

The end of the road? FIN 48 disclosures and the annual financial statement process

The end of the road? FIN 48 disclosures and the annual financial statement process

Many enterprises now have made their disclosures of uncertain tax positions (UTPs) in conjunction with annual financial statements — the second critical milestone under Financial Accounting Standards Board Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). The disclosure process presented a variety of challenges — many of them not significantly different than those encountered previously during adoption, which was the first critical milestone. Resources, clarity of technical requirements, communication, changes to key processes, and concern about disclosure expectations all challenged enterprises during the fourth quarter.

Key disclosure challenges

For many enterprises, the challenges associated with year-end FIN 48 disclosures were similar to some of those encountered during adoption.

Interpreting technical requirements. Without clear guidance and examples to follow, many enterprises struggled to interpret and apply the technical requirements of FIN 48 as they prepared their FIN 48 disclosures. There were a variety of elements that posed challenges:

- Understanding what must be represented in the paragraph 21(a) tabular reconciliation.
- Excluding interest and penalties from the amounts of unrecognized tax benefits reported in the tabular reconciliation and establishing them as a separate disclosure, as required under paragraph 21(c).
- Determining whether and when to present FIN 48 liabilities and deferred tax assets relating to net operating loss carryforwards on a gross or net basis on the balance sheet.
- Providing additional breakouts of the components of income tax expense beyond “current” and “deferred.”

Anticipating presentation and disclosure requirements.

Without a doubt, the biggest area of concern involved the types of information and amount of detail to be included in financial statement footnotes regarding expected significant changes to unrecognized tax benefits over the coming 12 months, as specified in paragraph 21(d). Many enterprises sought clarity around how much information must be included in this disclosure and the appropriate level of aggregation—but found little to guide them.

Across the board, enterprises have taken steps to analyze the rules, examine how other filers are reporting UTPs in their financial statements, and comply with what they understand to be the disclosure requirements. Still, many were left asking the question: What constitutes sufficient disclosure? In the end, they found it required as much judgment as it did analysis.

Incorporating new information. Another challenge was determining how to introduce events that emerged or that were otherwise not considered when implementing FIN 48. Those that

identified such issues through audits or other means faced new questions in determining how to account for these new events: When is it appropriate to reassess recognition or re-measure? Was there information that wasn't previously known or knowable that would warrant recognizing, derecognizing, or remeasuring the item?

While enterprises typically have established responsibility for monitoring identified UTPs, many do not yet have solid processes in place to identify and monitor items that are not currently on ‘the list’.

Managing effort and resources. Enterprises typically expended significant effort on adoption, but few recognized that gathering information for the year-end disclosure would represent a similar amount of work — work that they had to complete using existing resources. Many under-budgeted for the disclosure process. Of all the work streams, the tabular roll-forward was particularly time consuming for many.

International enterprises faced the added challenge of obtaining necessary information from their overseas entities. Preparing FIN 48 disclosures required more time devoted to examining, understanding, and accurately reporting local issues.

Dealing with the new rules together. Finally, enterprises and their external auditors faced the learning curve together as they sought to establish a process for the gathering and presentation of information in a timely and auditable fashion.

The disclosure process

Most enterprises relied on existing staff and tools to complete their FIN 48 disclosures.

Resources. Even coming out of the time-intensive adoption process, most enterprises did not have the luxury of increasing staff to address FIN 48 disclosure and documentation requirements. Many enterprises recognized they would need to get through the first year's disclosure process in order to quantify additional resource needs and justify increasing headcount for year two.

Many enterprises reallocated people from other activities, including tax planning, to work on disclosures and related documentation, seeking outside advice or assistance as needed. Some have established point responsibility within the tax department for maintaining the list of disclosure items and obtaining regular updates with respect to those items. Given the level of judgment involved in the disclosure process and possible scrutiny, some enterprises delegated critical reporting activities and decisions upward to directors and vice presidents. And, they sought the involvement of the CFO and/or SEC counsel in key decisions and reviews.

Tracking tools. Most enterprises relied on self-developed spreadsheets and databases to maintain and track FIN 48 information and as the basis for preparing disclosures. There are multiple versions of FIN 48 software available, but the interest in this new technology has been inconsistent. Companies with more UTPs and those with an existing provision software package (rather than a spreadsheet-based provision) typically demonstrate the most interest. Interest in FIN 48

software is likely to increase, consistent with the overall increase in interest in provision software to replace spreadsheets.

