

FAS 109 and IAS 12

*Insights on the corporate income
tax accounting convergence project*

FAS 109 and IAS 12: Insights on the corporate income tax accounting convergence project

International Financial Reporting Standards (IFRSs) are a hot topic — one that has produced some significant developments and frequent media attention over the past year. The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) continue to work together to converge U.S. accounting standards and IFRSs. Income tax accounting is just one of the projects on which the FASB and IASB are collaborating as part of their convergence plan. Other convergence projects include consolidations, leasing, liabilities and equity, and revenue recognition. Additionally, the Securities and Exchange Commission (SEC) has been discussing potential rulemaking that may include an optional and mandatory conversion to IFRSs for U.S. public companies. Given the pace and direction of developments, companies may need to think about IFRSs — both convergence and conversion — sooner rather than later.

Deloitte hosted a Dbriefs webcast on June 23, 2008, to discuss the background and objectives of the income tax convergence project. Rich Paul, a practice fellow with the FASB and project manager for the income tax convergence project, joined the panel to highlight key areas of focus, including differences between FAS 109 and IAS 12 that have been proposed for elimination, some differences that may remain and some possible next steps. The webcast also addressed planning considerations for a broader conversion to IFRSs. More than 3,800 participants shared their own views through polling responses and posed questions to the presenters.

Conversion and convergence — two words that sound alike but have very different meanings. Conversion is the overall transition to a new set of accounting standards; convergence is the rewrite of one accounting standard at a time. What some people may not realize is that conversion and convergence may come at different points of time. The timeline for U.S. companies to convert to IFRSs on a voluntary basis may occur as early as 2011 and as early as 2013 on a mandatory basis. The timeline for convergence of Accounting for Income Taxes is uncertain at this time. Moreover, other convergence projects on consolidation and financial instruments with characteristics of equity will have their own timelines. Thus, companies will need to plan for not only the timing of conversion and convergence but also the interplay of other standards with their income tax planning.

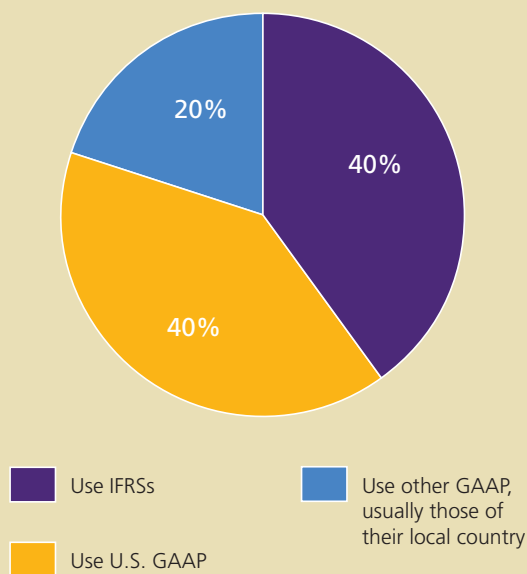
Trends in the use of IFRSs

Today, more than 100 countries either require or allow the use of IFRSs, a number certain to continue growing.

In many cases, the move toward IFRSs has been driven by changes in public listing requirements. In Europe, for example, where use of IFRSs by European Union countries has been mandated since 2005, some 7,000 companies have made the transition to IFRSs. Of these, more than 200 are foreign private issuers that also file in the United States. Several other major countries, including Brazil, Canada, India, Israel, Chile, and Korea, have announced intentions to move to IFRSs.

The chart, IFRSs Use Among FORTUNE® Global 500 Companies, further illustrates the growth in use of IFRSs. As individual countries allow or mandate usage of IFRSs, this percentage will continue to increase. By 2011, it is expected that all major countries will have adopted IFRSs to some extent, with U.S. public companies likely having the option of using either IFRSs or U.S. GAAP.

