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FASB FIN 48 DISCLOSURES: EVIDENCE ON USER PERCEPTIONS

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ABSTRACT

This study analyzes how financial statement users (users) interpret disclosures related to Financial Accounting Standards Board (FASB) Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48). While past research has examined the decision usefulness of various aspects of FIN 48 balances reported in the financial statements, there are no studies that examine the impact that FIN 48 disclosures have on the financial decisions the users make. This study aims to fill this gap by conducting an experiment to find evidence that users find FIN 48 disclosures useful in evaluating the conduct of a firm's management. Specifically, the study examines and finds that users regard FIN 48 disclosures as more of an indication that the management is enhancing the transparency of the financial statement information provided rather than using aggressive tax strategies. The finding of this study is important to standard setters as it suggests that users are interpreting the disclosures consistent with the intention of the FASB. This finding is also important to companies who may be hesitant to increase the robustness of FIN 48 disclosures as this study suggests that the outcome of such practices would likely improve the perception of the company in the users' eyes.

JEL: M42

KEYWORDS: Uncertain Tax Positions, Educated Non-Professional Investors, Information Usefulness, Financial Statement Transparency, Aggressive Tax Strategies

INTRODUCTION

Financial Accounting Standards Board (FASB) Interpretation No. 48: Accounting for Uncertainty in Income Taxes (FIN 48) was issued in 2006 to provide information on how a company should account for uncertain tax positions that may exist in their current and past tax returns (FASB, 2006) and was effective for financial reports issued after December 21, 2006. While tax positions that benefit the company and reduce tax payments may be taken at any time, firms must review all tax positions taken and identify those beneficial positions that will more likely than not (50% or more likelihood) be overturned upon an audit and when challenged by tax authorities. Thus, companies are required to record a liability for an uncertain tax benefit taken on the tax return that is not recognized as a deferred tax asset. They are also required to provide additional information about these expected future tax payments through a FIN 48 disclosure which include the cumulative beginning and ending balances of the reporting period and the details of the changes that occurred during the period. The main objective of FASB standards is to provide authoritative guidance that must be used in the preparation of financial information that is understandable to potential and current non-professional investors who have a basic level of education or understanding concerning business and economic activities and financial reports that describe those activities. With companies disclosing information on uncertain tax positions, it is worthwhile to examine how financial statement users (users) perceive these disclosures. For example, users might interpret FIN 48 disclosures as an indicator of improved transparency about the firm's tax planning strategies as well as the management's willingness to enhance the transparency of the financial statements as a whole. On the other hand, users may interpret FIN 48 disclosures as an indicator of management's use of aggressive tax practices and, by extension, the use of aggressive overall financial accounting policies.

It is therefore an empirical question as to how users view these disclosures, and the findings are important to both the FASB and companies involved. If the disclosures are viewed in a positive light, it suggests that users are interpreting the disclosures consistent with the intention of the FASB. A favorable finding would also bring comfort to companies that may have been hesitant to increase the robustness of these disclosures and suggest that such practices would likely improve the perception of the company in the users' eyes. The results would be beneficial to the FASB as it studies the impact of FIN 48 as part of its 2023-2024 post-implementation review cycle that aims to determine if published standards are achieving their intended outcomes. The study uses an experimental setting with 77 users and finds evidence that users view the FIN 48 disclosures as both an indicator of improved transparency and aggressiveness. Further analysis reveals that users view the FIN 48 disclosures as more an improvement of transparency than a signal of aggressive financial reporting, when considered together with tax strategy and financial reporting. The following sections first discuss the prior literature and provide background on FIN48 accounting rules, followed by the development of the research hypotheses and methodology. The results of the experiment are presented and discussed next followed by concluding remarks.

BACKGROUND AND LITERATURE REVIEW

FIN 48 was put in place to specify the requirements for accounting and reporting of a company's uncertain tax positions arising from an entity's tax filing uncertainties under various Internal Revenue Service (IRS) tax regulations (Mynatt, Schroeder & Wiggins, 2014). An uncertain tax position (UTP) is a position taken on a previously filed tax return or a position that a firm expects to take on a future tax return. Uncertain tax positions arise when tax laws don't have a specific application for a position that a firm is taking. While tax law validates tax positions, sometimes the law is subject to interpretation, and an entity is forced to choose the best way to report its position (Sogoloff & Wong, 2006). Examples of UTPs include decisions of classifying certain transactions as taxable or tax-exempt, including or excluding income on a return due to tax period uncertainties, filing or avoiding to file state tax returns, shifting income due to transfer pricing, or characterizing expenses as deductible vs. non-deductible. UTPs create unrecognized tax benefits (UTBs) that are recorded as liabilities and the income tax expense reported in the income statement is increased when the current tax payable or the future tax liability was or will be reduced due to the position taken.

