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A Response to the FASB Exposure Draft on Accounting for Uncertain Tax Positions: An Interpretation of FASB Statement No. 109

American Accounting Association's Financial Accounting Standards Committee
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INTRODUCTION

The Financial Accounting Standards Committee of the American Accounting Association (the Committee) is charged with responding to requests for comment from standard setters on issues related to financial reporting. This paper summarizes the Committee's response to the Financial Accounting Standards Board's (FASB) exposure draft, "Accounting for Uncertain Tax Positions: An Interpretation of FASB Statement No. 109" (hereafter, the ED).

An uncertain tax position is one where some ambiguity exists in tax treatment under the tax code; therefore, an uncertain tax position requires judgment by companies as to whether to recognize any tax benefits or costs, and what amounts to record. According to the ED, a variety of recognition methods and measurement bases are currently being used to account for uncertain tax positions, resulting in the lack of comparability across companies (paragraph B2).[1] The ED defines the recognition (and derecognition) criterion, measurement basis, and disclosure requirements for uncertain tax positions.

The opinions stated in this manuscript reflect the views of the individuals on the Committee and not necessarily those of the American Accounting Association.

[1] For example, the ED notes that tax positions are sometimes recognized in the financial statements on an as-filed or to-be-filed tax basis, such that current or deferred tax assets and liabilities are immediately recognized when the related tax position is taken (or anticipated to be taken). The ED also states that some companies recognize uncertain tax positions based on a predetermined threshold of whether the positions would be sustained on audit, and a liability for a contingent loss is recorded when either the threshold is no longer met or it becomes probable a payment would be made to the taxing authority.

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Specifically, the ED requires that an uncertain tax position be recognized when the position is *probable* of being sustained on an audit by taxing authorities based solely on the technical merits of the position.[2] The amount reported is equal to the best estimate of the amount that is probable of being sustained upon audit by the taxing authority, including final resolution of any related litigation or appeals process. Individual tax positions that fail to meet the probable recognition threshold will generally result in either (1) a reduction in the deferred tax asset or an increase in a deferred tax liability or (2) an increase in a liability for income taxes payable or a reduction of an income tax refund receivable.

The criterion set out in the ED for derecognition of an uncertain tax position differs from that required for recognition. An uncertain tax position must be derecognized in the period in which it becomes *more likely than not* that the tax position would not be sustained on an audit. Required disclosures related to the uncertain tax position are based on the disclosures of a gain or loss contingency within Statement of Financial Accounting Standard (SFAS) No. 5, *Accounting for Contingencies*. The ED also addresses the accounting for interest and penalties, where firms will be required to recognize interest and penalty costs in their financial statements in the period in which these costs are incurred. However, the Board does not propose any guidelines on the classification of interest and penalties in the ED because the classification of interest and penalties in the income statement is not addressed in Statement No. 109. The ED will be applied to all tax positions for which the statute of limitations remains open upon initial adoption of the ED.

While not explicitly stated in the ED, concerns about aggressive tax accounting and the overstatement of tax benefits appear to drive the FASB to take action on this issue. Prior to the ED, the U.S. Securities and Exchange Commission (SEC) also expressed interest in and concern about the accounting for tax benefits. The impact of the ED both in the number of companies affected and the dollar amounts involved is believed to be extensive although difficult to quantify. Current reporting and disclosure requirements do not expressly detail disclosure of or amounts of uncertain tax positions. Mills (1998), however, provides a rough estimate of the consequences of aggressive tax accounting, which includes the overstatement of tax benefits related to uncertain tax positions. She reports that proposed IRS audit adjustments are about 0.8 percent (0.3 percent) of total assets at the mean (median) for a sample of 1,545 firm-year observations between 1982 and 1992 (Mills 1998, 349).[3]

In this commentary, the Committee summarizes the relevant literature on and our comments pertaining to three components of the ED: (1) the probability thresholds driving the recognition and derecognition of tax positions, (2) the best-estimate method of measuring the benefit of a tax position, and (3) the requirement that the tax benefit be sustained in an audit by the taxing authority. We also comment on several other issues discussed in the ED. We conclude our commentary with a summary of the FASB's re-examination of its decisions on the accounting for uncertain tax positions and a discussion of our view of the potential effects of the ED on the alignment of tax and financial reporting.