IFRSs Use Among FORTUNE® Global 500 Companies



FASB and IASB collaboration: A timeline

The FASB and the IASB entered into the Norwalk Agreement in September 2002, marking the first time the two organizations committed in writing to collaborate. In this agreement, the FASB and IASB agreed to work on short-term convergence projects aimed at eliminating certain differences between IFRSs and U.S. GAAP. They also agreed to initiate a number of major projects to improve standards. Finally, they commissioned their interpretive bodies — the Emerging Issues Task Force on the U.S. side and the International Financial Reporting Interpretations Committee on the IASB side — to work together. It is important to keep in mind that this agreement came at a time when foreign private issuers that filed financial statements with the SEC and used an accounting standard other than U.S. GAAP were obligated to reconcile those financial statements to U.S. GAAP. At that time, European companies were pushing for the elimination of that reconciliation requirement.

In February 2006, the FASB and IASB entered into a Memorandum of Understanding (MOU) reaffirming the principles outlined in the Norwalk Agreement and their shared objective to develop high-quality accounting standards for use around the world. Most important, the MOU outlined two tracks for progressing convergence: short-term projects to be completed by the end of 2008 and longer-term projects. A primary objective, as it was earlier, was to facilitate elimination of the reconciliation requirement — a step that the SEC eventually took in 2007.

In April 2008, the boards discussed updates to the MOU to address concerns about lack of progress on key projects because the SEC is now considering allowing U.S. companies the optional use of IFRSs for SEC reporting purposes. The boards established a small group to issue recommendations for moving projects forward between now and 2011, with a suggested target date for mandatory adoption of IFRSs of 2013. Each board will determine how to proceed on its key projects and an updated MOU is expected to be issued shortly.

The income tax convergence project and developments to date

One key project stemming from the Norwalk Agreement and subsequent discussions is the income tax convergence project, which began in 2004. Because FAS 109 and IAS 12 are based on similar principles — that is, they both require use of temporary differences and a balance-sheet approach to accounting for income taxes — the effort was to be limited in scope and focused primarily on reducing the differences between those standards. The boards agreed to exclude certain items from the project scope, including leveraged leases and share-based payments.

The project's primary focus has been the exceptions in each standard to providing deferred taxes on certain temporary differences — that is, a difference between the tax basis of an item and the amount recorded for financial reporting purposes that has had, or will have, tax consequences. The FASB and IASB reached several key tentative decisions as a result of their respective reviews:

Tax basis definition. Both boards agreed that IAS 12 and FAS 109 should include a common definition of tax basis, and their intent is to be consistent with current practice under U.S. GAAP.

Exceptions to providing deferred tax on certain temporary differences. The FASB has agreed to eliminate the exception for recording both the current and deferred taxes arising from intercompany transactions as explained in paragraph 9(e) of FAS 109. Likewise, the exception to provide deferred taxes on temporary differences that arise due to either the impact of foreign currency fluctuations when remeasuring the non-monetary assets of an entity whose functional currency is not the local currency or indexing for tax purposes, as described in paragraph 9(f) of FAS 109, will also be eliminated. IAS 12 does not include either of these exceptions.

Implications of tax law changes. Both boards agreed that if there is a tax law change in the United States, it should be reflected in the measurement of income taxes upon enactment. If there is a tax law change in another jurisdiction, it should be reflected in the measurement of income taxes upon substantive enactment. This decision is based on legislative processes in the United States.

Asset acquisitions with basis differences. FAS 109 and IAS 12 prescribe divergent approaches for the initial acquisition of an asset (that is not part of a business combination) when a basis difference exists. Here, the boards ultimately agreed that an asset should be recorded at its fair value and to eliminate the use of a simultaneous equation (EITF 98-11) to determine the amounts recorded for the asset and the deferred tax. Furthermore, the boards concluded that the difference between the amount paid and the sum of the fair market value of the asset and the recorded deferred tax should be recorded in an entity's balance sheet as a purchase discount allowance and amortized into the income statement as the related tax benefits are realized.

Use of distributed versus undistributed tax rates. Both boards also considered differences in approaches for measuring deferred income tax items when rates differ, depending on whether taxable income is distributed to owners or retained by the company for future operations or capital expenditures. After extensive discussions, the boards concluded that an entity should use the distributed rate if it expects to distribute earnings and it has the ability to do so. If the entity does not expect to distribute earnings, then it should use the undistributed rate. The boards also decided that if an entity

receives a deduction or tax exemption if it distributes earnings, then it could consider that deduction or exemption as long as it expects to distribute earnings and has the ability to do so.

