather than a liability. If a tax position will more likely than not (MLTN) be sustained, the amount of tax benefit related to the position is recognized and then measured as the largest amount of benefit that has a cumulative probability greater than 50 percent likely to be realized, considering the various amounts and outcomes that could be realized. When more than two outcomes may resolve an uncertain tax position (*i.e.*, resolution may occur other than on an "all-or-nothing" basis), each potential outcome is assigned a probability to determine the greatest amount of tax benefit that has a greater than 50 percent cumulative probability of being realized. The measurement process is often referred to as the cumulative probability weighting approach.<sup>2</sup>

Upon implementation, financial statement issuers were required to analyze and inventory every material tax position — whether claimed or unclaimed — in every tax jurisdiction and for every year where the statute of limitations was open in order to document the company's tax positions at the effective date. Moreover, FIN 48 imposes a continuing obligation upon the issuer

to review its inventory of tax positions in all open tax years and to recognize and de-recognize tax positions as the underlying facts, or the law applicable to those positions, evolve. Under the FAS 5 loss contingency approach, only a truly significant development or series of events would alter a prior "probable" conclusion requiring a change in the contingent liability.

In applying the MLTN recognition standard to a tax position: (i) it is presumed that the tax authority will examine the tax position and have full knowledge of all relevant facts; (ii) the technical merits of a tax position derive from sources of authority in the tax law and their applicability to the facts and circumstances; and (iii) each tax position must be evaluated without consideration of the possibility of offset. In other words, financial statement issuers cannot base their recognition or measurement on the risk of audit detection, must assume that the facts and legal rationale for each position will be scrutinized by the tax authority with the same level of knowledge and understanding of the facts and law as the issuer, and may not offset positions by assuming that settlements will be achieved by compromising or "trading" issues or positions.

### **Accuracy and Reliability of FIN 48 as a Measure of Income Tax Liability**

There are a number of questions in the FAF's questionnaire relating to whether FIN 48 improves the accuracy and reliability of reported tax reserves. In TEI's view, the best measure of the reliability and accuracy of tax reserves is a comparison of the predicted liability for uncertain tax positions to the actual outcome on settlement after examination by the taxing authority. Under this measure, FIN 48 seems less accurate than FAS 5. The MLTN recognition standard under FIN 48 is clearly more prescriptive than FAS 5 in establishing when reserves are created and measured, but we do not believe that such a standard, when combined with the requirement to measure the liability based on probabilities of possible outcomes, produces more accurate or reliable measure of the amount at which tax liabilities will ultimately settle.

One deficiency in FIN 48 is the substantial cliff effect of the MLTN standard. A tax position with a 45-percent chance of suc-

cess on the merits cannot be recognized at all (even though a taxpayer may satisfy a tax jurisdiction's threshold for taking a position on a return without a penalty (*e.g.*, a substantial authority level)), whereas a tax position with a slightly higher, say, 55-percent chance of success on the merits, is recognized. Under FAS 5, an issuer with a tax position with a 45-percent likelihood of success would likely accrue a slightly higher reserve for a contingent tax liability than a position with a 55-percent likelihood of success. Under FIN 48, the position with the 45-percent chance of success is not recognized, but the position with a 55-percent chance of being sustained is recognized and measured. Moreover, if the issue is one where an all-or-nothing outcome is likely, the position may be fully recognized even though the taxpayer would settle the issue for a lower amount in order to increase the certainty of its reported tax results and reduce its administrative costs, including litigation expenses.

In addition, the measurement process for non-binary issues is far more cumbersome and less predictive of the likely outcome on settlement. Each entry in a table summarizing a cumulative probability weighting of the outcome is subject to a wide range of opinion and judgment. The judgments underlying such a table are no more — and in some cases — less reliable than a FAS 5 estimate of the "probable" outcome. Indeed, while the FIN 48 process for recognition and measurement is more regimented and prescriptive than FAS 5, there are as many or more judgments and complex weightings underlying each number in the probability weighted table of FIN 48. With more granular judgments and more complexity involved in each judgment, the amount of the reserve for each issue and the totality of the reserves will vary significantly under FIN 48 from issuer to issuer and audit firm to audit firm than under FAS 5.