Timing of activities. Typically, enterprises addressed their FIN 48 requirements quarterly, including gathering updated information, in conjunction with filings. At this point, many had not implemented more continuous processes for tracking and monitoring the required information. Those that had started early — initiating discussions and drafts as early as the second quarter in order to socialize them with senior management, audit committees, and auditors — typically found themselves better prepared and facing fewer fire drills at year-end.

FIN 48 disclosures' impact on tax planning

FIN 48, as a whole, not merely the disclosure process, has prompted enterprises to examine their tax planning philosophies and methods. Most issues raised by FIN 48 that have affected tax planning — such as accounting method changes, documentation, and transfer pricing — came to light during adoption.

While some enterprises have not altered their tax planning strategies, others have effectively halted future tax planning until they are able to analyze existing documentation, clarify historic tax positions, and remediate current issues.

Overall, the disclosure process has touched planning activities in several ways. It has:

- Required companies to improve information gathering and analysis around their UTPs.
- Elevated management and board attention to the benefits of prudent tax planning and initiated more extensive discussions around tax risks.
- Heightened awareness of risks in certain areas that previously did not receive the same level of scrutiny—for example, risks around state tax planning, international structures, and transfer pricing.
- Instilled more discipline around documentation when tax planning is involved, particularly on matters with FAS 109 and FIN 48 impact.

Some observers believe this process, combined with new paid preparer penalty rules, has further served to elevate UTP resolution as a priority over new tax planning efforts. How can enterprises better understand historical tax positions? What do they need to do to remediate existing UTPs? What should they put in place going forward to manage tax exposure effectively?

In any event, enterprises with the first year of FIN 48 behind them are now more likely to discuss tax planning with the rules in mind, asking the key question up front: What are the tax and financial statement documentation and tracking requirements that must be followed when implementing this tax planning idea?

While the disclosure process has been as strenuous as most expected and many concerns remain, enterprises acknowledge some benefits—most notably, a heightened awareness of tax matters.

For one, the attention paid to UTPs in the financial reporting process has elevated boards' and executive teams' attention to tax issues, strategies, and decisions. In some organizations, tax is now a topic of board and/or audit committee discussions at least once per year — an occurrence that was practically unheard of before the emergence of FAS 109 and FIN 48. In addition, working through the disclosure process has helped tax directors to open lines of communication with CFOs and other senior executives that may not have existed in the past.

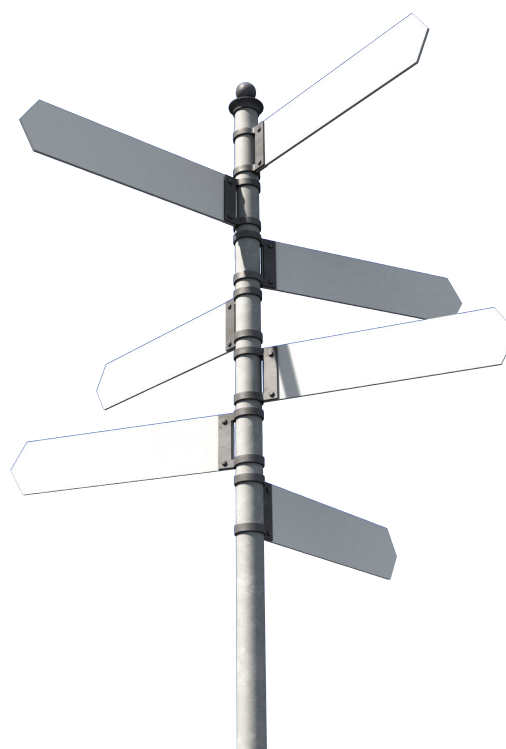
For tax staffs, the effort — while challenging at times — has heightened education and awareness of tax planning issues and tax risks, while at the same time preparing individuals to manage the process more proactively in the second year.

What to expect in year two

Practically speaking, the challenges that enterprises can expect in year two will not change much from those faced during the first year. Some will begin making changes to integrate FIN 48 and its disclosure requirements into their regular operations and longer-term planning efforts; yet, it is unlikely that there will be wholesale changes in their approach in the short term. Enterprises will continue to assess resource and process needs, technical requirements, and, in some cases, impact on the progress of ongoing audits.