Other IASB decisions. The IASB made several other decisions over the course of the project, with two of the more significant changes being the adoption of the intra-period allocation guidance in FAS 109 and adoption of the valuation allowance approach to accounting for deferred taxes. Under the IASB's tentative decision, an asset will be recorded and then an assessment made as to whether a valuation allowance will be necessary. In addition, as part of the effort to converge accounting standards, IAS 12 will refine the definition of the threshold for recognition of valuation allowances to be consistent with FAS 109 (i.e., is the realization of deferred tax assets considered more likely than not). The IASB's website, www.iasb.org, includes more information about changes to IAS 12.

What comes next?

Even with the boards' tentative decisions outlined, some differences remain. For example, there are significant differences in income tax accounting for share-based payments between IFRS 2, the international standard for share-based payments, and the U.S. standard, Statement 123(R). In addition, the IASB has tentatively agreed on an approach for dealing with uncertainty in income tax accounting that is different than the FASB's FIN 48 approach. How the boards will address these areas, or move forward with the project, remains to be determined.

Both the FASB and IASB employ processes that require extensive exposure of their recommendations (see the sidebar below for a description of the approach). Given the momentum behind developing a single set of quality accounting standards for global use, the FASB recently discussed the potential for exposing the converged version of IAS 12 in the United States as a replacement for FAS 109, resulting in the elimination of FIN 48.

The FASB's income tax convergence project's due process

The FASB follows an extensive due process for all of its projects. Once an item is added to the board's agenda, it generally will undertake the following steps:

- Gather data, including reaching out to constituents of different backgrounds — for example, users of financial information, preparers of financial information, auditors, and others
- Deliberate individual topics
- Set project scope
- Deliberate guidance to be considered
- Expose that guidance or initial thinking for comments
- Re-deliberate initial thinking based on comments received
- Issue an exposure draft, the first step to a final standard
- Receive input on the exposure draft
- Deliberate issues raised and develop conclusions
- Issue a final document or final standard

There are many arguments for and against proceeding with exposure of IAS 12 in the United States — including concerns about requiring too many changes in a short period of time. Alternatively, the FASB may issue an improved version of FAS 109 (resulting in the retention of FIN 48) or may go with the status quo and wait until U.S. public companies have the option of using IFRSs. The FASB may also choose to solicit input from constituents on the project's overall direction. At the time of writing, the FASB is still considering how it will proceed with this convergence project and is continuing to seek input through various forums. Accordingly, there is still quite a bit of uncertainty as to how the FASB will proceed.

Companies are also awaiting more information from the SEC about the potential for a ruling that will allow U.S. issuers the option of using IFRSs. At the time of writing, the SEC has not yet made a final decision, although a “roadmap” allowing such an option is expected later this year.

Considerations in making a conversion to IFRSs

Even though the boards' next steps are still evolving, companies considering the use of IFRSs in the future should begin thinking about not only the tax accounting implications described earlier, but also the broader implications of a conversion to IFRSs on cash taxes, tax planning, and tax department operations.

Tax accounting is likely to be the starting point for a much broader discussion around the accounting consequences of conversion. Depending on the effective date and content of any converged standard, a company reporting on U.S. GAAP today may actually convert first to a new version of FAS 109 and then to IAS 12. While this may seem like a burden on tax departments, it would actually split the burden into two buckets: one for tax accounting changes and another for technical tax implications resulting from a full conversion to IFRSs. The timing of the two may or may not overlap.

IAS 12 is only one of many accounting standards that will be changing as part of a conversion to IFRSs. In the absence of a specific tax statute prescribing a different treatment, the accounting method used for financial reporting purposes is generally the accounting method used for tax purposes. While the trend has been to minimize the number of book-to-tax differences in the United States, a conversion to IFRSs actually could result in the opposite: new book-to-tax differences. Alternatively, requests for changes in tax accounting methods may need to be filed to use the new IFRSs' method for tax reporting purposes. Planning should consider whether the new book method accelerates income or defers expense to anticipate or avoid any increases in cash taxes payable. Particular attention should be paid to areas where significant differences may arise between U.S. GAAP and IFRSs such as revenue recognition, fair value accounting, fixed assets, leases, and employee benefits, to name a few.