Before the implementation of FIN 48, there was no specific guidance on how to account for UTPs under FASB Statement No. 109, Accounting for Income Taxes. Because of the lack of regulation on accounting for UTPs, many companies used the FASB Statement No. 5, Accounting for Contingencies, as a guide for reporting their UTPs which required the recognition of a liability and an expense if the future occurrence was probable (typically, an 80% or higher probability). Under this guidance, companies estimated the amount of additional taxes they would be held liable for upon an IRS audit and reported it by debiting the current tax expense and crediting a reserve account for the liability (Mynatt, Schroeder & Wiggins, 2014). The main purpose of FIN 48 was to increase comparability of financial reporting of income taxes across companies and recognize all possible liabilities that more likely than not (MLTN) will be realized (typically, a 50% or higher probability). There was concern that income tax assets and liabilities weren't being reported uniformly across entities, making it difficult for investors to compare and understand the effects of these transactions on the financial statements. To achieve these goals, FIN 48 provides guidance on how companies should recognize, calculate, report, and disclose UTBs on their financial statements (Blouin, et al., 2007). FIN 48 determines the recognition of the consequences of the UTBs in a two-step process. The first step requires the company to make a hypothetical assessment on whether their position is 50% or more likely to be upheld if they were to undergo an audit by a taxing authority. During this assessment, they should take into account the support they have to back their position. The support does not necessarily need to be a legal tax opinion; it could be a tax opinion from any qualified expert.

Another important aspect that FIN 48 explains is that there are certain administrative practices and precedents that can be considered when evaluating a tax position. Although many tax positions are deemed violations of the tax law, exceptions can occur when widely understood practices and precedents have been established as meeting the recognition criteria. This is established based on the fact that if, and when, a taxing authority examined their position, it would not be objected to. With this information, an entity can then determine whether they believe a taxing authority with full knowledge of relevant information would agree with their position (Blouin, et al., 2007). It is also important for companies to evaluate each position separately rather than accumulating different tax positions together even if they think they would potentially offset each other (Sogoloff & Wong, 2006). However, the standard allows management to decide the unit of accounting. Management may decide to aggregate certain tax positions that are similar and evaluate the probability of the aggregate position to be more than 50%, whereby several probabilities in the total may be above 50% and offset the impact of those tax positions that have less than 50% probability of surviving an audit by tax authorities. Thus, the recognition and disclosure of a UTPs and their UTB depend on which unit of account is used to determine these positions and a determination of the probability of successfully sustaining these positions. A US firm operating, for example, in Chile and Mexico and filing a consolidated tax return, may decide to evaluate similar UTBs that exist in each country as one position or two separate positions. If both positions have equal UTBs in US dollars but one has a probability of success of 48% and the other 51%, it pays to aggregate the positions and have a probability of over 50% which means that there is no need to establish reserves. It is clear that management has much discretion in this area and can either minimize the amount of the reserves reported under FIN 48 or can take an aggressive stance and maximize them (Furner, 2017). Once an entity has determined that the position satisfies the MLTN criteria, the second step is to determine the amount of the reserves that must be recognized. To determine this amount, an entity must consider the amounts and the probabilities that those outcomes will be realized upon a settlement with a taxing authority. The company should start by identifying the largest possible benefit and determine if it is more than 50% likely to happen. If it isn't, they should move to the next largest benefit, and determine the cumulative probability of this outcome. They need to continue to do this analysis until they reach a 50% or higher cumulative probability. Once this probability is met, they can recognize the amount that remained below the MLTN level multiplied by the current tax rate as the tax expense and liability on their financial statements (Sogoloff & Wong, 2006).

To improve the transparency of the financial statements, there are several other factors that need to be disclosed along with the amount of the UTB. For example, FIN 48 requires financial statement footnotes disclose a detailed roll forward of tax benefits taken that weren't qualified to be recognized in the financial statement. In addition, firms must disclose: 1) the total amount of UTBs that would impact the effective tax rate if they were recognized; 2) where interest and penalties are classified on the balance sheet; 3) the amount of interest and penalties recognized on the balance sheet and income statement for current and prior periods; and 4) the amount of those positions that they believe are reasonably possible to experience a significant increase or decrease in probability of success within 12 months of the reporting date (Mynatt, Schroeder & Wiggins, 2014). FIN 48 not only addresses how to recognize UTBs, but also how to derecognize them when the position exceeds the threshold criteria. The entire benefit must be derecognized because FIN 48 does not allow the use of valuation allowance accounts (Sogoloff & Wong, 2006).