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[2] The final ruling, *Accounting for Uncertainty in Income Taxes: An Interpretation of FASB Statement No. 109*, Financial Interpretation No. 48, issued in June 2006, defines tax technical merits as being derived "from sources of authorities in the tax law (legislation and statutes, legislative intent, regulations, rulings, and case law) and their applicability to the facts and circumstances of the tax position" (FASB 2006, paragraph 7b).

[3] While a seemingly small percent of total assets, these adjustments are about 8 percent (3 percent) of net income at the mean (median) if the return-on-assets averages 10 percent. In addition to uncertain tax positions not being disclosed, databases like Compustat usually do not separately report deferred tax assets and deferred tax liabilities, making a systematic, large-scale assessment of the financial reporting impact of the ED particularly difficult.

MAJOR COMPONENTS OF THE PROPOSED INTERPRETATION

Recognition and Derecognition Thresholds

ED Summary

The ED requires initial recognition of the financial statement effects of a tax position when for that position it is probable that it will be sustained on an audit by taxing authorities based solely on the technical merits of the position. The Board concludes that the implementation of the term *probable* should be consistent with its use in SFAS No. 5, *Accounting for Contingencies*, to mean that the future event or events are ''likely to occur.'' In addition, the ED notes several examples of facts and circumstances that warrant that the tax benefit is likely to occur (paragraph 9). These include:

- Unambiguous tax law supporting the tax position.
- An unqualified *should prevail* tax opinion from a qualified expert for which all conditions are objectively verifiable.
- Similar positions in prior years' tax returns that have been obviously presented in the tax returns and have been either accepted or not disallowed or challenged by taxing authorities during an examination.
- Legal precedent from similar positions taken by other taxpayers, where analogy is appropriate, that have been favorably resolved through litigation with taxing authorities.

The criterion for derecognition differs from that of recognition. Derecognition occurs in the period in which it becomes *more likely than not* that any previously recognized benefit would not be sustained on audit.

Comments

There is a rich literature that examines judgment and decision making in accounting settings that is relevant to understanding how managers, or more generally accounting professionals, make their judgments and how their judgments of probabilities and outcomes affect their financial reporting choices.[4] Specifically related to the tax setting, Cuccia et al. (1995) conduct two experiments to investigate whether tax professionals engage in aggressive reporting conditional on their incentives and the stringency of the reporting standard, where stringency is defined by the level or precision of the threshold for reporting. They provide evidence that suggests that replacing vague thresholds (e.g., more than likely) with more stringent thresholds (e.g., probable) does not always diminish the aggressiveness of tax professionals' reporting decisions. The work of Alm (1991) and Beck and Jung (1989) suggests that aggressive tax reporting declines in settings where tax preparers judge there is less uncertainty of a tax position due to greater legal precedence. The literature suggests that decision-makers' risk perceptions are conditional on their knowledge about the setting and control over the outcome (Koonce et al. 2005).

A number of studies focus on the correspondence between the three probability terms used in SFAS No. 5 (''probable,'' ''reasonably possible,'' and ''remote'') and numerical probability assessments to understand the judgment exercised in applying these terms. Using experimental settings, several studies find auditors assess similar numerical probability thresholds for ''reasonably possible to probable,'' implying a consistent interpretation of recognition thresholds (see, e.g., Amer et al. 1994). However, Aharony and Dotan (2004)

[4] See Libby et al. (2002) for a review of this literature.

provide evidence that suggests that preparers' and users' assessments of SFAS No. 5 probability thresholds differ. They interpret their findings as evidence ''support[ing] the existence of an interpretation gap between users and preparers of financial statements, with the implication that preparers may omit loss contingency information valuable to users for assessing the enterprise's prospective net cash flows'' (Aharony and Dotan 2004, 21).

While the literature suggests that interpretation of the proposed recognition threshold criterion appears consistent among auditors, there is little evidence that other accounting professionals consistently interpret and implement the ''probable'' threshold. Assessing the probability of an actual uncertain tax position remains a matter of judgment. The literature indicates that judgment is influenced by behavioral factors such as the newness of the setting or the controllability of the outcome (Slovic 1987). Consequently, while the stated objective of the ED is to improve financial reporting comparability by requiring a consistent criteria by which to recognize (and derecognize) all uncertain tax positions, it is not clear that increasing the level or precision of the threshold for recognizing an uncertain tax position will increase the comparability of firms' financial statements. This is because the feasibility of managers' judgments will vary across firms. In addition, the feasibility of a manager's judgments potentially differs across tax settings.[5]

