



Where Tax and Technology InterACT



# Journal of Corporate Tax Automation

The professional journal for those responsible for automating the corporate tax function.

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### FIN 48

## Employing Integrated Tax Technology to Address The New Imperatives Created By FIN 48

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*How companies can manage, measure and report on tax positions with increased efficiency, accuracy, and certainty*

In June 2006, the Financial Accounting Standards Board (FASB) issued the latest pronouncement in what has become a continuous stream of regulatory and policy changes designed to increase corporate accountability and the transparency of financial reporting. The new pronouncement, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48 or the Interpretation), was established with the same intent and overriding goals as were Sarbanes-Oxley and recent Public Company Accounting Oversight Board (PCAOB) pronouncements from early 2006—namely to increase corporate financial reporting accuracy and auditability. How will FIN 48 improve financial reporting?

As a threshold matter, and at the risk of stating the obvious, the income tax line – federal, state and international – is one of the largest corporate costs. As a result, in recent years, income tax accounting has become the subject of intense scrutiny. FIN 48 is an interpretation of FAS 109 and addresses the specific issue of accounting for uncertainty in income taxes. According to the FASB, "Diversity in practice exists in the accounting for income taxes. To address that diversity, [FIN 48] clarifies the application of Statement 109 by defining a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in an enterprise's financial statements."<sup>1</sup> In FASB's opinion, by eliminating diversity, the result will be increased relevance and accuracy in the financial reporting of income taxes because each tax position will be evaluated for recognition, de-recognition, and measurement using consistent criteria. That

### Upcoming Meeting

## ACT Winter Conference

The Hilton St. Petersburg Bayfront, St. Petersburg, FL; February 26-28, 2007.

Join us for a full three day program of corporate tax automation education at



the Hilton St. Petersburg Bayfront Hotel in St. Petersburg, FL. See Page 40 for a glance at the program topics. Visit our website at [www.taxACT.org](http://www.taxACT.org) to view the conference brochure and register online.

criterion is the “more likely than not” threshold and is applied at two junctures – (1) the decision to recognize the tax benefit of an uncertain tax position based on an evaluation of its technical merits; and (2) the determination of how much of the benefit to recognize.

## FIN 48’s Aggressive Scope, Schedule, and Substantiation Requirements

While companies have begun analyzing from every angle the granular requirements of FIN 48 to apply them in their own environment, the high-level impact has become abundantly clear. FIN 48 is extensive in scope, it sets aggressive deadlines for compliance, and the convergence with regard to SOX 404 has created unprecedented demands for process, documentation, and internal controls. Specifically, FIN 48:

- Affects every company issuing financial statements based on generally accepted accounting principles.
- Is effective for fiscal years beginning after December 15, 2006, which means a process must be in place for the first quarter of 2007
- Applies to all tax positions related to income taxes subject to FAS 109
- Applies to tax positions taken as well as those not taken
- Encompasses tax positions considered routine as well as ones with high levels of uncertainty
- Encompasses all open tax positions—past, present, and future—which even for a smaller company with only \$500 million in annual revenue could mean hundreds of positions
- Requires taxpayers to identify all tax positions, break those positions down into units of account, and apply two independent, but interrelated analyses, one for benefit recognition and the other for benefit measurement
- Clarifies guidelines for measurement, interest and penalties, and disclosure

## Scrutiny Beyond Income Tax Exposure

FIN 48 is clearly centered on income tax accounting reform. However, the impact of FIN 48 may well extend beyond the scrutiny of income tax positions alone. Current chatter in the accounting community has led some companies to conclude that auditors will likely heighten their focus on the review of *all* uncertain tax positions—both non-income tax-related (for example, sales and use taxes, property taxes, excise taxes, and VAT) and potentially to non-tax-related positions as well (for example, environmental and legal). Combined, these could create a significant resource drain and cost burden on corporate tax departments unless the corporate tax department is adequately prepared and has the necessary processes and infrastructure in place.