With FIN 48, companies would also need to recognize their previously unreported and unrecorded tax reserves (for those positions that had between 50% and 80% probability) that they maintained prior to the effective date of the standard as a one-time cumulative adjustment to the beginning balance of retained earnings. Blouin, et al (2010), analyzed how firms reacted to the cumulative adjustment recognition requirement and found that, between the issuance and effective dates of FIN 48, firms took an aggressive stance and increased the settlement of disputes with tax authorities which led to an overall reduction in existing contingent liability reserves when FIN 48 was implemented. Thus, instead of a projected increase in future tax liabilities, there was a slight decrease in reserves. Additionally, Mills, Robinson, and Sansing (2010) found that many firms took a passive stance and were deterred from entering into transactions that would generate UTPs and the audit rates by tax authorities increased.

FIN 48 is specific to income taxes and does not apply to other taxes such as property, sales, and payroll taxes. The implementation helped create a more uniform and transparent disclosure of UTPs that investors of both public and non-publically traded companies benefit from (Blouin and Robinson, 2012). In addition, the implementation likely increased both the transparency of the financial statements and the tax burden of large companies who benefited from the information asymmetry accruing to them during the pre-FIN 48 period (Tomohara, Lee, and Lee, 2011). In a study conducted during the five years following the implementation of FIN 48 (2007-2011), Mynatt, Schroeder & Wiggins (2014) investigated the S&P 100 and found that the cumulative effect of FIN 48 was immaterial for most companies at the time of adoption. However, they document that UTB balances have been rising over time. They also found increases in UTB balances to be small and stable in comparison to stockholders' equity and different across industries. It is therefore reasonable to assume that the transparency of the financial statements has improved and this disclosure has become more important for professional investors over time.

Another piece of academic literature researched the effect FIN 48 had on the amount of tax reserves disclosed from 2005 to the first quarter of 2007 (Blouin, et al, 2007). Data was gathered for the 100 largest and 100 smallest non-financial and non-regulated firms to describe disclosures related to tax reserves. They found that the smaller firms were less likely to discuss the effect of UTBs prior to the issuance of FIN 48 because they had low reserves or may not have ever even recorded reserves previously. After 2006, more companies began disclosing reserves and they were more likely to increase reserves or not change reserves to minimize the likelihood of getting audited by the IRS. In the case of large firms, the result was the opposite. Before the adoption of FIN 48, the large firms increased their stockholders' equity by releasing approximately $2 billion to reflect a decrease in the tax reserves. Large firms did this because they were constantly audited by the IRS and they wanted to have a clean slate when they started implementing FIN 48. Thus, FIN 48 increased the transparency of financial reporting by all firms and reduced the level of aggressiveness large firms display in implementing tax strategies.

Several researchers addressed the effect of FIN 48 on the audit process. Erickson, Goldman, and Stekelberg (2016) analyzed the impact of FIN 48 on audit fees and found that, while the costs first increased in 2007, they went back to the pre-FIN 48 levels after that year. Aier and Visvanathan (2019) studied the impact of FIN 48 reserves on the auditor's going concern opinions. They determined that the existence of reserves reduced the probability of the issuance of going concern opinions except for those firms that also reported tax related material weaknesses. The FASB is interested in ascertaining whether FIN 48 meets the goals of improving the transparency of the tax expense amounts and the level of aggressiveness in selecting tax strategies that firms report. Robinson, Stomberg, and Towery (2016) analyzed the effect of FIN 48 on the relevance of income tax accounting to economic decision makers and found no evidence that the reported amounts increased the ability of tax expense to predict future tax cash flows. In fact, the predictive ability of future tax cash flows decreased as the FIN 48 impact became more restrictive. Later, Gleason, Markle, and Song (2017) found that FIN 48 disclosures incrementally improved the ability to forecast future tax cash flows for firms that face a high probability of audit by tax authorities.

While the impact is very limited, findings suggest that FIN 48 marginally improved the relevance of tax reserves and current tax expense and suggests that the prior study was not sufficiently detailed to capture this slight improvement in transparency of financial reports. Another facet of the impact of FIN 48 was analyzed by Goldman, et al (2021) who used the comparison of the number of patent applications by public (treatment group-subject to disclosure rules) and private (control group-not subject to disclosure rules) firms prior to and after the issuance of FIN 48. There was a measurable decrease in the patent applications attributable to incremental innovation of the public firms since those transactions are subject to uncertainties and use aggressive tax strategies more often than other UTPs.

