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IFRS — Implications for tax

The movement toward International Financial Reporting Standards (IFRS) as a single set of globally accepted accounting standards is quickly gathering momentum. IFRS is rapidly gaining acceptance around the world, spurring U.S. companies to assess the potential implications of adopting the standard.

Among recent developments that have heightened interest among U.S. companies are the following:

- The Securities and Exchange Commission (SEC) issued a “concept release” in August 2007 that solicited input on whether U.S. issuers should be permitted to prepare their financial statements using IFRS or accounting principles generally accepted in the United States (U.S. GAAP) for SEC reporting purposes. The majority of comments received on the concept release expressed support for U.S. issuers using IFRS. The SEC is expected to issue a roadmap and possibly a proposed rule during 2008 that may offer certain U.S. companies the option to use IFRS as early as 2011.
- The SEC approved a final rule in November 2007 that eliminated the requirement for foreign private issuers using IFRS to reconcile to U.S. GAAP; the rule was effective for periods ending after November 15, 2007.
- IFRS is now used for public reporting purposes in more than 100 countries, ranging from Australia to the United Kingdom. Other countries are expected to adopt IFRS in the next few years, including Israel (2008), Chile (2009), Korea (2009), Brazil (2010), and Canada (2011).
- During the last half of 2008, the FASB may issue an exposure draft of Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes, (FAS 109) that may be similar to the converged version of International Accounting Standards No. 12, Income Taxes, (IAS 12). It is uncertain at this time whether FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, (FIN 48) will continue to be applicable under FAS 109. The revised standard may apply as early as 2010.

The bottom line: By 2011, almost every major country around the world, including the United States, may have adopted IFRS as either an option or the required standard for financial reporting.

The impetus to convert to IFRS in the United States will not be coming solely from the regulatory accounting bodies that govern financial reporting. It will also be driven by global markets and the desire of investors for one standard of financial accounting principles to achieve consistency in financial reporting around the world. Early preparation and planning are key to a successful transition.

Get ready for another major change in accounting for income taxes

Although IAS 12 and FAS 109 have much in common, significant differences currently exist between the two standards. Many of these differences are expected to be eliminated as a result of the joint IASB/FASB income tax convergence effort.

Selected areas expected to converge

- Balance sheet classification of deferred tax assets and liabilities as current or noncurrent
- Enacted (U.S. tax jurisdictions) or substantially enacted (all other tax jurisdictions) tax rates
- Elimination of backward tracing
- Valuation allowance to reduce deferred tax assets to amount more likely than not to be realized
- Exception for initial recognition of deferred tax with regard to certain acquisitions
- Use of distributed or undistributed rate applicable to accumulated earnings based on intent
- Provision for current and deferred taxes arising from intercompany transactions
- Provision for deferred taxes on temporary differences that arise due to changes in exchange rates in foreign subsidiaries that use the reporting currency as their functional currency (as opposed to using the local currency as their functional currency)
- Alignment of treatment for investments in subsidiaries, associates, joint ventures, and branches

Potential continued areas of divergence

- Uncertain tax positions
- Leveraged leases
- Share-based payments

What comes first: convergence or conversion?

Tax departments should begin planning now to fully understand the computational and disclosure changes that will accompany the seemingly inevitable adoption of a new, converged tax accounting standard. This analysis should contemplate an easily overlooked process issue: For U.S. multinationals, changes to the financial reporting of income taxes may occur in two stages rather than once in connection with an overall conversion to IFRS:

- 1) Adoption of a revised FAS 109 standard for reporting under U.S. GAAP resulting from the convergence project between the IASB and FASB; and
- 2) Conversion to IAS 12 in place of FAS 109 as a result of a full conversion to IFRS.

The timing and implementation effort will depend on the outcome of the convergence efforts by the FASB and IASB. Regardless, tax accounting is likely to be at the forefront of planning for an IFRS conversion.

Get ready to assess potential changes in tax accounting methods

Companies that make the most of a conversion to IFRS will approach the undertaking as more than an “IAS 12 vs. FAS 109” exercise. It is important to address the tax consequences of the pretax differences between IFRS and U.S. GAAP because a conversion to IFRS requires changes to several financial accounting methods. Consequently, companies may need to reevaluate their existing tax accounting methods. According to the Internal Revenue Code, the starting point for the computation of taxable income is income calculated in accordance with the method of accounting the taxpayer regularly uses for book purposes. For U.S. based companies this method is typically U.S. GAAP. Change the starting point, and half the tax equation changes. If there is a change in the accounting method used for financial reporting purposes, companies must consider issues such as:

- Is the new financial reporting standard a permissible tax accounting method?
- Is the new book method preferable for tax reporting purposes?
- Is it necessary to file changes in methods of accounting?
- Will there be modifications in the computation of permanent and temporary differences?
- How will reporting in accordance with IFRS impact the computation of taxable earnings and profits, foreign source income, and investments in subsidiaries?

Example

A common concern with the conversion of U.S. GAAP to IFRS is the prohibition against last-in, first-out (LIFO) as an acceptable method of accounting for inventories. Entities wishing to report inventories on LIFO for tax purposes are required to use LIFO for financial reporting purposes (IRC §472(c)). Thus, current tax law remains an impediment to companies valuing inventories on LIFO that may wish to adopt IFRS.

Significant differences between U.S. GAAP and IFRS that may require considerable tax analysis include:

- Revenue recognition principles
- Revaluation of property, plant, and equipment
- Component depreciation
- Inventory valuation
- Sale and leaseback transactions
- Pension liabilities and assets
- Business combinations
- Share-based payments

A word of caution: carefully consider the details. A cursory analysis of the U.S. GAAP and IFRS treatment of a particular method might lead one to think that they are mostly the same. A closer analysis may reveal that the differences and the tax impact actually arise from the exceptions or the special rules that can result when applying an accounting method under IFRS rather than U.S. GAAP.