*In accordance with FIN 48, every tax position must be evaluated based on a two step process:*

*Step 1:*

*Recognition: The enterprise must determine (based on technical merits) whether it is more likely than not that a tax position will be sustained upon examination.*

*Step 2:*

*Measurement: A tax position that meets the threshold must be measured at the largest amount of benefit that is greater than 50 percent likely to be realized upon ultimate settlement.*

## What Does This Mean for the Corporate Tax Function?

The process of assessing and determining tax positions is not revolutionary for corporate tax departments. Companies have been tracking positions, managing exposure amounts, and computing estimates of their exposure for years. These activities are routinely conducted on a quarterly basis as part of the tax accrual process. What's changed with FIN 48, however, are the new imperatives of accuracy and auditability that create a higher standard that must be met in order for benefits of positions to be recognized on a company's financial statements. It has introduced a "more likely than not" standard, a cumulative probability model for recognition, and much tougher disclosure requirements. These changes have in turn placed greater emphasis on process, documentation, and controls. Because of this, FIN 48 cannot be viewed as an isolated policy development, but instead one that ties into SOX 404 requirements. The convergence with Sarbanes considerably broadens the scope of FIN 48 beyond just assessment and judgment of open positions. In essence, heightened transparency and internal control requirements compel the corporate tax department to adopt a much more comprehensive approach to ensure nothing has been overlooked, surprises are avoided, and a record of sign-offs and audit trails are captured to track how and why decisions were made. All of this has driven greater demands on the corporate tax function that require process, workflow, decision-making, and documentation to track positions and underlying units of account from period to period and year to year.

To answer these greater demands, tax executives must address an ancillary set of issues. For example, how can the tax department be sure it has identified all positions? Who is responsible for identifying the positions and units of account? How can the Vice President of Tax be certain that the critical technical assessment decisions are made by the right person and appropriately reflected in the company's reserve calculation? How will the department manage the massive flow of information to these parties? How will they record changes and approvals in an auditable way? How will the tax department set up a sustainable and repeatable process to identify new tax positions and changes?

*Heightened transparency and internal control requirements, resulting from the convergence of SOX 404 and FIN 48, has driven greater demands on the corporate tax function that require process, workflow, decision-making, and documentation to track positions and underlying units of account from period to period and year to year.*

## Key Imperatives FIN 48 Places on the Corporate Tax Function

In order to address these questions and the changes brought about by FIN 48, there are several key imperatives that must be considered.

**Controlled process and workflow:** The tax department needs to have in place a controlled process to support FIN 48 that works within the internal control framework of the company. Process and procedures are required to ensure certainty, continuity, and consistency for identifying, measuring, and disclosing potentially significant uncertain tax positions. In addition, processes must be adapted or created to identify when changes in those positions need to be made.

**Information accuracy, granularity, and transparency:** First and foremost, the tax function must be able to rely on the accuracy of its information to support positions and reserve calculations. The data also must be tracked at a granular level to provide the detail required by internal audit committees and others who must sign off on judgments. Finally, it must be readily available to support positions during examination.

**Decisions and documentation tracked over the lifecycle of a position:** The tax department must be able to demonstrate underlying units of account from period to period and year to year. Clear demarcation is required for decision-making and approvals, consistent with the internal control framework. Further, the audit history supporting any position at any point in time must not be lost as changes are made to that position in subsequent periods.

**Detailed and summary data to support internal and external reporting and disclosure requirements:** Quick and informal assessments to support new internal reporting requirements, and what is expected to be much greater external disclosure requirements, will not suffice. Tax positions must be assessed based on their technical merits in line with the “more likely than not” standard. Tax professionals will need to prove out their sub-positions or units of account and provide a basis for who is making the decision, how it is being made, who ultimately approves the decision, and what is available for review by an external auditor.

From a tax process and technology perspective, this accelerates the need for automated workflow, centralized single source data, and integrated tax position information from calculation through approvals and supporting documentation.