Others analyzed the use of UTP liability reserves in earnings management after FIN 48 was issued. Cazier, et al (2012) examined whether UTB accruals are used to manage earnings. They found that firms that have pre-tax earnings that are below consensus analyst forecast are likely to reduce their tax reserves to meet the forecasts. While the rate of use in the management of these reserves show a slight decline when compared to the rate that existed during the pre-FIN 48 period, managers continue to use their discretion upon these reserves to meet earnings forecasts. Contradicting these general findings, Gupta, Laux, and Lynch (2016) investigated whether firms use tax reserves to meet analysts' forecast and found that while firms managed this reserve to meet earnings forecasts during the pre-FIN 48 period, the use stopped after FIN 48 became effective. In a related study, Bauman and Bowler (2018) found that those firms that are found to manage earnings in the past, increased their use of the deferred tax asset valuation allowance accruals in the post-FIN 48 period to mitigate the restrictive impact of FIN 48 on their UTB accruals.

This may explain the contradictory research results by Cazier, et al (2014) and Gupta, Laux, and Lynch (2016) and shows that both the transparency of the financial reports and the level of aggressiveness in selecting tax strategies increased. The use of aggressive tax positions and tax avoidance were also examined by researchers. The aggressive tax behavior of firms was analyzed by Borkowski and Gaffney (2021) and found that, contrary to FASB's intentions, the use of aggressive tax behaviors by global corporations increased during the post-FIN 48 period (indicated by the increased use of UTBs, unrepatriated earnings, and tax havens). Gupta, Mills, and Towery (2014) studied the effect of FIN 48 disclosure requirements on multistate tax avoidance and found that both firm specific and total state level tax payments increased when FIN 48 was first implemented. Thus, FIN 48 mandates increased the transparency of reporting and decreased the level of aggressive tax strategies employed by firms. Gleason, Mills, and Nessa (2018) studied the impact of FIN 48 on the accuracy of tax reserves because there was a difference between the adequacy of such reserves depending on the firms' use of auditor-provided tax services during the pre-FIN 48 period. The results showed that these differences were eliminated during the post-FIN 48 period, supporting one of the outcomes the FASB wanted to achieve.

Finally, Furner (2017) examined the impact of FIN 48 on the transparency of financial statements and the level of the use of aggressive tax strategies by firms using the debt covenants and auditor agreement with the management's choice of the unit of account as variables of interest. First, the managements choice of the level of disaggregation (evaluating each UTP separately) or aggregation (evaluating several UTPs together) used was determined. Next, the auditors' agreement with the managements' choice was analyzed. The results showed that management overwhelmingly selected the level of aggregation that resulted in a greater than 50% probability for UTBs to be upheld by tax authorities and auditors agreed with those choices when they reduced the negative consequences (e.g., violating debt covenants) of setting up additional tax liabilities. This indicated a self-serving bias on the part of the auditors. The impact on debt covenants was studied by Alexander, et al (2017) and found that there were negative cumulative abnormal returns for the stock price of those firms that had very little debt covenants slack and aggressive tax strategies. While, the majority of the firms increased their UTP tax reserves, those who had little debt covenant slack had relatively much smaller increases than those who had large amounts of slack.

It is clear that UTB reserves may be manipulated by management and the auditors may accept the positions management takes, especially when increasing the UTB reserves has large negative financial consequences for the firm. In addition, many research studies have examined the impact of FIN 48 on the transparency of financial statements and the level of aggressiveness in the tax strategies that firms adopt. Finally, a large number of studies analyzed the impact of FIN 48 on the decisions made by financial analysts, auditors, and other professional investor groups. However, there are no studies that address the impact of FIN 48 on the economic decisions made by users. Therefore, it is worthwhile to examine the level and areas of decision usefulness these balances command when users use them and how they view these disclosures. The following sections will present the methodology and data sources of an experiment that will address these questions, followed by the discussion of results and concluding comments.