Another source of inaccuracy in tax reserves under FIN 48 is the proscription against taking account of issue trading in setting tax reserves. Negotiation discussions and settlements reflect a complex weighing of the facts as well as the legal merits of a taxpayer's position. Indeed, the negotiation process itself affects the amount of the settlement as much as the legal mer-

its for each of the respective tax positions. We believe that the inability to take account of this dynamic process and reflect the issuer's judgment about the *overall* outcome produces excessive reserves for liabilities that will never be realized.<sup>3</sup>

Finally, the requirement to reassess the merits of each income tax position on a MLTN basis every quarter is not helpful to those who rely upon the enterprise's financial statements. Tax disputes, especially those requiring litigation, can stretch over many years and require the assessment of thousands of documents and multiple witnesses. Although the effect of any particular development in the process of resolving a disputed tax position may be transient and inconsequential in light of other developments, the MLTN recognition standard is more sensitive to changes in developments than the FAS 5 probable standard. During the course of a typical dispute, what is unreserved on Day 1, may, under a MLTN standard, be reserved on Day 180 (because of meeting with an IRS agent), and unreserved again on Day 365 (or later) (because of a meeting with the agent's supervisor). Under FAS 5, only a truly significant development or series of events would alter a "probable" conclusion and require an addition to or reduction of a reserve.

Overall, we believe that FIN 48 suffers from a number of requirements that can lead to accrued reserves that vary significantly from the amount for which a tax position will ultimately be settled. As a result, we do not believe that it represents an improvement over FAS 5 in the accuracy and reliability of reporting of tax reserves. Properly applied, the FAS 5 threshold reflected the dynamic adversarial process of tax examinations and provided investors with better information about management's judgment about the most likely resolution of significant issues.

### Is FIN 48 More Structured than FAS 5?

FIN 48 substantially clarified *how* and *when* to recognize and measure tax benefits and liabilities for financial statement purposes. By refusing to define an uncertain tax position and instead requiring all issuers to document every tax position at a MLTN standard, FIN 48 is clearly more demanding, prescriptive, and burdensome for is-

suers than FAS 5. In conjunction with the heightened internal control requirements of section 404 of SOX, issuers must document their tax positions more rigorously than before so that the issuers' auditors can review and confirm *each* reported tax position. We question, though, whether imposing the heightened evidentiary and documentation burden for every tax position was necessary in order to provide more information about issuers' *uncertain* tax positions. For example, a timing item accounted for as a temporary difference (*e.g.*, depreciation expense) should not warrant the same scrutiny and concern as a significant corporate tax transaction (*e.g.*, an acquisition) or tax planning strategy.

The FASB recognized that FIN 48 imposes greater administrative costs on companies than FAS 109 (and thus FAS 5). In Appendix B to FIN 48, the Board

... acknowledge[d] that this Interpretation may increase the costs of applying Statement 109. The expected benefit of this Interpretation is improved financial reporting resulting from a more consistent application of Statement 109 in the recognition of tax benefits. Financial statements of different enterprises will be more comparable because the uncertain tax positions that are within the scope of this Interpretation and their related income tax effects will be accounted for more consistently.

Regrettably, the Board did not explain why different companies would apply a MLTN standard more consistently than they would the probable standard of FAS 5 in respect of the same tax issue, especially where the probability of success on the merits lies between 45 and 55 percent. As important, while the measurement step prescribes a rigorous process for determining the amount to recognize, the judgments applied by companies with respect to each amount in a cumulative probability table are no more likely to be consistent from company to company than a single judgment (or point estimate) about the most likely settlement outcome. In other words, the measurement step with its cumulative probability weighting requires more documentation and analysis and seemingly provides more substantive certainty, but in

reality the measurement step of FIN 48 is no more likely to produce consistency and comparability of reported tax liabilities than FAS 5 because each measurement judgment can produce multiple, reasonable differences of professional opinion. As a result, companies report having substantially more frequent and more extensive discussions with financial statement auditors about the number, scope, and amount of uncertain tax positions. What's more, the subjectivity of the judgments in the measurement process produces greater variation in reported tax amounts.