*In a recent survey of 75 tax executives, 61% of the respondents indicated that they will be expected to present their FIN 48 compliance procedures and reserve analysis to their corporate audit committee.<sup>2</sup>*

## Using Technology to Implement a Consistent and Standardized FIN 48 Process

As mentioned earlier, most corporate tax departments are knowledgeable and equipped to estimate tax exposure amounts. They have been doing so for years and although FIN 48 has clarified the measuring stick, tax departments are generally comfortable with these requirements. The palpable concern lies more in the task of developing and implementing a consistent, repeatable, standardized process that dovetails with the internal controls framework and clearly places the company on the path to FIN 48 compliance. Furthermore, because the disclosure and documentation requirements from external auditors are still evolving, configurability is a key consideration in the implementation of process or technology to support the process.

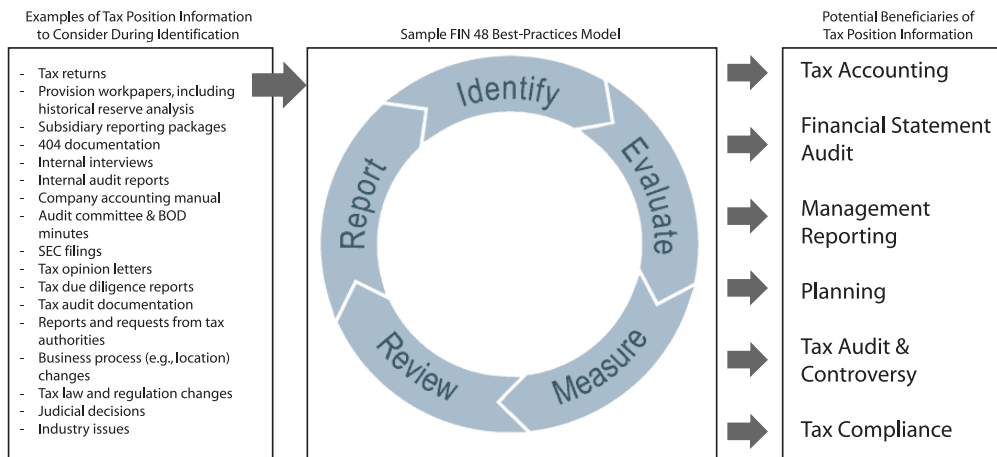
Given these considerations, we've outlined an integrated process below consisting of five best-practice steps that were developed with three primary goals in mind: reducing risk, increasing accuracy, and improving efficiency.

On the left side of Diagram A (see next page) is a small list of the types of information that a company will need to consider in the identification of tax positions. Items such as tax returns, prior year provision work papers, and subsidiary reporting packages are expected elements. However, an area

*A consistent theme resonates from the author's frequent discussions with corporate tax executives. One executive stated it this way: "FIN 48 unquestionably puts an added burden on already resource-constrained corporate tax departments. The identification and reevaluation of tax positions requires a tremendous amount of work and is now an imperative to ensure that financial statements appropriately reflect tax expense and related liabilities. Software that provides a streamlined, controlled framework for identifying, evaluating, measuring, and reporting on uncertain tax positions — going well beyond what spreadsheet systems are capable of — is critically needed to help today's corporate tax departments manage these new requirements."*

that will require much greater attention is the need to work side-by-side with business units throughout the enterprise to better understand business changes, such as M&A activity and regulatory developments that have a material impact on tax positions and increase risk. This could include internal interviews, reviews of documentation such as tax opinion letters, due diligence reports, internal audit documentation, and judicial decisions.

**Diagram A**



To make the information types most useful to those who rely on them – the corporate tax personnel, the CFO, financial statement auditors, compliance officers, etc. listed on the right hand side of the diagram – companies must re-examine their current processes and adopt a best practices model that will enable them to comply with the demands of FIN 48 within their SOX Section 404 control environment. While somewhat arbitrary, a best-practices model can be broken down into five separate but interdependent steps:

**Step 1: Identify.** Companies must put in place procedures to ensure they can confidently identify all relevant, significant open tax positions on both a domestic and global basis. There must also be a way to ensure those responsible for identifying tax positions are doing so consistently, based on the same source material, and that their decisions are approved and documented.

