September 12, 2005

Technical Director
Financial Accounting Standards Board
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Dear Director and Members of the Financial Accounting Standards Board:

The Financial Accounting Standards Committee of the American Accounting Association (the Committee) is charged with responding to discussion memoranda and exposure drafts on financial accounting and reporting issues. This letter summarizes the Committee’s comments on the Exposure Draft on the Interpretation of FASB Statement No. 109: Accounting for Uncertain Tax Positions. In this letter, the Committee identifies and responds to three key components of the proposed Interpretation and comments on several other issues of the Exposure Draft. The letter concludes with our view of the effects of the proposed Interpretation on the alignment of tax and financial reporting. The opinions in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association.

The proposed Interpretation would require a firm to recognize, in its financial statements, the best estimate of the impact of a tax position if that tax position is probable of being sustained in an audit by tax authorities. The proposed Interpretation would also require derecognizing a tax benefit when it is more likely than not the tax position cannot be sustained. Included in the proposed Interpretation are guidelines on the accrual of 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. It is proposed that the Interpretation be effective as of the end of the first fiscal year ending after December 15, 2005, and the scope of the Interpretation shall be applied to all tax positions for which the statute of limitations remains open upon the initial adoption of the Interpretation. Below we summarize the relevant literature on and our comments pertaining to three components of the proposed Interpretation: (1) the probability thresholds driving the recognition and derecognition of tax positions, (2) the best estimate method of measuring the benefit from a tax position, and (3) the requirement that the tax benefit be sustained in an audit by the taxing authority.
Recognition and Derecognition Thresholds

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.¹ Specifically related to the tax setting, Cuccia, Hackenbrack, and Nelson (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 as level or precision of the threshold for reporting.² 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.³ The literature suggests that decision-makers’ risk perceptions are conditional on their knowledge about the setting and control over the outcome.⁴

A number of studies focus on the correspondence between the three probability terms used in FASB Statement No. 5 ("probably," "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.⁵ However, Aharony and Dotan (2004) provide evidence that suggests that preparers and users assessments of FASB Statement No. 5 probability thresholds differ.⁶ 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" (p.21).

While the literature suggests that interpretation of the proposed recognition threshold criterion appears be 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

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judgment. The literature indicates that judgment is influenced by behavioral factors such as the newness of the setting or the controllability of the outcome. Consequently, while the stated objective of the proposed interpretation 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 viability of a manager's judgments potentially differs across tax settings and the feasibility of judgments will vary across managers within and across firms.  

Gleason and Mills (2002) illustrate differences across firms in implementing FASB Statement No. 5. Using archival data, they investigate whether companies provide FASB Statement No. 5 disclosures if they report a potential liability to the IRS for underpayment of federal income taxes. They find that only 27% of firms make any disclosure of contingent tax liabilities in financial statements and only 30% of these disclose the detailed information required by SFAS 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. The term “more likely than not” is not used in FASB Statement No. 5, and thus the FASB Statement No. 5 literature is not directly applicable to the derecognition criterion suggested by the proposed Interpretation.

The proposed Interpretation suggests a dual threshold approach to recognizing and derecognizing uncertain tax assets. The Committee would like to highlight a cost and benefit of the dual threshold approach. Related to the costs, 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 versus derecognition of the uncertain tax asset. 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

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8 Large publicly traded firms can have upwards 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.
10 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.
reasonableness of managers' implementation of the standard. Finally, investors face additional learning costs when standards are more complex.\textsuperscript{11}

The potential benefit of the dual threshold approach is the possible reduction in earnings volatility. Volatile earnings are generally perceived to be noisier and of lower quality.\textsuperscript{12} The initial raising of the criterion for recognition to "probable" may have a one-time shock to earnings volatility, but in the end, the dual threshold approach is expected to reduce earnings volatility. It is important to note, however, to the extent the dual threshold approach reduces earning volatility when in fact volatility is more representative of the underlying economics of a firm, then the dual threshold approach is not desirable.

We believe the costs of the dual threshold outweigh the potential financial reporting benefits, and recommend that the Board adopt a single threshold criterion to recognize and derecognize uncertain tax positions. The threshold could be consistent with SFAS 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 37, Provisions, Contingent Liabilities and Contingent Assets, that defines "probable" as "more likely than not."\textsuperscript{13}

The proposed Interpretation also notes that a valuation allowance as described in Statement 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. We support this conclusion given the research that suggests that managers use the deferred tax asset valuation allowance as an earnings management tool.\textsuperscript{14}

\textbf{Measurement of Tax Benefit}

Under this proposal, the measure of the amount of benefit recognized for a tax position is required to be the \textit{best estimate} meaning "the single most-likely amount in a range of possible estimated amounts" (para. 11). We know of no research that directly addresses the measurement of an amount at a \textit{best estimate}. The \textit{best estimate} approach fundamentally differs from fair value, which while currently being proposed as an

improvement to financial reporting, is excluded from the proposed Interpretation. Although the FASB states that the proposed Interpretation is the result of a limited-scope project and has decided against any consideration of fair value (para. B10), if another measurement approach is being used for other current reporting (and perhaps may be taken in future financial reporting on this issue) using the best estimate approach here will result in continued inconsistent measurements within a company’s financial reports.

