

The FIN 48 Roller Coaster

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One of the most memorable parts of visiting Disney this year was riding the attractions with my daughter. Our favorite, at zero to 60 in just 2.8 seconds, was the Rock'n'Roller Coaster. And as with most other roller coasters, at the end of the ride you are right back where you started, but in between there are countless thrilling peaks and dips. While perhaps less predictable, but certainly more intimidating, new accounting pronouncements are far too often similar to the classic roller coaster ride. Upon the adoption of new rules, companies are frequently subject to erratic peaks and dips in their financial statements as they make required adjustments, sometimes only to be reversed in subsequent periods. One of the latest accounting roller coasters that businesses are faced with is Financial Accounting Standards Board Interpretation Number 48, an interpretation of the FASB SFAS 109 Accounting for Income Taxes.

Recently, I read the financial statements of a clinical research organization that clearly illustrates the roller coaster effect produced by FIN 48. In adopting FIN 48, at January 1, 2007 the company booked \$833,000 in tax liabilities against retained earnings. But in the third quarter, the company was able to reverse the tax liability, resulting in an \$833,000 increase in net income because the statute of limitations on that particular tax position expired! Yet, as with our roller coaster ride, at the end the equity of the company was right back where it started.

Overview of FIN 48

A FIN is issued by the FASB (Financial Accounting Standards Board) as an interpretation of existing FASB accounting rules. Generally a FIN provides clarification and guidance for accounting issues while prescribing appropriate steps for recognition and measurement. In other words, the accounting rules are already in place. In this case, SFAS 109 with FIN 48 simply providing additional guidance and interpretation.

FIN 48 applies to all entities that prepare financial statements under Generally Accepted Accounting Principles (GAAP). Interestingly, this also includes tax exempt organizations since, among other things, they must consider the remote possibility that exempt income could be determined to be unrelated business income. In addition, the tax exempt status itself is a tax position that must be assessed under FIN 48.

The scope of FIN 48 is broad and subject companies must consider all material tax positions already taken or expected to be taken. This would include the exclusion of income streams, uncertain tax free restructures and the election to not file income tax returns in a jurisdiction where one may be required. Keep in mind that when a return is not filed, the statute of limitations generally would not run and therefore one may argue that a reserve related to unfiled income tax returns could remain on the books indefinitely.

In essence, FIN 48 requires that the company disclose in their financial statements how much they have kept in reserve to cover the possibility that the IRS or other tax authority may disallow the tax positions taken.

Application of FIN 48

The evaluation of a tax position under FIN 48 is a two step process, recognition and measurement. In the recognition step, the enterprise has to determine whether it is more likely than not that a tax position will be sustained upon examination, including the resolution of any related appeals or litigation processes. In evaluating each tax position, the enterprise should go under the presumption that the tax position will be examined by the appropriate taxing authority with the full knowledge of all relevant facts. Under the "more-likely-than-not" (MLTN) threshold, a tax benefit related to a position may not be recognized in the financial statement unless it is MLTN that the position will be sustained. The definition of MLTN is more than 50 percent likely based on a cumulative score.

In the measurement step, a tax position that meets the MLTN threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon ultimate settlement.

In other words, the company must "handicap" the likelihood that the tax position will survive audit by the IRS or other tax authority. The real work and perhaps greatest cost attributable to implementing FIN 48 entails creating and maintaining records to catalog the company's various tax positions and their status.

Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which the threshold is met, the position is settled, or the relevant statute of limitations expires. And previously recognized tax positions that no longer meet the MLTN recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met.

A Simple Example

As an example, we can assume that a company recognizes \$4m in R&D credits on their tax return in 2008 for tax purposes at 100 percent. For the GAAP based financial statements prepared under FIN 48, we recognize that the credit is made up of four separate and distinct credits each worth \$1m. Furthermore, the company determines that three of the four credits are sustainable with a greater than 50% likelihood that they will settle for \$900,000 each over a time span estimated to be about 2 years. Therefore, $\$900,000 \times 3 = \$2.7m$ would be the benefit and the remaining \$1.3m would be recorded as a non current liability under FIN 48. In addition to the tax, the company would also be required to consider accrued interest and penalties that would occur if the tax position were not sustained. Once the statute of limitations runs out on all four credits, the liability would be reversed and the company would pick up income in that year.

FIN 48 adds a number of qualitative and quantitative disclosures. One item that FIN 48 requires to be disclosed is the entity's policy on classification of interest and penalties accrued within the income statement. Total penalties and interest included in the statement of operations for the period also must be disclosed. Another required disclosure is a tabular presentation that reconciles the total amounts of unrecognized tax benefits at the beginning of the period and at the end of a period. In addition, an entity must disclose the total amount of unrecognized tax benefits that would affect the effective tax rate if the benefits were recognized. A description of the tax years that remain open by major tax jurisdictions must also be disclosed. Finally, a detailed disclosure is required, related to positions for which there is a reasonable possibility that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date.

Generally, the Internal Revenue Service (IRS) has not requested tax accrual work papers in past audits. However, upon adoption of FIN 48, these work papers may provide a road map of the company's tax strategies. Therefore, there is some speculation as to whether the IRS will modify their audit procedures or tax forms to better assist them in automating the process of analyzing FIN 48 information.

Brief History

FIN 48 was developed because the FASB wanted to introduce more transparency for the tax reserves utilized by public companies. The FASB found that corporate executives were able to effectively manage earnings by simply overstating tax reserves in one year and then dipping into the "cookie-jar" as needed. The downside to this is that the "cookie-jar" more often than not included legitimate tax positions that would not ordinarily be disclosed to competitors. Furthermore, these tax positions also included positions that had not yet been subject to a tax court decision or IRS ruling, thus exposing possible weaknesses in tax positions that would put the company at a disadvantage should the matter go to tax court.

Last year, Senate investigators under the Permanent Sub Committee on Investigations under the Senate Committee on Homeland Security & Governmental Affairs, used the FIN 48 disclosures of large public companies to zero in on companies with large tax reserves. Presumably Congress is interested in closing loopholes and they, as well as the IRS, will not likely turn a blind eye to the opportunity that is presented as a result of FIN 48.

We have to consider whether this will have a chilling effect on tax positions taken in the future. Will FIN 48 deter entities from pursuing legitimate but aggressive tax strategies? What about small business? Originally, private companies were to adopt FIN 48 at the same time as the public companies but the regulators have given a one year reprieve. The effective date for adoption by public companies is fiscal years beginning after December 15, 2006 and for non-public companies, fiscal years beginning after December 15, 2008.

On January 4th, this year, the Private Company Financial Reporting Committee PCFRC co-sponsored by the FASB and American Institute of Certified Public Accountants (AICPA) issued a survey on the cost benefit of FIN 48. Responses will be used to implement further guidance for private companies. The PCFRC believes private companies in general lack the hands-on experience that public companies possess for determining the likely outcome of certain tax positions. They are likely correct. However, public company experience related to tax audits on specific issues may be less relevant to private companies due to the fact that the large and small companies are not examined by the same section of the IRS. Therefore, smaller privately held companies will to a large extent have to rely on their independent accountant's experience to assist them in quantifying their requirements under FIN 48.

Conclusion

With early planning and proper execution, satisfying the requirements of FIN 48 may still be a roller coaster ride but perhaps more manageable. So fasten your safety restraints and keep your arms and legs inside the vehicle at all times. I will not suggest that you enjoy this ride. I would leave that to your accountants.



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