**Step 2: Evaluate.** There should be a standardized evaluation methodology for each unit of account to ensure that the right individuals are making and reviewing the decisions, and that sufficient documentation exists to support the reserve calculation at any point in time.

**Step 3: Measure.** Companies must apply and document a cumulative probability approach to determine measurements, along with related approvals and calculations of interest and penalties at the federal, state, local, and international levels. Measurements must also reflect changes to foreign currency amounts to ensure accurate reporting in the appropriate currency.

**Step 4: Review.** Companies must ensure visibility at a very detailed level into all global tax positions. At any point they must be able to identify who made a particular decision, whether that individual was appropriate for that decision, and how that decision was arrived at and documented.

**Step 5: Report.** Companies must be able to provide summary and detailed reports for both internal audiences and external auditors by period, entity, jurisdiction, or type, and also be able to show where the company was at any point in time with regard to its reserves and reserve analysis.

Following these steps, however, takes the corporate tax function into new territory – territory where traditional tools and methods are insufficient. Tax departments need a more advanced and integrated approach to succeed. There are four key considerations to take into account when evaluating technology that will best support FIN 48 efforts: comprehensiveness, configurability, a controlled framework, and scalability and flexibility.

**First**, tax departments should aim for comprehensive coverage; they must be able to identify and support all tax positions globally. For example, a repository tool in and of itself isn't sufficient to help with calculating related interest and penalties and foreign exchange impact, nor is it enough by itself to enable the corporate tax department to track approvals and reviews, or roll balances forward from period to period, etc. Tax executives must be able to evaluate all positions completely, with one comprehensive application that tracks activity for original source detail to final reporting decision, and everything in-between.

**Second**, companies will need technology that is highly configurable. Requirements evolve, and in the case of FIN 48 they are not set in stone and will require adaptation as tax departments apply them in their own unique environments. Different auditors – even from within the same firm — may further approach their task differently. It is still too early for companies to identify all the controls they will need to put in place to manage FIN 48 within their own unique workflow, reporting, and 404 control environment.

**The third key** consideration is that the technology solution be fully integrated to provide sufficient control of the process. For example, it will be difficult to demonstrate that controls are in place if information remains scattered across multiple areas (such as when documents are gathered in a centralized repository but positions are kept in a provision product). An integrated environment enables companies to streamline processes and share critical information and standards across all tax functions, so they can manage, measure, and report on all of their global tax positions as well as the impact those positions will have on the company's financial statements.

**The fourth consideration** is the solution's scalability and flexibility. It is critical that the technology be 100% Web-based so it can support decentralized tax teams, enable anytime access to critical data from any location, keep up with business expansion and changes, and reduce ongoing system maintenance and upkeep. System capacity is also important; the solution must support continuous growth of the database, the user base, and the amount of documents retained. The system should include a robust, world-class database architecture for optimal performance. Finally, the solution should not only satisfy current requirements, but can be further enhanced to handle new features and capabilities that might be required in the future.

## Summary

The extensive scope and aggressive deadlines of FIN 48 are compelling tax departments of all sizes to search for ways to improve or streamline their processes, documentation, and internal controls associated with calculating and supporting their tax positions. The accompanying imperatives of accuracy and auditability are simultaneously raising the standard that must be met in order for the benefits of positions to be recognized on a company's financial statements. To comply with these new imperatives, the corporate tax function will need to rely more heavily on technology to automate workflow, centralize data, integrate tax position information, and bolster the ability to sustain its positions under audit. Selecting technology that supports a best practices model can substantially help the tax function realize its more immediate compliance goals, and also keep up with the changing landscape as companies and their auditors gain experience with FIN 48 and implement process improvements.

### Footnotes

1. FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, June 2006, available at [www.fasb.org](http://www.fasb.org).
2. Polling results from Liquid Engines Webcast Oct 2006.

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