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International Financial Reporting Standards  
for U.S. Companies: Tax Implications of an  
Accelerating Global Trend

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HIGHLIGHTS INSIDE



TAX EXECUTIVES INSTITUTE, INC.

# International Financial Reporting Standards for U.S. Companies: Tax Implications of an Accelerating Global Trend

By Nathan Andrews

The movement toward International Financial Reporting Standards (IFRSs) as a single set of globally accepted accounting standards is quickly gathering momentum. IFRSs are 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:

- On August 27, 2008, the Securities and Exchange Commission (SEC) introduced a proposed IFRS “roadmap” and specific rule changes that would permit the use of IFRSs for certain U.S. issuers. The proposed roadmap acknowledges that IFRSs have the potential to become the global set of high-quality accounting standards and formally proposes a timetable and appropriate milestones that need to be achieved for mandatory transition to IFRSs starting for fiscal years ending on or after December 15, 2014. The rule changes would give a limited number of U.S. issuers the option to use IFRSs in their financial statements filed on Form 10-K for fiscal years ending on or after December 15, 2009.
- The SEC approved a final rule in November 2007 that eliminated the requirement for foreign private issuers using IFRSs to reconcile to U.S. Generally Accepted Accounting Principles (U.S. GAAP); the rule was effective for periods ending after November 15, 2007.
- The International Accounting Standards Board (IASB) plans to release an exposure draft of International Accounting Standards No. 12, Income Taxes, (IAS 12).
- The Financial Accounting Standards Board (FASB) will solicit input from U.S. constituents on its convergence strategy by issuing an Invitation to Comment containing the IASB’s revised version of IAS 12, Income Taxes. Depending on the comments it receives, the FASB may decide to adopt this revised standard as well as other IFRSs.

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

The impetus to convert to IFRSs 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 keys to a successful transition.

## Get Ready for 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 with the issuance of the IAS 12 exposure draft.

### Expected revisions to IAS 12

- 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
- Use of distributed or undistributed rate applicable to accumulated earnings based on intent
- Adoption of FAS 109 treatment for investments in subsidiaries, associates, joint ventures, and branches

### Potential continued areas of divergence

- Provision for current and deferred taxes arising from inter-company 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)
- Exception for initial recognition of deferred tax with regard to certain acquisitions
- Uncertain tax positions
- Share-based payments

## Get Ready to Assess Potential Changes in Tax Accounting Methods

Companies that make the most of a conversion to IFRSs 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 IFRSs and U.S. GAAP because a conversion to IFRSs 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 IFRSs affect the computation of taxable earnings and profits, foreign source income, and investments in subsidiaries?

One of the often cited concerns about a conversion of U.S. GAAP to IFRSs is the IFRSs' 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 IFRSs.

Significant differences between U.S. GAAP and IFRSs 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 treatment of a particular method under U.S. GAAP and IFRSs might lead one to think that they are mostly the same. A closer analysis may reveal that the differences and the tax effect actually arise from the exceptions or the special rules that can result when applying an accounting method under IFRSs rather than U.S. GAAP.

### Get Ready to Update Your Global Tax Plan

The discussion on IFRSs taking place in the United States today is only one part of a global shift toward consistent accounting standards. Somewhere in the world, accounting standards are changing today. Many countries have already adopted IFRSs as their required reporting standard for public companies. Several countries are in the process of adopting IFRSs and other jurisdictions are contemplating converging their own local GAAP to align more with IFRSs. It is these changes to local GAAP that should be of greatest concern to global tax departments. By and large, countries rely on local, or statutory, GAAP as the starting point for tax calculations. Most of the jurisdictions that have adopted IFRSs for financial statement reporting purposes require maintenance of local statu-

tory books for tax purposes. Some jurisdictions may begin to drop this requirement as the global trend toward IFRSs continues.

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 IFRSs should consider changes in the global effective tax rate and cash taxes payable as a result of the consolidation of shared services centers, mitigation of tax risks through the elimination of unnecessary legal entities, and updates to transfer pricing. The tax effect of repatriation planning as a result of differing equity computations arising from IFRSs will also need to be addressed. Specific areas of global tax planning that may warrant additional consideration in light of the global migration to IFRSs include:

- Local interest deductibility
- Hybrid instruments
- Foreign currency gains and losses
- Amortization and other deductions
- Share-based payments
- Intercompany transactions

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 versus the other.

#### EXAMPLE

##### Facts

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

- 30 of the foreign subsidiaries record financial transactions in accordance with IFRSs.
- 20 record financial transactions in accordance with local accounting principles, although they have the option to adopt IFRSs.
- 5 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 decides to convert the 20 entities recording earnings on a local accounting principle basis to IFRSs. 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 services center responsible for all back office accounting functions, including reconciliations of IFRSs to U.S. GAAP (until the company replaces GAAP with IFRSs) and preparing all regulatory filings.

### Global Tax Planning

Pursuant to a global tax planning analysis, the shared services center is sited in a jurisdiction with a relatively low tax rate. The shared services 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 IFRSs will have a significant effect 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 IFRSs and U.S. GAAP standards. Furthermore, tax professionals must now understand the relationship between IFRSs and the statutory tax laws of each jurisdiction in which their company operates.

**Process and technology:** Entities adopting IFRSs 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 IFRSs 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.

And it's not all about income taxes. As tax departments assess or prepare for a shift from U.S. GAAP to IFRSs, it will be paramount to keep in mind how certain differences between the standards, such as the option under IFRSs to revalue fixed assets, or the treatment of share-based payments, will impact property tax, sales and use tax, value added tax (VAT), franchise tax, and payroll tax.

Understanding the effect of IFRSs on your organization's share-based compensation plans requires a broad, multifunctional perspective — one that can enable employers to address the various accounting, valuation, tax, finance, human resources, and technology implications. Given this level of complexity and the substantial lead time that may be required to implement changes, it is not too early to begin planning now.

### Get Ahead of the Curve

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

Tax directors will need to begin an assessment of the effect of IFRSs 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. 

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