Get ready to update your global tax planning

Global tax planning will need to be updated to capitalize on the operational and other anticipated changes associated with an IFRS conversion to ensure such changes are executed in a tax-efficient manner. Tax planning in connection with IFRS should consider changes in the global effective tax rate as a result of the consolidation of shared service centers, mitigation of tax risks through the elimination of unnecessary legal entities, and updates to transfer pricing. The tax impact of repatriation planning as a result of differing equity computations arising from IFRS will also need to be addressed.

Planning may involve an analysis of whether to implement a certain tax strategy either before or after a conversion. Also, to the extent a tax result depends on the pretax statutory books, consideration should be given to whether there are additional tax benefits to be obtained under one standard over the other.

Last, because IFRS is more principles based than U.S. GAAP, standardized accounting policies may have to be developed to ensure consistent tax accounting throughout an organization. Understanding the future ramifications of these policies will be paramount to generating the most favorable tax consequences in the greatest number of jurisdictions.



Example

Facts

An entity has a U.S. parent with foreign subsidiaries in 55 different countries:

- Thirty of the foreign subsidiaries record financial transactions in accordance with IFRS.
- Twenty record financial transactions in accordance with local accounting principles, although they have the option to adopt IFRS.
- Five of the foreign subsidiaries record financial transactions in accordance with local accounting principles.
- The current IFRS and local accounting principles to U.S. GAAP reconciliations that are necessary to report to the U.S. parent are generally undertaken by the controllers at each subsidiary.

Finance transformation

As a result of an IFRS assessment, the U.S. parent of this organization decides to convert the 20 entities recording earnings on a local accounting principle basis to IFRS. This move allows for a reduction of statutory reports as well as an opportunity to create an IFRS Center of Excellence (COE). The entity is also now in a position to open a shared service center responsible for all back office accounting functions, including reconciliations of IFRS to U.S. GAAP (until the company replaces GAAP with IFRS) and preparing all regulatory filings.

Global tax planning

Pursuant to a global tax planning analysis, the shared service center is sited in a jurisdiction with a relatively low tax rate. The shared service center charges management fees to the subsidiaries for which it provides services, thus causing the profit associated with the service center activities to be subject to the lower tax rate. As a majority of accounting functions and reconciliations are now undertaken by the IFRS COE, the tax directors are free to focus on tax planning while the local controllers can turn their attention to reporting of results. During the IFRS conversion, entities in certain foreign jurisdictions and dormant entities are liquidated in an effort to simplify the organization structure without adverse tax consequences, reduce the tax risk associated with such an unnecessarily complex structure, and generate tax operational efficiencies by reducing the number of required tax filings.

Get ready for transition and implementation issues

A conversion to IFRS will have a significant impact on what tax professionals need to know and how they gather the information necessary to satisfy financial reporting and tax compliance requirements.

Training: Historically, U.S. tax professionals have been trained to both convert the U.S. GAAP financial reporting of income to the tax basis of federal and state taxable income and apply the

principles of FAS 109. As a result, these professionals will now need to be educated to understand not only the differences between IAS 12 and FAS 109, but also the pretax differences between IFRS and U.S. GAAP standards. Furthermore, tax professionals must now understand the relationship between IFRS and the statutory tax laws of each jurisdiction in which their company operates.

Process and technology: Entities adopting IFRS will need to revise their accounting processes, modifying the way they collect data and account for transactions. The reengineering process provides the perfect opportunity for an entity to rethink the way in which it gathers the data necessary to calculate and report its income tax provision and the adjustments necessary to go from IFRS book income to taxable income. Likewise, adoption of IFRS may be the catalyst many companies are looking for to replace their spreadsheet models with tax provision software, and every affected business enterprise will need to determine if its existing tax provision software will accommodate an IFRS conversion.

Get ahead of the curve

Market forces, regulatory activity, the promise of efficiencies, and other factors are pushing IFRS into the headlines and to the top of senior tax executives' agendas across corporate America. The movement toward IFRS is real. Tax departments must ask themselves: Can we afford not to investigate the impact of IFRS?

As previously mentioned, the FASB and the IASB may release an exposure draft of the converged standard of accounting for income taxes during the last half of 2008. The proposed timing of the issuance puts accounting for income taxes as one of the leading issues that many U.S. public and private reporting entities will encounter in the overall convergence of IFRS and U.S. GAAP. As a result of convergence, tax departments will likely find it necessary to convert to a new standard of accounting for income taxes regardless of whether or not the company is a multinational or a domestic enterprise. In addition, tax directors will need to begin an assessment of the impact of IFRS on their organization's tax accounting methods, deferred tax balances, and after-tax cash flows as well as the modifications that will ultimately be necessary to existing tax compliance processes and systems.

In addition to the converged accounting for income taxes standard, the last half of 2008 may also see an SEC announcement of its plans for issuing both an IFRS adoption roadmap and possibly a proposed rule for the voluntary conversion to IFRS for U.S.-based registrants. Early planning for the tax implications of such a transformative organizational change can put tax executives in the position of offering strategic advice. Stay tuned for more information and further guidance from Deloitte on next steps.

For additional resources and information on IFRS, visit the [Deloitte IFRS website](#). There you can find a link to [IAS Plus](#). In addition, please join our [Dbriefs](#) webcast on June 23, 2008, when we will present "FAS 109 and IAS 12: Insights on the Corporate Income Tax Accounting Convergence Project."

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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