As U.S. companies contemplate converting to IFRSs, they should consider the potential **tax costs and benefits**. An oft-cited example of a cost for companies using LIFO to value inventory is the potential recapture of the tax LIFO reserve should a change to IFRSs result in a LIFO termination by virtue of it not being a permissible book accounting method under IFRSs. Conversions in other jurisdictions where the book treatment dictates the tax treatment—for example, differences in the amortization of intangibles in certain jurisdictions — could result in similar costs.

To capitalize on operational or other anticipated changes associated with IFRSs, enterprises may need to update **global tax planning** by considering factors such as:

- Changes in global effective tax rates as the result of the establishment or consolidation of shared service centers to maintain a single global accounting standard
- Mitigation of tax risks through elimination of unnecessary legal entities
- Updates to global transfer pricing and distribution planning

One of the most significant consequences of a conversion will be in the area of **tax department operations**. While the output requirements — tax returns and provisions — will not change, the processes for obtaining and presenting data definitely will. This, in turn, may require changes in:

- Training for tax department personnel
- Processes for gathering, maintaining, and reporting data
- Enterprise systems used in these processes; at the same time, companies will need to consider which legacy systems must be maintained in order to comply with tax requirements that do not change as a result of a conversion to IFRSs
- Tax software programs, for example, those used for stock option or provision reporting
- Standard accounting policies to ensure consistent tax accounting throughout the organization

For companies anticipating a conversion to IFRSs in the future, understanding and planning for the future ramifications of these policies will be paramount to generating the most favorable tax consequences in the greatest number of jurisdictions.

For additional resources and information on IFRSs, visit the [Deloitte IFRS website](#). There you can find a link to [IAS Plus](#).



Tax executives' views

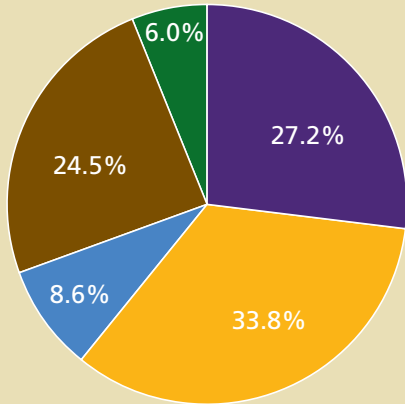
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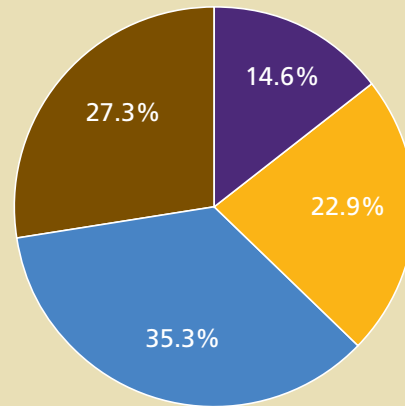
conversion to IFRSs. More than 3,800 participants shared their own views through responses to polling questions.

Of the respondents, 61 percent believe that a conversion to IFRSs will have a moderate to significant impact on their organizations' tax functions. Meanwhile, only 14.6 percent of respondents indicated that their companies have begun to assess the implications of a conversion to IFRSs.

What impact do you believe a conversion to IFRSs will have on your organization's tax function?



Has your company begun its assessment of the implications of a conversion to IFRSs?