Gleason and Mills (2002) illustrate differences across firms in implementing SFAS No. 5. Using archival data, they investigate whether companies provide SFAS No. 5 disclosures when they report a potential liability to the IRS for underpayment of federal income taxes. They find that only 27 percent of firms make any disclosure of contingent tax liabilities in financial statements, and only 30 percent of these firms disclose the detailed information required by SFAS No. 5. They find that the likelihood of disclosure increases with the amount of claim or expected loss, suggesting firms gauge materiality when making the decision to report. Their results also show that companies operating in a more litigious environment are more likely to disclose, suggesting that such companies seek to reduce potential litigation by revealing more information about tax uncertainties.[6] Based on Gleason and Mills (2002), it appears that different companies facing similar circumstances provide vastly different disclosures under SFAS No. 5.

The ED proposes a dual threshold approach to recognizing and derecognizing uncertain tax assets and liabilities, where the recognition criteria of *probable* is deemed to be more stringent than the derecognition criteria of *more likely than not*. The ED states that the Board drafted this proposal under the belief that a dual recognition threshold will be easier to apply than a single threshold for both recognition and derecognition, and that there will be greater consistency in application of a dual threshold. In addition, the ED states that the Board believes that preparers, auditors, and regulators would be less likely to disagree about the judgments needed in applying the dual threshold.

The Committee notes that there are potential costs to the dual threshold approach. The dual threshold increases the complexity of the standard, which can result in additional reporting costs being imposed on the preparers and the users of financial statements. These reporting costs are both explicit and implicit. The explicit costs are the additional out-of-pocket costs required to monitor and document differences between the recognition

[5] Large publicly traded firms can have upward of 1,000 uncertain tax positions across numerous U.S. and international tax jurisdictions, suggesting that more than one manager will be responsible for assessing the probabilities and outcomes of a firm's tax positions.

[6] The term ''more likely than not'' is not used in SFAS No. 5, and thus the SFAS No. 5 literature is not directly applicable to the derecognition criterion suggested by the proposed Interpretation.

versus derecognition of the uncertain tax assets and liabilities.[7] The implicit costs include the possibility that the complexity of the accounting standard can result in less consistent implementation when managers are unable to put into practice the standard requirements because of a lack of understanding or expertise. Furthermore, accounting standard complexity can result in less consistent implementation when auditors are unable to attest to the reasonableness of managers' implementation of the standard. Finally, investors face additional learning costs when standards are more complex.[8]

The Committee recognizes that the FASB is aiming to provide consistent ''thresholds'' for recognition and derecognition (when none existed before). However, we disagree with the Board's belief that a dual recognition threshold will be easier to apply than a single threshold. Furthermore, research suggests that parties will interpret the dual recognition thresholds differently, resulting in less consistent financial reporting. Therefore, we recommend that the Board adopt a single threshold criterion to recognize and derecognize uncertain tax positions. The threshold could be consistent with SFAS No. 5, which defines the term *probable* to mean ''[t]he future event or events are likely to occur,'' or, for the sake of international convergence, be consistent with International Accounting Standard No. 37, *Provisions, Contingent Liabilities and Contingent Assets*, that defines *probable* as *more likely than not* (IASB 2005).

The ED explicitly states that a valuation allowance as described in SFAS No. 109 or a valuation account as described in FASB Concepts Statement No. 6, *Elements of Financial Statements*, should not be used as a substitute for derecognition of the benefit of a tax position. Although the evidence that suggests managers use the deferred tax asset valuation allowance as an earnings management tool is mixed (Miller and Skinner 1998; Bauman et al. 2001; Schrand and Wong 2003), we support this conclusion.

Measurement of Tax Benefit

ED Summary

Once the probable recognition threshold has been met, the amount recorded is the best estimate of the amount that is probable of being sustained upon audit by the taxing authority, including the final resolution of any related litigation or appeals process. Here, the term *best estimate* means the single most-likely amount in a range of possible estimated amounts, consistent with FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements.*

Comments

We know of no research that directly addresses the measurement of an amount at a *best estimate*.[9] The *best estimate* approach fundamentally differs from other measurement methods currently employed in financial reporting (e.g., fair value or historical cost). The Committee points out that by recommending the use of the *best estimate* approach in the accounting for uncertain tax positions, the ED will result in more inconsistent measurements

[7] The out-of-pocket costs for firms are nontrivial as evidenced by the upstart in consulting services dedicated to the documentation and assessment of uncertain tax position by public accounting firms and tax professionals.

[8] The work of Fishman and Hagerty (1989) points out that while investors incur relatively low costs to access firm financial information, it is not costless for investors to process and understand the information.