### Does FIN 48 Produce Better Information for Constituents?

To the extent that FIN 48 produces better information for users than FAS 5, it may be attributable to a single decision: eliminating issuers' judgments about the risk of detection (either issue or audit selection) by tax authorities as a mitigating factor in establishing reserves for tax liabilities. In other words, by requiring companies to assume that all tax positions will be discovered on examination, FIN 48 shifts the focus from whether a tax position will be detected and contested to whether each and every tax position is supportable and measurable.

Thus, FIN 48 leveled the playing field by requiring that a minimum threshold (the MLTN standard) be satisfied in respect of all tax positions so that the tax benefits recorded on all companies' balance sheets are assured at a uniform level. Since there are fewer judgments about audit detection, FIN 48 has likely produced greater consistency and comparability for investors in respect of when and how tax liabilities and benefits are recognized. Where FIN 48 falls short, however, is that the measurement step introduces considerable subjectivity into the analysis thereby leading to reasonable differences of professional opinion and likely inconsistent results.

In addition, each company must provide a gross unrecognized tax benefit number in its footnote disclosures. The disclosure requirement creates a financial metric of tax risk that may be misleading for investors and tax authorities. For example, if Company A's gross unrecognized tax benefits as a percentage of total assets is higher than its peer companies, an investor (or tax authority) may conclude that Company A takes

more aggressive tax positions or that there is a greater risk of a significant financial outlay. Gross unrecognized tax positions, however, may be different among companies for many different reasons, including the currency of their audit cycles, the amount of mergers and acquisition activity, and the overarching philosophy (and risk profile) of the company. Indeed, a higher unrecognized tax benefit amount may be an indicator of a *conservative* company approach to implementing tax strategies and providing tax reserves. The FASB should consider eliminating the requirement to disclose unrecognized tax benefits in financial statements.

Next, we question the benefit of requiring companies to establish tax reserves for uncertain tax positions that are temporary differences.<sup>5</sup> Establishing and tracking reserves on temporary items produces little useful information to the reader of financial statements and entails significant burdens for the issuer. On the statement of financial position, the tax reserve for an uncertain temporary difference is presented with a corresponding deferred tax asset in exactly the same amount. A net financial statement effect generally arises only where there is a material temporary difference on which a reserve for interest expense would be required.<sup>6</sup>

Other situations where we believe FIN 48 requires companies to document and provide excessive, and potentially misleading, tax reserve amounts are, as follows:<sup>7</sup>

- Where tax returns are not filed in a particular jurisdiction based on the company's assessment of the nexus or permanent establishment standards, the FIN 48 and FAS 5 standards can result in very different tax provisions. Since the statute of limitations will not toll until a tax return is filed, the MLTN standard of FIN 48 and the requirement to consider only the legal merits of a position (rather than a practical negotiated settlement based on tax authority practices and the risks and benefits to tax authorities and taxpayers to reach a settlement) can produce a far higher reserve than would be necessary under FAS 5.
- FIN 48 requires companies to account for certain FIN 48 offsets — such as the

federal deferred tax asset that would arise as a benefit from settling an uncertain state tax position (a FIN 48 liability) or positions where correlative relief would be available — on a gross basis. In other words, rather than netting the benefit from one jurisdiction against the liability arising in another, the tabular reconciliation shows both positions on a gross basis.

- FIN 48 requires a company to include a potential tax penalty in its FIN 48 reserve for a particular uncertain tax position unless the company can demonstrate that the position satisfies the minimum legal standard for avoiding the penalty. In many cases, it is unclear whether a penalty would apply to a specific uncertain tax position. In other cases, the penalty may apply but as a practical matter the jurisdiction never asserts it as long as the company accepts the tax authority's settlement proposal (or changes its filing position on a prospective basis). Although the inability to consider (1) the risk of detection and (2) the likely *non*-assertion of a penalty is consistent with FIN 48's theory, the tax law in most jurisdictions is highly complex and subject to considerable interpretation and judgment. Requiring companies to assess the strengths and weaknesses of every position but to assume the assertion of penalties on those falling short of an unclear penalty standard is not practical or workable. The FASB should consider permitting companies to assess the likelihood of penalties being asserted.