DATA AND METHODOLOGY

The purpose of this study is to examine how users perceive and use FIN 48 disclosures. Specifically, the study analyzes whether a user interprets a FIN 48 disclosure as an indicator of: 1) improved transparency of tax strategies; and/or 2) aggressive tax planning. In addition, the study addresses whether the FIN 48 disclosures appear to influence a user's perception about the transparency/aggressiveness of the overall financial statement reporting. How users perceive FIN 48 disclosures is an empirical question, and it is reasonable to expect two outcomes from this analysis. The first potential outcome would result from users interpreting FIN 48 disclosures to be an indicator of improved transparency of tax strategies. Disclosure of uncertain tax positions is not a costless activity, as it provides information to not only users but also the IRS and other tax authorities. As discussed in the previous section, prior to the implementation of FIN 48, many corporate managers thought the IRS would use the amount of tax reserves disclosed as an indication of tax aggressiveness and increase the chance of an audit. So, in 2006, right before the effective date of FIN 48, they decreased their reserves to reduce their visibility to the IRS (Blouin et al., 2007). Therefore, to the extent that firms provide additional disclosures despite the increased potential for IRS scrutiny, it is reasonable that a user would interpret the disclosures in a positive light and see them as evidence that management is willing to be transparent. The second potential outcome would lead users to interpret FIN 48 disclosures as indicators of an aggressive tax strategy. All else equal, companies with higher reserves are likely receiving more unsustainable tax benefits on their tax returns. It is therefore reasonable to assume that a user could interpret FIN 48 disclosures consistent with an indication of aggressiveness. Finally, by extension, users may view FIN 48 disclosures as an indication of both enhanced financial statement disclosures and increased use of aggressive accounting policies. Given the lack of compelling support for either set of potential outcomes, this study examines the following research questions (RQs):

RQ1: Do users interpret FIN48 disclosures as an indicator of improved transparency of uncertain tax disclosures?

RQ2: Do users interpret FIN48 disclosures as an indicator of aggressive tax strategies?

RQ3: Do users interpret FIN48 disclosures as an indicator of improved transparency of overall financial statement reporting?

RQ4: Do users interpret FIN48 disclosures as an indicator of aggressive overall financial statement reporting?

The data was obtained from 77 senior accounting majors who were enrolled in the two Intermediate Financial Accounting III course sections during the 2014 fall semester at a doctoral level research university with AACSB accredited business programs and separately accredited accounting programs. This group was chosen because those students were exposed to accounting and reporting rules for UTPs and UTBs during the course and had sufficient education concerning the use of financial accounting data in decision making. Given the level of knowledge and analytical reasoning these students possessed, they were considered to represent an educated group of users. After the required human subjects research permission was obtained, a survey was created which used an actual company's (name deleted and dates revised to retain anonymity) FIN 48 disclosures obtained from the Securities and Exchange Commission (SEC) Form 10-K filings. All 77 students participated and were required to answer a series of questions about their assessment of the disclosures. The first four questions of the instrument asked participants whether the FIN48 disclosures represented transparency or aggressiveness. To reduce the potential for ordering effects to bias the results, two versions of the survey were created. The first version of the survey displayed two positive questions followed by two negative questions, whereas, the second version displayed the two negative questions first, followed by two positive questions. The fifth question asked the students' beliefs concerning the management's: 1) overall trustworthiness; 2) truthfulness of financial disclosures; 3) management's overall honesty; 4) management's honesty in tax position disclosures; and 5) appropriateness of the management's actions on behalf of stockholders. The sixth question asked students to rank the level of attractiveness of the company as an investment. The last two questions asked students if they are currently investing in the stock markets and if they plan to make investments during the next five years, respectively.

The first six questions asked the students to indicate their degree of agreeability (questions 1 – 4), beliefs (question 5), and rating (question 6) on a scale of one to seven. Questions 7 and 8 had yes/no answers. The answers to the five parts (5a – 5e) of question 5 were averaged into one answer, where the negative question (5b) was reverse coded. A copy of the survey instrument used in this study is included in the Appendix. To test the levels of agreement/disagreement with questions one through four, level of belief/non-belief of question 5, and the level of rating (high/low) in question 6, a two-tailed differences in the means (student's t-test) was used to discover the statistical significance of the differences between the means of questions one through six and the neutral mean result (mean = 4). A probability statistic (p value) of .05 or smaller would indicate a statistically significant difference from the mean assertion average of 4 with at least a 95% or higher certainty. While a probability of .10 may also be used, the assertion would not be as powerful (a 90% certainty) or dependable.

RESULTS

The first column of Table 1 shows the results from the 77 survey responses. Although only 21 percent (16 of 77) of the users report having personally invested in the stock market (question 7), 82 percent (62 of 77) indicate that they plan to invest in the stock market within the next five years (question 8). In addition, the users are neutral when they evaluate their beliefs of the management's trustworthiness (question 5, mean=4.06) and their rating of the attractiveness of the company as an investment (question 6, mean=3.92). Regarding the variables of interest, it is certain that users interpret the FIN 48 disclosure as an indicator of tax disclosure transparency (mean = 4.70; greater than neutral 4, p-value<0.01) and financial statement disclosure transparency (mean=4.57; greater than neutral 4, p-value<0.01). In contrast, the data shows that users do not view the FIN 48 disclosure as an indicator of tax aggressiveness (mean=4.21; greater than neutral 4, p-value = 0.17). Additionally, there is marginal support for the users' perception of financial statement aggressiveness (mean = 4.22; greater than neutral 4, p-value=0.08). To ascertain if users view FIN 48 disclosures as indicators of management's transparency rather than aggressive behavior, the differences in the mean answers to questions one and three (tax strategies) and two and four (financial reporting) were examined. The results show that users provide a significantly greater rating for transparency relative to aggressiveness for both the tax strategies (p-value= 0.02) as well as the financial statement reporting as a whole (p-value=0.06).

