FIN 48 Turns Two, and Certainly Isn’t All That Bad

By Harvey L. Pitt, Compliance Week Columnist — April 28, 2009

Back in the halycon days of June 2006, the Dow was 11,000, unemployment was 4.6 percent, and our collective mood was best described by the title of the movie, “On a Clear Day, You Can See Forever.”

So, too, apparently, was the mood at the Financial Accounting Standards Board, which issued Financial Interpretation No. 48, Accounting for Uncertainty in Income Taxes, to a chorus of objections and predictions of its awful consequences. Objections and predictions notwithstanding, FIN 48 took effect, with last year the first year of status quo FIN 48 compliance. In these uncertain times, boards and managements should examine new options to ameliorate exposure to FIN 48’s sharp elbows.

According to FASB, FIN 48 was supposed to increase the relevance and consistency of income tax reporting. This was to be accomplished by imposing consistent accounting criteria and related disclosure obligations, where none (in the case of disclosure), or at least no specific ones (in the case of accounting criteria) existed. Reading between the lines, FIN 48 was a response to accounting scandals, apparent widespread earnings management facilitated by the murkiness of the income tax accounting rules, and early Sarbanes-Oxley results reflecting a large number of material weaknesses and significant deficiencies in internal controls traceable to income tax accounting issues.

Prior to FIN 48, accounting for income taxes was governed by Financial Accounting Standard No. 109, Accounting for Income Taxes, which lacked specific guidance on income tax-related uncertainties. On the uncertainty question, guidance was to be derived from FAS 5, Accounting for Contingencies, which applied to loss contingencies generally. FAS 5 requires financial statement accrual of a loss contingency (1) if it is “probable” (or likely) that a loss has been incurred, and (2) if the loss can be reasonably estimated. If either condition isn’t met, no loss contingency need be accrued. In the case of income tax positions, this meant companies could recognize the full amount of a potential tax benefit, without any offset based on the possibility that the tax treatment would be disallowed.

FAS 5 left significant discretion as to when to accrue income tax-related loss contingencies (and how much to accrue). The FAS 5 analytical approach gave little incentive for detailed analysis of tax positions, their bona fides or risks, since all that was required to avoid accrual of a loss contingency was to “miss” the “probable” trigger or conclude that a reasonable estimate was not possible. This regime encouraged relatively
more risky tax positions and rendered income tax accounting an effective tool for earnings management.

FIN 48 starts from the premise that a company’s financial statements should fully and accurately reflect anticipated future consequences of its present tax positions. To that end, it removes income tax uncertainties from FAS 5’s “probable” standard and imposes a two-step analytical process for evaluating tax positions—first, recognition, then measurement. In order to recognize a benefit from a tax position, a company must be able to conclude it is more likely than not that the position will be sustained. If this test is passed, the company can recognize the largest amount of benefit having a greater than 50 percent likelihood of ultimately succeeding.

The difference between the full benefit claimed on the company’s tax return and the amount recognizable under FIN 48 becomes a charge to income and a balance sheet liability. It also becomes a useful disclosure to the Internal Revenue Service regarding a company’s own assessment of aggressive tax positions. Finally, the company must disclose the level of tax reserves, changes in the composition of such reserves, the amount of accrued interest and penalties associated with uncertain tax positions, and so-called “early warning” disclosure about tax positions for which it is reasonably possible that unrecognized tax benefits will change significantly within 12 months.

FIN 48 effectively required public companies to play by the same accounting and related disclosure rules. It also imposed new discipline, since the position-by-position analysis requires detailed documentation, as well as at least a modicum of objectivity in making tax accounting determinations. However, even under FIN 48, decisions relating to what income tax positions to take ultimately depend on risk appetite and are, therefore, inherently subjective. Even after threshold decisions about tax positions are made, accounting for them under FIN 48 relies, to a significant degree, on subjective management judgments, in assessing the likelihood each position could stand up to regulatory challenge, determining the benefit that ultimately might be realized (leavened by penalties and interest to which the company might be exposed) and, finally, in determining appropriate disclosure.

We’re into the second year of FIN 48 reporting, and generally speaking, it doesn’t seem to have caused a sea change for good or ill. Thus far, at least, there’s no reported upsurge in earnings volatility related to the new regime, nor in litigation or IRS activity, even though these were among the dire results predicted before FIN 48’s adoption. The ominous prediction that FIN 48 would turn into a financial monster, gobbling up company resources like Sarbanes-Oxley Section 404, also hasn’t materialized.