Finally, although we only have anecdotal evidence, companies are seemingly reporting more releases of FIN 48 reserves than accruals of additional tax liabilities as a result of audit settlements. This implies that FIN 48 is causing a systematic inflation of income tax liabilities and thus an overstatement of effective tax rates. Public companies suffer valuation reductions when providing reserves in their financial statements because their ongoing earnings per share are lower, but are rarely given credit for a settlement that results in a large one-time benefit to the income statement. Although

the same was true when tax reserves were computed under FAS 5, the level of reserves is even higher under FIN 48.

### Effect of FIN 48 on Tax Strategies of Constituents

Question 9 of the FAF questionnaire inquires whether, as a result of implementing FIN 48, "the overall tax strategy approach of [TEI's] constituents has become more or less conservative in nature." Member responses vary, but few believe that FIN 48 *per se* had a material or even significant effect on company tax strategies. To be sure, FIN 48 changed how reserves are recognized and reported, but has had minimal effect on the decision to implement a particular tax strategy.

Indeed, companies that believe their tax strategies are more conservative today than they were a decade ago generally attribute the change to other developments in the tax and financial reporting environment. Specifically, enactment of section 404 of SOX in 2002 required the management of public companies to produce an internal control report as part of each annual report. The report must "contain an assessment, as of the end of the most recent fiscal year of the company, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." Thus, companies were required to document internal control procedures and certify that the internal controls produce financial statements, including tax reserves, that comply with generally accepted accounting principles.

As important, the Internal Revenue Service created a mosaic of disclosure rules for reporting "tax shelter" and "reportable" transactions in order to identify and challenge aggressive transactions, and Congress substantially heightened the tax penalties for engaging in or misreporting transactions subject to either of the disclosure regimes. In TEI's view, congressional action and enforcement activities by the IRS and SEC have had a more direct and consequential effect on tax strategies than the change in the financial reporting standard.

### Has FIN48 Produced the Feared "Roadmap" to Tax Authority Audits?

Questions 27 and 28 of the PIR questionnaire inquire whether TEI's constituents

were concerned that FIN 48 would produce a “roadmap” for tax audits and whether the tax authorities use the information disclosed under FIN 48 more or less than expected.

Many of the concerns about FIN 48 producing “tax audit roadmaps” were mitigated by FASB’s decision to permit aggregation of liabilities for uncertain tax positions reported in financial statements. Thus, although FIN 48 requires disclosure of more information about uncertain tax positions and unrecognized tax benefits than FAS 5, the tax footnote in issuers’ financial statements does not itself disclose sufficiently detailed information to permit tax authorities to issue information document requests. The tax authorities, however, understand that FIN 48 requires companies to create substantial documentation about their uncertain tax positions on an issue-by-issue basis, including the companies’ self-assessments of the evidence supporting their positions. Indeed, the more rigorous the analysis of the merits of a position in the FIN 48 workpapers, the more likely the tax authorities can use them to assert a deficiency.

The IRS has recognized that FIN 48 workpapers are more elaborate and extensive than FAS 5 workpapers and that the workpapers may include an assessment of alternative positions, settlements, and probabilities of success. While adhering to its longstanding “policy of restraint” against generally seeking company tax accrual workpapers, the IRS has developed Schedule UTP (*Uncertain Tax Position Statement*) to require companies to rank and disclose uncertain tax positions on an issue-by-issue basis. In addition, the MLTN recognition threshold permits the IRS to require disclosure of significant “all or nothing” issues by requiring issuers to disclose uncertain tax positions for which no reserve is provided because the issuer expects to litigate those positions. The stated purpose of the schedule is to minimize the amount of time the IRS spends identifying potential issues for examination. Although the IRS maintains that the FIN 48 reserve analysis will not be routinely requested from taxpayers, the existence and disclosure of a reserve for a particular uncertain tax position and its identification on Schedule UTP may well lead to a dispute about a tax position (or settlement of a disclosed position at a potentially

higher level) than might otherwise occur. Finally, state and foreign tax authorities are evaluating the IRS’s process for requiring disclosure of major uncertain tax positions and may well require specific jurisdiction-by-jurisdiction disclosure of uncertain tax positions.