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 FASB Statement No. 109, Accounting for Income Taxes, that 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 Statement No. 109 to an approach consistent with IAS, requiring measurement based on tax rates (and tax laws) that have been enacted or substantively enacted by the balance sheet date. It is concerning 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 it expects to issue a new exposure draft on the “Short-Term Income Tax Convergence Project” sometime in the fourth quarter of 2005. The Committee suggests 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”. 15

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

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.

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. For example, in experimental work, Cloyd (1995) and

15 Updates on the project can be obtained at http://www.fasb.org/project/short-term_ind_convergence_income_tax.shtml.
Cloyd, et al. (1996) find that tax advisors and corporate tax managers assess a higher probability that there will be greater scrutiny from the taxing authority when there is a difference in tax and financial income and a higher probability that there will be a weakened tax position in audit as tax and financial income diverge. Consequently, one expects managers to choose a financial accounting method which (usually) lowers reported income to increase expected tax savings and cash flows. Additionally, positive accounting theory suggests that tax consequences relate to accounting choices. Differences between tax and book income could potentially increase scrutiny and political costs to the firm. 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.

Managers, then, have incentives to reduce both taxable income and book income to save taxes, reduce scrutiny by aligning taxing and book treatments, and potentially increase the probability that a tax treatment is allowed. As Mills (1998) notes reducing book income creates financial reporting costs that very across firms. For example, accounting-based contracts, such as debt covenants and compensation plans, often provide incentives to increase or maintain reported income. Her work provides evidence that justifies the general assumption in financial accounting research that firms face a trade-off between book and tax incentives for earnings management.

More recent account investigates whether differences between pre-tax financial reporting earnings and taxable income (i.e. non-conformity) can provide information about current earnings. The maintained hypothesis in this literature is that less discretion is allowed in the computation of taxable income. Therefore, book-tax differences can be informative about management discretion in financial reporting. This


17 In experimental work, Cloyd (1995) and Cloyd, et al. (1996) find that tax advisors and corporate tax managers assess a higher probability of both 1.) greater scrutiny from the taxing authority when there is a difference in tax and financial income and 2.) a weakened tax position in audit.


19 A consistent treatment also can reduce record-keeping costs.


research provides conflicting evidence on the nature of the book-tax difference. On the one hand some studies find that book-tax differences are associated with earnings management measures. When the book-tax difference is greater, tests using proxies for earnings quality imply lower quality earnings. Consistent with lower quality earnings and/or earnings management, firms’ earnings-return relations are weaker when their book-tax differences are greater. On the other hand other research provides evidence that suggests that the difference in book and taxable income is informative to financial statement users. The ratio of taxable income to book income is related to future growth and future returns. Relative and incremental to book income, taxable income is informative, suggesting that there is a loss in information from tax-book conformity.\(^{23}\) Accounting for uncertain tax positions is clearly a case where management discretion must be exercised. However, accounting for uncertain tax positions is also a case where less discretion is not necessarily allowed under the tax code. Rather, discretion must be used because the tax position is unclear.

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 versus financial reporting choices.

**Other issues**

**Interest and Penalties**

The scope of the proposed Interpretation specifically excludes guidance on the classification of interest and penalties. Research suggests that investors recognize differences in the categories of expenses 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.\(^{24}\) If it is believed that the accrual of interest and penalties on uncertain tax positions is necessary to achieve relevant and reliable balance sheets, 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**

The effective date of the Interpretation is the end of the first fiscal year ending after December 15, 2005. The Committee notes that firms have two basic strategies to reduce their overall effective tax rate. First, firms can engage in transactions and financing strategies to reduce local or domestic taxation. Second, firms can use business models

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that permit the migration of profits to low-tax jurisdictions. Given the potential volume of transactions and number of jurisdictions that a publicly traded firm embraces in its tax strategy, along with the knowledge that many of the reported material weaknesses in internal control are due to inadequate tax documentation, the Committee suggests that the FASB extend the implementation date to the fiscal year ending on or after December 15, 2006 conditional on the timing of the issuance of the exposure draft on the “Short-Term Income Tax Convergence Project”.

Concluding Comments

There is an extensive literature on how taxes influence firms’ financial decision making.\(^{25}\) 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.\(^{26}\) They conclude that the body of 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. The Committee believes that the proposed Interpretation takes a step towards tax and financial reporting alignment. To the extent divergent tax and financial reporting practices result in competing and potentially perverse reporting incentives for managers, we believe the intent of the proposed Interpretation to align financial reporting and tax reporting is beneficial to financial statement users.

Sincerely,

Financial Accounting Standards Committee of the American Accounting Association

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