The disclosure process. With a year of effort behind them, enterprises are beginning to take a fresh look at, and plan for, the time, resources, and tools required to maintain information and produce documentation during the year ahead. Many enterprises expect to spend significant time on monitoring UTPs and FIN 48 disclosures. Some steps that enterprises may take include:

- Automating some of the highly manual steps involved in monitoring information or performing certain complex calculations, such as interest and penalty calculations—freeing up executives' time for addressing issues rather than simply monitoring them.
- Creating better ways to warehouse and report disclosure data to internal teams.



- Monitoring changes and accumulating data continuously throughout the year, rather than just during filing periods.
- Enhancing communication among departments responsible for tax planning, tax returns, and financial reporting and ensuring that the right people understand the standards and are prepared to support the process going forward.
- Improving visibility into tax implications of international operations.
- Ensuring adequate internal capabilities for utilizing and tracking data gathered at adoption.
- Adding FAS 109 and FIN 48 expertise to in-house staffs.
- Working in advance with external auditors to plan the information-gathering process and timeline and to determine how events such as reversals or re-measurements will affect timing.
- Beginning to draft disclosures early—even in the second quarter—and socializing them to foster consensus on approach.
- Educating and seeking the active participation of board and audit committee members and other senior financial executives.
- Monitoring SEC comment letters.

Disclosure requirements and expectations. The first filing year produced a wide disparity in the detail of disclosures. The few comment letters issued by the SEC to date have generally applied to adoption disclosures and have asked for more information, indicating that enterprises may have erred on the side of not disclosing enough detail. But, until the SEC issues a significant number of comment letters — expected to begin in the summer of 2008 — enterprises will have little to alleviate concerns about whether they have prepared FIN 48 disclosures according to SEC expectations.

To adjust and shape their year-two disclosure approach, enterprises will need to review SEC comment letters in detail to understand, and then conform to, expectations for the type of information and the level of detail expected in the financial statement disclosures.

Research and education. Executives can continue to expect a variety of educational forums on FIN 48 throughout 2008 and can benefit by connecting with their peers and industry groups to analyze findings and learn how others are dealing with similar issues. They should be on the lookout for additional guidance on preparing financial statement disclosures and be prepared to assess the accounting impact of tax law changes. As executives monitor their enterprises' UTPs, they should ask themselves:

- Have there been legislative changes in the states or foreign jurisdictions where they do business?
- Have there been any legislative changes or court cases pertinent to their industries?
- What issues are arising in IRS or state exams?
- How have other companies presented their disclosures?

By all means, executives should educate themselves on the SEC's expectations for future filings.

What lies ahead?

After completing adoption and the first year's FIN 48 disclosures, enterprises and observers agree: FIN 48 disclosures present a long-term challenge. Even if the current rules evolve, enhanced tracking and disclosure requirements for UTPs likely are here to stay and enterprises may need to adapt their enterprises to manage this process more efficiently going forward.

In order to gain greater certainty on how a taxing authority may rule on a particular tax position, there may be an uptick in the number of special requests or treatment sought by enterprises — for example, pre-filing agreements from the IRS or voluntary disclosure agreements from the states.

While many enterprises are beginning to plan for their second year under FIN 48, few are looking beyond due to resource constraints and the uncertainty of how the possible transition to International Financial Reporting Standards would impact FIN 48. Most enterprises will continue to assess the effort and skills required in year two before taking significant actions — such as adding a technology solution to manage UTP documentation requirements on an ongoing basis.

Primarily, though, enterprises are waiting to see the SEC's response to the first year of FIN 48 disclosures on financial statements before shaping their longer-term strategies. Although the SEC has issued a few comment letters on FIN 48 adoption to date, a more substantial review process will begin soon and continue through the summer. Many enterprises expect this process to provide needed clarity around the level of detail and substance of disclosure requirements, as well as certain technical elements of disclosure documents. Until the results of these reviews are in the open, enterprises remain concerned about the questions the SEC and taxing authorities may raise in response to financial statement disclosures.



This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte, its affiliates and related entities shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte Tax LLP and Deloitte & Touche LLP, which are separate subsidiaries of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

Copyright © 2008 Deloitte Development LLC. All rights reserved.

Member of
Deloitte Touche Tohmatsu