In summary, the answer to whether FIN 48 produced a “tax audit roadmap” is currently “no,” but the answer is evolving in a troubling direction.

## Are the Costs of Applying FIN 48 Reasonable Compared with the Benefits?

### A. Responses to PIR Questions

Questions 8 and 12-15 of the PIR questionnaire elicit feedback about the burdens of implementing FIN 48 as well as the ongoing costs of compliance. The responses to the PIR that follow are based on a canvas of members of the Institute’s Financial Reporting Committee who participated in the development of these comments and, while not a survey of the full membership, we believe the committee’s anecdotal responses are representative of the membership’s experience.

In response to question 12, most companies reported diverting a significant number of personnel hours to implementing FIN 48. On average most companies reported requiring three to six months to develop the infrastructure necessary to address the ongoing requirements of FIN 48.

Question 8 inquires about the operational changes that companies made to comply, including (a) significant information system changes; (b) employing additional tax specialists; (c) engaging tax advisers from a law firm; (d) engaging tax advisers from an accounting firm; (e) changing tax jurisdictions; (f) changing tax position strategy; (g) changing the level of coordination of the tax department with other departments; and (h) increasing the level of protective tax returns. Nearly all companies reported making significant operational changes in all these categories except (e) changing tax jurisdictions and (f) changing tax strategies. The most frequently cited costs were (a), (b), (c), (d), and (g)

Question 14 inquires about the nature of the *implementation* costs incurred, request-

ing feedback about the following categories of costs: (a) internal process changes; (b) securing internal tax expertise; (c) staff training; (d) information system changes; (e) external legal tax expertise; (f) external accounting tax expertise; (g) additional audit fees; (h) settlement discussions with tax authorities; (i) documentation of existing tax positions; (j) changing the level of coordination of the tax department with other departments; (k) increase in the level of protective tax return filings; (l) change in tax strategy; and (m) other. The PIR also inquires whether the costs were “generally in line with expectations,” “significantly lower than expected,” or “significantly higher than expected.” Most companies reported incurring substantial implementation costs in all of the categories except (h) settlement discussions with tax authorities and (l) change in tax strategy.

Deciding which categories were the most significant contributors to the costs of implementation is challenging and varies by company. Indeed, the distinction between (b) securing internal tax expertise and (c) staff training is unclear, but every company incurred significant costs in one or both categories. Similarly, categories (e) external legal tax expertise and (f) external accounting tax expertise blend together with (i) the costs of documenting existing tax positions and, taken together as a whole, this group of costs constituted the largest category of implementation costs. Among other costs cited, the highest costs incurred were in respect of (a) internal process changes and (j) changing the level of coordination of the tax department with other departments, but, again, the distinctions between costs incurred in respect of categories (a), (d), and (j) are difficult to distinguish practically. Finally, some members cited the significant opportunity cost of diverting scarce resources to FIN 48 implementation that could otherwise have been devoted to tax compliance, planning, audits, and support for business units. Nearly all companies said that the implementation costs were in line with or exceeded their expectations.

Question 15 inquires about the *ongoing* costs to comply with FIN 48, requesting feedback about the same categories of costs as in question 14. The PIR also inquires whether the costs were “generally in line

with expectations,” “significantly lower than expected,” or “significantly higher than expected.” On an ongoing basis, categories (b) and (c) taken together, categories (e), (f), and (i) taken together, and categories (a), (d), and (j) taken together constitute the most significant components of ongoing costs. In addition, several companies noted that audit firm fees (category (g)) had increased substantially in the wake of FIN 48. In most cases, the ongoing costs of compliance are in line with expectations.