That FIN 48 isn’t disruptive isn’t the same as saying it has produced its intended effects. Earlier this year, one report concluded that one-third of public companies didn’t comply with FIN 48’s minimum disclosure requirements in 2008. It’s too early to tell whether compliance with underlying accounting rules has been any better. What is clear, though, is that even in the best of times, such a high level of non-compliance likely generates a high degree of interest from, and action by, regulators and others.
These aren’t, of course, the best of times. The financial, economic, and regulatory worlds where companies operate, report, and pay taxes have changed radically since 2006, and in ways that, when seen through the lens of FIN 48, point toward increased exposure and demand increased attention. The risk environment has been fundamentally altered with virtually all constituencies newly sensitized to the dangers of exposure to untoward levels of risk. Within this new, risk-sensitive (one might say risk-averse) environment, governments are hungry for revenues. Therefore, it’s likely both the IRS and state tax authorities will be increasingly aggressive in reviewing FIN 48 disclosures and challenging aggressive or “creative” tax positions.

Shareholders are angry and looking for blood—or at least scapegoats. If companies “guess wrong” in assessing tax positions, they’ll face exposure not only to tax authorities but also shareholder litigation. And, the Securities and Exchange Commission can be expected to closely review company disclosures required by FIN 48. Since FIN 48 permits subjectivity, and income tax accounting historically has been thought to provide a vehicle for earnings manipulation, FIN 48 matters are likely to garner high SEC interest. Of course, under Sarbanes-Oxley, CEOs and CFOs must certify company financial statements, so “guessing wrong” on FIN 48 matters can have dire consequences.

In this new environment, boards of directors and management should take steps to be sure that their company’s risk-management apparatus is in place, finely tuned and functioning effectively. Effective risk management is key to enterprise survival and success, particularly in a hostile environment, and income tax accounting risk is simply a subset of enterprise risk. I gave my thoughts on appropriate reactions to Fin 48 shortly after its adoption (please see the July 2007 edition of Compliance Week for that column), but with the heightened risk environment, some additional considerations are in order.

At the outset boards should reconsider and, if necessary, reset, their company’s risk tolerance. Historically, tax accounting decisions have been made deep within the bowels of organizations, by technical accounting gurus. This approach is no longer appropriate. Tax professionals need guidance from boards as to the degree of risk the board believes acceptable. And, the board or audit committee should stay in the loop as to the disposition of specific tax positions as well as related disclosures.

Companies also should consider tools available to mitigate FIN 48 risk. One obvious tool is using outside experts to evaluate, and even render opinions, about income tax positions. Outside experts can provide independent support for tax determinations, unlike in-house tax staff, or even a company’s outside auditors, whose independence may be open to challenge. Such independent support increases the likelihood that a company’s tax positions will be appropriate and that Fin 48 will be correctly applied, which in turn reduces risks associated with regulatory intervention and litigation, as well as those associated with income and cash flow volatility.

FIN 48 risk insurance is a new and potentially powerful tool in the tax risk-management arsenal. It provides comparable benefits to retaining outside experts, since an insured company will be able to point to review and evaluation of its tax positions by the
insurer’s tax accounting experts. It goes further, however, by actually shifting the risk of adverse outcomes from the company to the insurer, and effectively capping the cost of such outcomes at the cost of the premiums, reducing cash flow volatility by providing a source of cash in the event of adverse tax consequences and reducing potential earnings volatility by reducing the likelihood of adverse outcomes.

FIN 48 was adopted to deal with particular concerns. Recent events indicate that income tax accounting will be a sensitive area for entirely different reasons. Given this new reality, it behooves boards and companies to reconsider their income tax risk tolerance and consider additional steps to manage such risk effectively.

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As the 26th chairman of the SEC, Pitt led Commission adoption of dozens of rules responding to corporate and accounting crises, created an SEC “real time enforcement” program, and responded to market disruptions from the Sept. 11 terrorist attack.

Before becoming SEC chairman, Pitt was senior corporate partner at Fried, Frank, Harris, Shriver & Jacobson, an international law firm, for nearly 25 years.

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