[9] Accounting for pensions and other post-retirement benefits requires the use of the best estimate within a set of assumptions. Likewise, certain accounting for financial instruments requires the use of the best estimate of the fair value for instruments that do not trade regularly. However, research in these areas does not directly address the use of best estimates. For discussions of research in these areas, see Committee responses to recent exposure drafts to proposed changes in fair value accounting (AAA 2006a) and pensions and other post-retirement benefits accounting (AAA 2006b).

within a company's financial reports. Some members of the Committee question the need for what may be a short-term solution to this problem when the FASB's efforts could more fruitfully be directed at addressing the long-term solution of a consistent measurement framework.[10]

Additionally, in its "Short-Term Income Tax Convergence Project," the FASB addresses another tax measurement matter that also will potentially result in further inconsistent measurements within a company's financial reports. The FASB is advocating a different point at which deferred tax assets and liabilities should be adjusted for the effect of a change in tax laws or rates. For operations in U.S. tax jurisdictions, the proposal is to use the guidance in SFAS No. 109, *Accounting for Income Taxes*, which requires the effect of the change in tax laws or rates be recognized in the period of enactment. For operations other than those in U.S. taxing jurisdictions, the proposal is to amend SFAS No. 109 to an approach consistent with International Financial Reporting Standards, requiring measurement based on tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date. It is disconcerting that in an effort to converge financial reporting standards, financial reporting practices would have clear differences in measurement of the uncertain tax position across jurisdictions.

The FASB indicates that an exposure draft addressing the use of distributed tax rates will be issued after a final document for uncertain tax positions is issued. The Committee questions whether the topics should be addressed sequentially or concurrently. Some Committee members suggest that no ruling on the measurement of uncertain tax assets be made until the public has an opportunity to comment on the "Short-Term Income Tax Convergence Project."[11]

Presumption of a Tax Audit in Order to Recognize the Tax Asset or Liability

ED Summary

Integral to the recognition criteria is the premise that the financial statement effects of a tax position be recognized when that position is probable of being *sustained on audit by taxing authorities based solely on the technical merits of the position*. In assessing the probability for recognition, the ED requires the presumption that the tax position will be examined by the relevant taxing authority.

Comments

We know of no research that directly addresses the recognition criteria related to uncertain tax positions being validated by presumed tax audits. Accounting researchers, however, have examined incentives related to tax and financial reporting treatments of uncertain (ambiguous) treatments in the context of affecting the likelihood of an audit.

The general view is that a firm faces an immediate incentive to reduce taxable income, resulting in the benefit of increased net cash flows. When the tax treatment is uncertain, a firm weighs the benefit of taking an aggressive tax position against the potential costs that include additional future taxes, interest, and penalties. Importantly, the firm faces the decision of whether or not to align the tax treatment with financial reporting treatment.

[10] We note that uncertainty can enter the financial reporting process along two dimensions: recognition or measurement. In the ED, uncertainty enters the financial reporting process along both dimensions as the ED addresses when to recognize an uncertain tax position and how to measure the tax benefit or cost. Many of the recent FASB deliberations are more focused on uncertainty in the context of the measurement dimension (i.e., fair value accounting). While discussing the role of uncertainty is beyond the scope of this response, we acknowledge the importance of addressing the accounting for uncertainty in the standard-setting process.

[11] Updates on the project can be obtained at: http://www.fasb.org/project/short-term_intl_convergence_income_tax.shtml.

One line of research posits that a firm may choose a financial accounting method that conforms to the tax choice in an effort to increase the probability that the taxing authority will allow the tax treatment presumably after a tax audit. For example, in experimental work, Cloyd (1995) and Cloyd et al. (1996) find that tax advisors and corporate tax managers assess a higher probability that the taxing authority will scrutinize their tax position, and the firm's tax position will be weakened in an audit when tax and financial income diverge. Consequently, one expects managers to choose a financial accounting method that (usually) lowers reported income to increase expected tax savings and cash flows. Additionally, positive accounting theory suggests that differences between tax and book income potentially increase scrutiny and political costs to the firm (Watts and Zimmerman 1986; Guenther et al. 1997). If these costs are believed to be higher than the cash savings, a firm would choose to reduce them through conforming tax and financial accounting.[12]

In summary, the relevant research suggests that in the presence of the requirement to presume a taxing authority will, during an audit, evaluate a tax position taken or expected to be taken when assessing recognition of an uncertain tax position, managers will likely continue to weigh the costs and benefits of their tax and financial reporting choices.