The remaining columns of Table 1 report survey responses separately for the 16 participants that indicated prior investment experience and the 61 that had not (based on their response to Q7). Interestingly, we only observe a difference between these two subsamples in the magnitude of difference between their ratings of transparency and aggressiveness for financial statement reporting. Specifically, those with investment experience assigned an even greater rating to transparency relative to aggressiveness (p-value=0.05).

Table 1: Survey Response Statistics and Test Results

	(1) Full Sample (n=77)		(2) Q7 = Yes (n=16)	(3) Q7 = No (n=61)	
Question	Mean	Mean = 4 p-value	Mean	Mean	(2) vs (3) p-value
Q1	4.70***	<0.01	5.06	4.61	0.24
Q2	4.57***	<0.01	4.94	4.48	0.15
Q3	4.21	0.16	4.25	4.20	0.89
Q4	4.22*	0.08	3.88	4.31	0.16
Q5	4.06	0.58	3.91	4.10	0.50
Q6	3.92	0.65	4.44	3.79	0.12
Q7	0.21	N/A			
Q8	0.82	N/A			
		Mean = 0 p-value			
Q1-Q3	0.49**	0.02	0.81	0.41	0.44
Q2-Q4	0.35*	0.06	1.06	0.16	0.05**

*This table shows a two-tailed differences in the means (student's t-test) that was used to discover the statistical significance of the differences between the means of questions one through six and the neutral mean result (mean = 4). In addition, it shows if users view FIN 48 disclosures as indicators of management's transparency rather than aggressive behavior by analyzing the differences in the mean answers to questions one and three (tax strategies) and two and four (financial reporting). */**/*** indicate significance at the 0.10/0.05/0.01 level, where Q1-Q8 refer to the questions asked per the survey (see Appendix).Q5 is calculated as the average response to the five trust related questions where the negative question (5b) is reverse coded.*

There are a few different takeaways from the data. A major goal of FIN 48 was to increase comparability and understandability among financial statements for both sophisticated professional investors (e.g., financial analysts) and educated non-professional investors (e.g., those with accounting or other business degrees. Overall, users in this study appear to view the FIN 48 disclosures consistent with this goal. In addition, disclosing UTPs and UTBs under FIN 48 achieves a major goal of standard setting as it increases the usefulness of the financial reports as users consider these disclosures as an indication of enhanced transparency in financial reports. Finally, there is strong indication that users view FIN 48 disclosures as an indicator of transparent rather than aggressive behavior. While not as certain as the results indicating transparency, our findings also suggest that users appear to view the FIN48 disclosure as an indicator of overall financial statement aggressiveness, which may be an unintended negative consequence of increased disclosure surrounding a complex accounting standard.

As previously mentioned, approximately half of the students received a survey with the first two questions asking about the aggressiveness of the firm's tax strategy and overall financial statements followed by two questions asking about the transparency of the firm's tax strategy and overall financial statements. The other half of the students received surveys with the questions reversed. This was done to see if there was any evidence of order bias in the responses. The statistical tests show that it was important to vary the ordering of the questions since the order of the questions did impact how participants answered the subsequent questions, as participants that were asked aggressive (transparent) questions first (second), were more likely to answer the remaining questions negatively (positively). Failure to use this approach would have made the results favoring transparency and lack of aggressiveness stronger and may have eliminated the weak evidence that users view FIN 48 disclosures as an indication of aggressive financial reporting.

CONCLUDING COMMENTS

The main objectives of FASB standards are to report financial information that is understandable to potential and current financial statement users in making economic decisions. This study uses an experiment to examine if users view FIN 48 disclosures as indicators of enhanced transparency in describing tax strategies and financial reporting by management or as aggressiveness in tax strategies and the use of accounting policies. Finding a perception of enhanced transparency would support the goals of the FASB and give comfort to companies that are reluctant to disclose sensitive information that can be used by the IRS in audits. Results show that most users view FIN 48 disclosures as indicators of increased transparency of tax strategies and financial reporting, suggesting that users interpret the disclosures consistent with the intention of the FASB. While there is no evidence that users view FIN 48 disclosures as aggressive tax behavior, there is weak evidence that they view the disclosures as aggressive use of accounting policies. Overall, these findings should encourage companies to increase the robustness of this disclosure given that such practices would likely improve how educated non-professional investors perceive the company's financial information. The use of senior level students in one university limits the generalizability of the results. Future research may duplicate the experiment with different groups of users. Such groups may be senior students in one or a combination of two or more other universities. Other prime targets are participants at regional and national professional and academic accounting meetings. The results would be beneficial to the FASB as it studies the impact of FIN 48 as part of its 2023-2024 post-implementation review cycle that aims to determine if published standards are achieving their intended outcomes.