## B. Discussion

The ongoing costs of complying with FIN 48 are significant. Management’s discussions with financial statement auditors about tax risks and uncertain tax positions are far more extensive and costly than they were under FAS 5.<sup>8</sup>

In addition, companies incur significantly greater transaction costs for large commercial transactions because they must often seek external opinions from third-party advisers (either law or accounting firms) about uncertain positions arising from those transactions. Prior to FIN 48, internal company advisers often determined whether the “probable” level of FAS 5 would require a tax reserve for the uncertain tax positions arising from mergers, acquisitions, and dispositions. Under the MLTN standard (and the SOX financial statement certification requirements), fewer CEOs and CFOs will risk a material misstatement of their tax reserves and thus require third-party opinions more frequently. Moreover, because of the independence rules promulgated by the Public Company Accounting Oversight Board, most companies engage law firms or non-attest accounting firms to provide the opinions. The independent accountants auditing the company financial statement, however, often undertake their own detailed review and assessment of whether the taxes provided for the uncertain tax positions for material transactions satisfy the MLTN standard and whether the amounts are properly measured. The cost of the audit is thereby increased and is often duplicative of the costs incurred by the company for external opinions.

On the other hand, FIN 48 has elevated the profile of tax risk discussions at the CEO, CFO, and Board levels. Arguably, this

benefits investors and other users of financial statements by increasing the profile of tax risks and ensuring that management is properly apprised of and manages its tax risk exposures. On balance, however, we believe the explicit incremental compliance costs for FIN 48 (as well as the opportunity cost of siphoning company resources from other activities) outweigh the incremental benefits that FIN 48 provides. Indeed, if the reliability, accuracy, and consistency in measurement of reported tax reserves in financial statements are best assessed by comparing the amounts reserved against the amounts ultimately paid to settle uncertain tax positions, FIN 48 falls short of its goal.

## Conclusion

TEI appreciates the opportunity to comment on Financial Accounting Foundation’s post-implementation review of FIN 48. These comments were prepared under the aegis of TEI’s Financial Accounting Committee, whose chair is Donald J. Rath. If you should have any questions about the comments, please do not hesitate to contact Mr. Rath at 650.584.2697 or don.rath@synopsis.com or Eli J. Dicker of the Institute’s legal staff at 202.638.5601 or edicker@tei.org.

1. Specifically, paragraph 8 of FAS 5 provided that:

An estimated loss from a loss contingency (as defined in paragraph 1) shall be accrued by a charge to income if both of the following conditions are met:

- a. Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- b. The amount of loss can be reasonably estimated.

Paragraph 36 of FAS 5 enumerates the factors to be considered in determining whether the conditions of paragraph 8 are satisfied. Paragraph 38 permits enterprises to determine the degree of probability that a claim (*i.e.*, a tax assessment) would be asserted and the possibility of an adverse outcome.

- 2.. A tax position with an all-or-nothing outcome is often referred to as a binary issue. A non-binary issue, on the other hand, will have a range of potential settlement outcomes from 0 to 100 percent of the tax benefit and may require the use of a cumulative probability weighting table to determine the amount to recognize.
3. The following example illustrates the overstatement of tax reserves under FIN 48. Assume a company incurs \$25 million in investment banking fees to purchase the stock of a target in 2010, but the investment banker fails to keep time records supporting the portion of the fee attributable to analyzing acquisition candidates and the portion related to work performed following a decision to purchase the target. Hence, the company has no basis for asserting at a more likely than not level that the fees can be deducted. The company takes a deduction on its tax returns for a portion of the fees based on the ratio of days the firm was engaged before the decision to buy the target was made (assume 80) and the total days the firm was engaged (assume 100) to claim a deduction of \$20 million in its return. Based on prior audits, recent IRS guidance applicable to post 2010 tax years, and its knowledge of the IRS examination team, the company believes that it would be able to reach an agreement with the IRS to deduct 70 percent of the total fee (\$17.5 million). Under FIN 48, the company records a reserve for the entire tax benefit related to the \$25 million fee. Under FAS 5, it would record a reserve only for the tax benefit of the \$2.5 million likely to be paid to the IRS in settlement. Thus, the reserves that are being recorded under FIN 48 will be larger than the actual tax settlements because the reserves do not reflect the knowledge, experience, and judgment of the company with respect to its own audit activity.
4. On the other hand, it is unclear why management’s judgment about what it considers an uncertain tax position is less relevant for tax issues than it is for other loss contingencies.
5. For example, under the tax rules all fixed assets with useful lives in excess of one year must be capitalized and depreciated regardless of the amount. Most companies, however, have a capitalization policy that mandates expensing fixed assets with a value of less than some minimum amount