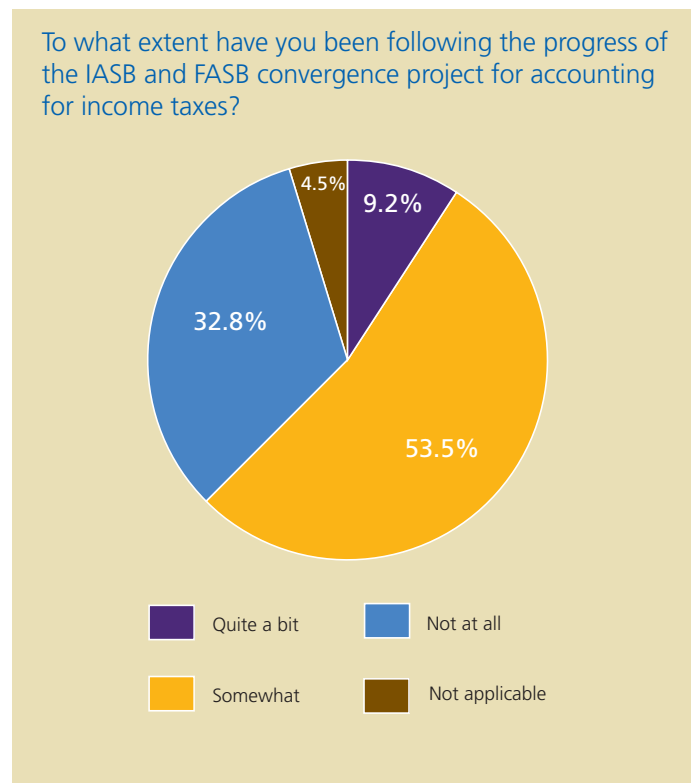
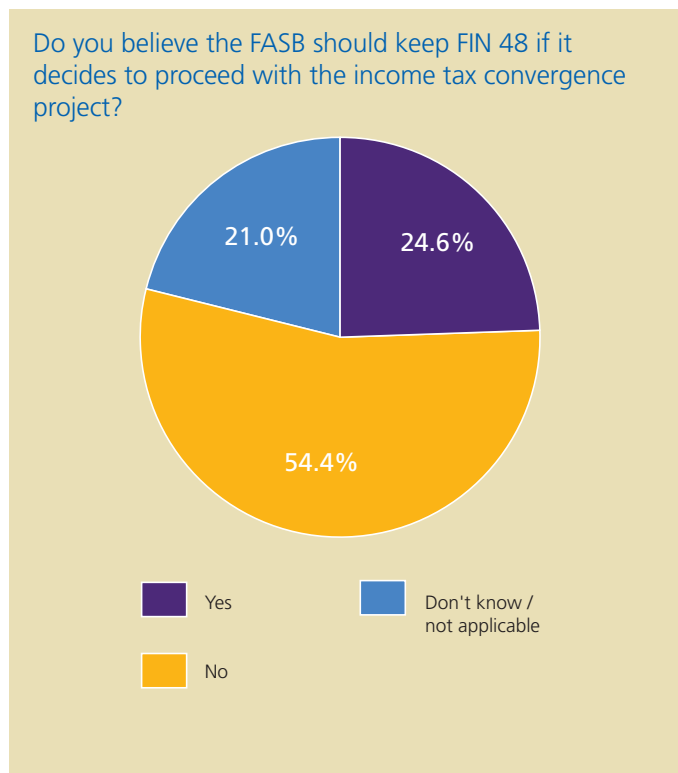


Tax executives' views (continued)

In the event that FASB proceeds with the income tax convergence project, slightly more than half of the respondents indicated that they do not believe FIN 48 should stay.

Given the time and costs incurred to adopt FIN 48, that number is not

surprising. It is interesting to see, however, that nearly one-quarter of the respondents want FIN 48 to stay and another 21 percent remain undecided.



Editor's note. The FASB has been working closely with the IASB over the last several years on converging IAS 12 and FAS 109. The FASB was expected to issue an exposure draft in the fourth quarter of 2008. The FASB recently discussed the overall direction of the project and discussed a number of options, including whether to issue a revised version of FAS 109, a revised version of IAS 12, or do nothing. It appears that the project will be put on hold for the foreseeable future until the FASB gets a better understanding of any future SEC rulemaking on IFRS and decide how that rulemaking should affect standard-setting going forward. The FASB may solicit input from constituents on what the FASB's policy should be going forward on issuing IFRSs as exposure drafts. Therefore, an exposure draft will probably not be issued by the FASB this year. The IASB is expected to move forward with an exposure draft. The content contained herein has not been updated to reflect the FASB's announcement.

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