APPENDIX

All 77 students enrolled in the two sections of the course participated in this survey. They were provided with the FIN 48 disclosures shown below and were asked to answer the same questions. Questions 1 and 2 were presented after questions 3 and 4 for half of the participants. The FIN 48 text (6 paragraphs) and the financial disclosures (Tables 2, 3, and 4) were taken verbatim from the SEC Form 10-K filing of an actual firm. The company name was deleted and the years in the disclosures were changed to ensure anonymity.

<u>FIN 48 Disclosure Footnote Survey Questionnaire</u>

Please carefully examine the FIN 48 disclosure footnote below and answer the questions that follow to the best of your ability. Additional financial statement information about this publicly traded company can be found after the survey questions document should you wish to use it to help you with your responses.

<u>Uncertain Tax Positions</u>

Tax positions are evaluated in a two-step process. The Company first determines whether it is more likely than not that a tax position will be sustained upon examination. If a tax position meets the more-likely-than-not recognition threshold it is then measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured as the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The Company classifies gross interest and penalties and unrecognized tax benefits that are not expected to result in payment or receipt of cash within one year as non-current liabilities in the Consolidated Balance Sheets. As of September 27, Year 3, the total amount of gross unrecognized tax benefits was $4.0 billion, of which $1.4 billion, if recognized, would affect the Company's effective tax rate. As of September 28, Year 2, the total amount of gross unrecognized tax benefits was $2.7 billion, of which $1.4 billion, if recognized, would affect the Company's effective tax rate. The aggregate changes in the balance of gross unrecognized tax benefits, which excludes interest and penalties, for Year 3, Year 2, and Year 1, is as follows (in millions), (see Table 2).

Table 2: Uncertain Tax Benefit Balances for Years 1, 2, and 3

	Year 3	Year 2	Year 1
Beginning Balance	$ 2,714	$ 2,062	$ 1,375
Increases related to tax positions taken during a prior year	1,295	745	340
Decreases related to tax positions taken during a prior year	(280)	(118)	(107)
Increases related to tax positions taken during the current year	882	626	467
Decreases related to settlements with taxing authorities	(574)	(592)	(3)
Decreases related to expiration of statute of limitations	(4)	(9)	(10)
Ending Balance	$ 4,033	$ 2,714	$ 2,062

The Appendix and the data in the table above is based verbatim on an actual firm's 10-K (page 65-66).
The link is: https://www.sec.gov/Archives/edgar/data/0000320193/000119312514383437/d783162d10k.htm#toc783162_26

The Company includes interest and penalties related to unrecognized tax benefits within the provision for income taxes. As of September 27, Year 3 and September 28, Year 2, the total amount of gross interest and penalties accrued was $630 million and $590 million, respectively, which is classified as non-current liability in the Consolidated Balance Sheets. In connection with tax matters, the Company recognized interest and penalty expense in Year 3, Year 2, and Year 1 of $40, $189, and $140 million, respectively.

The Company is subject to taxation and files income tax returns in the U.S. federal jurisdiction and in many state and foreign jurisdictions. During the fiscal year ended September 27, Year 3, the U.S. Internal Revenue Service (IRS) concluded its review of the period covering 6 years prior to year 0, which resulted in the Company reducing its gross unrecognized tax benefits by $570 million and recognizing a tax benefit of $166 million. The IRS is currently examining the years 0 and 1. In addition, the Company is also subject to audits by state, local and foreign tax authorities. In major states and major foreign jurisdictions, a 7-yaer period generally remains open and could be subject to examination by the taxing authorities.

Management believes that an adequate provision has been made for any adjustments that may result from tax examinations. However, the outcome of tax audits cannot be predicted with certainty. If any issues addressed in the Company's tax audits are resolved in a manner not consistent with management's expectations, the Company could be required to adjust its provision for income taxes in the period such resolution occurs. Although timing of the resolution of audits is not certain, the Company does not believe it is reasonably possible that its unrecognized tax benefits would materially change in the next 12 months.