OTHER ISSUES

Interest and Penalties

ED Summary

The ED specifically excludes guidance on the classification of interest and penalties.

Comments

Research suggests that investors recognize different expense categories and weight individual line items within the income statement differently, and that managers respond by using their discretion in income statement classifications to influence investors' perceptions of the profitability of core operations (Lipe 1986; Davis 2002). If the accrual of interest and penalties on uncertain tax positions is necessary to achieve relevant and reliable balance sheets, then the Committee recommends that the FASB provide guidance on the classification of the interest and penalty costs on the income statement. Guidance intended to promote the consistent classification of such costs will increase financial statement comparability.

Implementation Date

ED Summary

The effective date of the ED is the end of the first fiscal year ending after December 15, 2005.

Comments

The Committee suggests that the implementation date of the ED be extended to the fiscal year ending on or after December 15, 2006, for two reasons. First, the Committee notes the potential volume of transactions and number of jurisdictions that a publicly traded firm embraces in its tax strategy. Furthermore, many of the reported material weaknesses in internal control are due to inadequate tax documentation. This suggests that firms will have a hard time implementing the ED in the short time horizon of the ED. Second, the Committee suggests that the FASB extend the implementation date conditional on the timing of the issuance of the exposure draft on the "Short-Term Income Tax Convergence Project."

[12] A consistent treatment also can reduce record-keeping costs.

CONCLUDING COMMENTS

Changes to the ED

In November 2005, the Board re-deliberated the accounting for uncertain tax positions and made several important decisions on the project. First, the Board decided to apply a single threshold approach to recognizing and derecognizing uncertain tax positions in response to constituents' concerns about potential decreased comparability, difficulty in implementing the dual threshold, and the potential overstatement of income tax expense under the more stringent recognition criteria (see Interpretation No. 48, paragraphs B30–33). Specifically, the Board decided that the tax position will be recognized if the weight of available evidence indicates it is more likely than not, based solely on the technical merits, that the tax position will be sustained on a tax audit. The amount to be recognized will be measured as the maximum amount that is more likely than not to be realized. A tax position will be derecognized when it is no longer more likely than not of being sustained on a tax audit.

The Board also decided that while the final Interpretation will require the recognition of a liability for interest or penalties or both as deemed to be incurred based on the provisions of the tax law, the final Interpretation will not provide guidance on the classification of interest or penalties in the income statement. Rather, the Board expects that the final Interpretation will require companies to establish a policy for classification of interest and penalties, and to disclose that policy in the summary of significant accounting policies as well as the amount of interest or penalties or both recognized in the financial statements.

In response to the concerns of constituents that the ED could not be effectively implemented in the short horizon proposed by the ED, the Board tentatively decided to extend the implementation date to the onset of the first annual period beginning after December 15, 2006.

Effects of the Interpretation on the Alignment of Tax and Financial Reporting

There is an extensive literature on how taxes influence firms' financial and operating decisions.[13] This literature examines the effect of taxes on financing choices, organizational form and restructuring decisions, compensation policy, and risk management decisions. In their survey of empirical tax research in accounting, Shackelford and Shevlin (2001) note the decision of whether to align tax reporting to financial reporting has been studied in a number of different settings (e.g., see Mills and Newberry 2001).[14] They conclude that the body of tax research suggests that tax rules influence firms' financial reporting choices. In addition, they note that firms and tax authorities are concerned with book-tax differences, and managers align book numbers to tax numbers when necessary to save taxes.

Some Committee members believe that the ED takes a step toward increasing the alignment between tax and financial reporting because the criteria for recognizing an asset or liability for financial statement reporting is defined based on the likelihood that the asset or liability will be recognized by tax authorities. To the extent divergent tax and financial reporting practices result in competing and potentially perverse reporting incentives for managers, these Committee members believe the potential additional alignment of tax and financial reporting induced by the ED will be beneficial to firms' stakeholders. Future research can explore this assertion. Regardless of the impact of the ED on the

[13] For a review see Graham (2003).

[14] For example, the settings include inventory accounting, compensation, intertemporal income shifting, capital structure, divestitures, asset sales, regulated industries, and other settings (Shackelford and Shevlin 2001).

alignment of tax and book income, however, the Committee supports firms disclosing the reconciliation between taxable income and book income that is currently reported in the corporate tax return, given the sometimes competing incentives for tax and financial reporting.

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