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Heads Up

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Improved Financial Reporting?
FAF Issues Post-Implementation Review Report on Effectiveness of FIN 48

by Scott Cerutti and Rob Morris, Deloitte & Touche LLP

Entities are reporting information about income tax uncertainties more consistently, and investors are using the reported information in their investment decisions.

Last week, the Financial Accounting Foundation[1] (FAF) issued a post-implementation review (PIR) report on FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48).[2] The objectives of the review were to (1) determine whether FIN 48 is accomplishing its stated purpose, (2) evaluate FIN 48's implementation and continuing compliance costs and related benefits, and (3) recommend ways to improve the FASB's standard-setting process. The report ultimately concluded that "on balance, the benefits of FIN 48's improved consistency and reporting of income tax uncertainty information outweigh its costs."

In the report, the PIR team summarizes the results of the FAF's outreach[3] and research[4] activities and outlines the FAF's conclusions about FIN 48. Although it intentionally avoided making specific recommendations about actual accounting, the FAF suggested ways the standard-setting process could be improved.

Assessment of Financial Reporting Under FIN 48

With regard to the stated purpose of FIN 48, which was to improve financial reporting related to income tax uncertainty, the PIR team observed that since adoption of the standard, entities have been reporting more information about tax uncertainties and that users of the financial statements are using this information in some fashion, such as to predict income tax cash flows and assess management's aggressiveness in entering into tax planning strategies.

The PIR team's research identified some disparities between constituencies regarding the usefulness of the information FIN 48 provides. Investors generally believed that tax reserve disclosures were more consistent and comparable under FIN 48. Although preparers and practitioners acknowledged that information was more consistent under the standard, they identified several areas of concern, including disclosure of sensitive information and inconsistencies in measurements that rely on significant judgments. In

[1] The Financial Accounting Foundation is responsible for the oversight, administration, and finances of the FASB. This oversight includes protecting the independence and integrity of the standard-setting process.
[2] FIN 48 was codified primarily in FASB Accounting Standards Codification Topic 740, *Income Taxes*.
[3] Outreach activities included conducting surveys and interviews with stakeholders. The FAF received 199 responses: 45 percent from users, 29 percent from preparers, 18 percent from accounting practitioners, and 8 percent from academics.
[4] Research included reviewing the FASB's historical files, academic publications, footnote disclosures, and other public information.

addition, they noted that the liabilities recorded are often larger than the settled amounts and are carried longer than justified. The reasons for potential overstatement of the liability included:

- "[T]he presumption that taxing authorities will examine each uncertain tax position rather than settle in the aggregate."
- "[T]he presumption that each uncertain tax position will be evaluated on its technical merits assuming taxing authorities' full knowledge of the facts and issues (many positions are either not reviewed or the issue/position is not raised during the review)."
- "[N]o value being given to uncertain positions that do not meet the MLTN [more-likely-than-not]threshold (i.e., no offset for settling amounts in the aggregate)."

The report also assesses whether FIN 48 works "in the real world." The PIR team concluded that preparers and practitioners generally understand FIN 48 and can apply its provisions. However, the team also noted that the information FIN 48 provides may not be relevant to investors in estimating cash flows related to income taxes and that users often adjust such information for their estimate of the ultimate settlement of the reported liability.

Preparers might not disclose sensitive income tax uncertainty information if they perceive it to be detrimental to tax settlements.

Editor's Note: To preserve the FASB's standard-setting independence, the PIR team did not make any recommendations related to FIN 48's accounting model. However, many of the survey questions asked about the model, and the report contained much discussion on feedback related to it.

Our views on FIN 48 are generally consistent with those expressed by the PIR team. We believe that FIN 48 establishes a consistent model for assessing uncertain tax positions and that disclosures are more comprehensive and comparable under this model; however, a number of issues remain. Most significantly, the MLTN recognition model often creates a difference between amounts accrued and amounts settled because it requires a reserve on the basis of what is "possible" rather than on what is "probable." We also believe there is confusion in assessing when a position can be remeasured or is effectively settled. For example, an uncertain tax position that does not meet the MLTN recognition criteria is sometimes tentatively settled in an examination. In such cases, the entity has received a notice of proposed adjustment even though there has been no fundamental change in the technical merits of the position. Therefore the reserve is not adjusted.

When FIN 48 was first introduced, preparers were concerned that the required disclosures would result in too much information being revealed to taxing authorities and that leverage in settlement negotiations would therefore be reduced. The PIR team noted that this was more of a concern of smaller entities with fewer jurisdictions to aggregate in their disclosures because they would be more significantly affected.

Other Areas of Focus

The report also addressed a number of other operational questions, including whether FIN 48 resulted in any unexpected changes in practice, significant implementation costs, or significant economic consequences. The PIR team found that preparers generally did not have any significant concerns associated with these matters.

PIR Team Recommendations

The PIR team made the following general recommendations to the FASB on improving the standard-setting process:

- Continue its efforts to improve user input in the agenda and early deliberation phases to evaluate alternatives addressing user needs.
- Include in each standard a thorough discussion about the need for new financial reporting guidance and the benchmark characteristics of useful financial information considered. If the FASB adopts one principle from a number of acceptable alternatives, the standard should explain how the principle selected best meets users' needs.

- Include in each standard a thorough discussion about the new guidance's benefits and beneficiaries, the associated costs to affected principal stakeholders, and how benefits and costs are evaluated and assessed.
- Follow consistently its established policies and procedures related to re-exposing all or part of a proposed standard.

FIN 48 may not help investors predict income tax cash flows because of its recognition and measurement provisions and the judgments involved.

Editor's Note: The report's recommendations appear to have already made their way into the FASB's standard-setting process. The Board's most recent work on the convergence projects has included significant outreach to all constituents, including users, through roundtable discussions, working groups, and other means. In addition, the FASB has already decided to reexpose its major projects, including revenue, leases, and accounting for financial instruments.

The IASB has also implemented a post-implementation review process. Its first review will be of IFRS 8, *Operating Segments*, and is expected to start in early 2012. The IASB's review process differs from that of the FAF. One difference is that the IASB's reviews are not independent — they are led by the IASB board and conducted by the IASB staff. In addition, the IASB's due process requires that a post-implementation review be performed for each new IFRS or major amendment.

The FASB is expected to review the report and submit a written response to its findings and recommendations. In addition, as part of its oversight responsibilities, the FAF plans to continue this process and expects to select two additional standards for review in February 2012.

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