<u>Survey Questions</u>

1- Indicate the perceived *likelihood* that management is being transparent about their tax strategies.

1 2 3 4 5 6 7

Very Unlikely Neutral Very Likely

2- Indicate the perceived *likelihood* that management is being transparent in other areas of financial statement reporting.

1 2 3 4 5 6 7

Very Unlikely Neutral Very Likely

3- Indicate the perceived *likelihood* that Management is engaging in aggressive tax strategies.

1	2	3	4	5	6	7
Very Unlikely			Neutral			Very Likely

4- Indicate the perceived *likelihood* that management is aggressive in other areas of financial statement reporting.

1	2	3	4	5	6	7
Very Unlikely			Neutral			Very Likely

5- Indicate your beliefs about each of the following statements regarding management's trustworthiness.

	Strongly Disagree	Moderately Disagree	Slightly Disagree	Neutral	Slightly Agree	Moderately Agree	Strongly Agree
a. I believe that management is very trustworthy.	1	2	3	4	5	6	7
b. I believe that management may *not* be truthful in their financial disclosures.	1	2	3	4	5	6	7
c. I believe that management is very honest.	1	2	3	4	5	6	7
d. I believe that management was honest when describing their uncertain tax positions	1	2	3	4	5	6	7
e. I believe that management acts in the best interest of the shareholders.	1	2	3	4	5	6	7

6- How would you rate the attractiveness of this company as an equity investment?

1	2	3	4	5	6	7
Very Unlikely			Neutral			Very Likely

7- Have you ever personally invested in the stock market? Yes No (circle one)

8- Do you plan to personally invest in the stock market in the next five years? Yes No (circle one)

Additional Financial Statement Information

Table 3: Consolidated Balance Sheets (In millions, Except Number of Shares Which Are Reflected in Thousands and Par Value)

	September 27, Year 3	September 28, Year 2
ASSETS:		
Current assets:		
Cash and cash equivalents	$ 13,844	$ 14,259
Short-term marketable securities	11,233	26,287
Accounts receivable, less allowances of $86 and $99, respectively	17,460	13,102
Inventories	2,111	1,764
Deferred tax assets	4,318	3,453
Vendor non-trade receivables	9,759	7,539
Other current assets	9,806	6,882
Total current assets	68,531	73,286
Long-term marketable securities	130,162	106,215
Property, plant and equipment, net	20,624	16,597
Goodwill	4,616	1,577
Acquired intangible assets, net	4,142	4,179
Other assets	3,764	5,146
Total assets	$ 231,839	$ 207,000
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Current liabilities:		
Accounts payable	$ 30,196	$ 22,367
Accrued expenses	18,453	13,856
Deferred revenue	8,491	7,435
Commercial paper	6,308	0
Total current liabilities	63,448	43,658
Deferred revenue – non-current	3,031	2,625
Long-term debt	28,987	16,960
Other non-current liabilities	24,826	20,208
Total liabilities	120,292	83,451
Commitments and contingencies		
Shareholders' equity:		
Common stock and additional paid-in capital, $0.00001 par value; 12,600,000 shares authorized; 5,866,161 and 6,294,494 shares issued and outstanding, respectively	23,313	19,764
Retained earnings	87,152	104,256
Accumulated other comprehensive income/(loss)	1,082	(471)
Total shareholders' equity	111,547	123,549
Total liabilities and shareholders' equity	$ 231,839	$ 207,000

Table 4: Consolidated Statements of Operations (In Millions, Except Number of Shares Which Are Reflected in Thousands and Per Share Amounts)

	Years Ended		
	September 27, Year 3	**September 28, Year 2**	**September 29, Year 1**
Net sales	$ 182,795	$ 170,910	$ 156,508
Cost of sales	112,258	106,606	87,846
Gross margin	70,537	64,304	68,662
Operating expenses:			
Research and development	6,041	4,475	3,381
Selling, general and administrative	11,993	10,830	10,040
Total operating expenses	18,034	15,305	13,421
Operating income	52,503	48,999	55,241
Other income/(expense), net	980	1,156	522
Income before provision for income taxes	53,483	50,155	55,763
Provision for income taxes	13,973	13,118	14,030
Net income	$ 39,510	$ 37,037	$ 41,733
Earnings per share:			
Basic	$ 6.49	$ 5.72	$ 6.38
Diluted	$ 6.45	$ 5.68	$ 6.31
Shares used in computing earnings per			
Basic	6,085,572	6,477,320	6,543,726
Diluted	6,122,663	6,521,634	6,617,483
Cash dividends declared per common	$ 1.82	$ 1.64	$ 0.38

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