

# COMPLIANCE WEEK

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## How the Tax Executives Should Approach IFRS

By Tammy Whitehouse — July 22, 2008

As a U.S. transition to international accounting standards appears more and more inevitable, corporate tax departments need to get a seat at the table to assure they're included in the monumental planning process that is beginning to unfold.

That's the advice of tax advisers, who say it's critical for companies' tax staff to share their expertise on how a shift to a new accounting system is going to change the way taxes are calculated and reported.

"It may be that the finance department has already set up some sort of implementation team, maybe without including a tax person," says Jarvis Bomar, director of federal taxes for consulting firm Jefferson Wells. "The tax director should proactively go out and get himself or herself inserted onto the implementation team."



Bomar

Without a tax perspective added to the mix, Bomar warns, decisions about how to move to International Financial Reporting Standards could be made without considering the potentially formidable tax changes. "If that happens, you could see errors in tax returns, incorrect tax provisions, and potentially Sarbanes-Oxley implications," he says.

In a recent KPMG Webcast, KPMG Audit Partner Kees Bakker said tax executives are facing the "inconvenient truth" that the world is gravitating away from U.S. Generally Accepted Accounting Principles and toward IFRS as the preferred accounting rulebook. That compels tax executives to get up to speed on IFRS, pronto.

Like many other observers of the U.S. regulatory scene, Bakker said the key was the Securities and Exchange Commission's decision last fall to let foreign registrants file statements in IFRS and not reconcile them to GAAP. Once that happened, he said, "it became a question of when, not if," the SEC will give the same choice to domestic companies.

Ashby Corum, a KPMG tax partner, said during the KPMG Webcast that companies will encounter technical difficulties between GAAP and IFRS tax accounting standards. Both use a balance-sheet approach and recognize deferred taxes for temporary differences, carry-forwards and other items, he said, which are significant chunks of common ground. Still, the final income tax amounts reported in the financial statements will differ for

several reasons.

First, Corum said, a company's tax liability may change simply because the numbers on the balance sheet or the income statement change. In other cases, IFRS may change the amount of deferred tax recognized in financial statements. As an example, he said, if a company's pension liability changes significantly as a result of adopting IFRS, that alters the deferred tax liability to be reported.

"To fully grasp what a transition to IFRS will mean for a tax department, one must first begin to get an understanding of how tax numbers will change," Corum advised. "Then you can understand how those changes will impact other elements of the organization and the entire reporting process."

With a grasp of technical differences, tax departments need to assess how a change to IFRS would affect the company from a tax standpoint. "Tax directors need to proactively look at their own business," Bomar said. "It's difficult to assess what the impact is going to be on any company without knowing that company's accounting policies and detailed transactions. At a very high level, that's what [tax managers] should be doing now."

### **The Cascade Effect**

One example of a high-level issue: A change from GAAP to IFRS would be seen by the Internal Revenue Service as a change in accounting method; that usually triggers a tax liability. That new liability, in turn, could affect any number of items on the balance sheet or income statement.

"If, for instance, we have some way we account for bad debts in a particular country, or a way we account for reinvested foreign earnings, those may have an effect from a cash tax standpoint," says Chad Koebnick, managing director at RSM McGladrey. "That could create a pretty significant liability. Hopefully it will be timing in nature and not permanent in nature, but that's something to look at."

Ken Kuykendall, a partner at PricewaterhouseCoopers who specializes in taxes under IFRS, says companies must closely examine what will happen to accounting for inventory under a move to IFRS. Many companies reporting under GAAP rely on the "last in, first out" (LIFO) method of accounting for inventory. U.S. tax rules dictate that if a company uses LIFO to calculate tax liability, it must use LIFO in its financial reporting as well.

IFRS, however, doesn't allow the LIFO method. "That's an issue that really gets tied up," Kuykendall says. "Tax policy debate is likely to ensue over this. The only way seemingly for this issue to be addressed is for Congress to address it or for tax rules to be changed somehow. We're encouraging companies to pay attention to the debate over tax policies."

Then there's the question of what happens to Financial Interpretation No. 48, *Accounting*

*for Uncertainty in Income Taxes*. FIN 48 requires companies to disclose where they may have uncertainty in their tax positions and report prospective liabilities if they're deemed more likely than not to be incurred at some future date. The rule went into effect in 2007, and companies hate it.

IFRS currently has nothing like FIN 48. The International Accounting Standards Board is working on revisions that would add a FIN 48-like requirement, but it would probably require companies to book such prospective liabilities only to the extent they deem them certain—which is a lesser standard than FIN 48 under GAAP.

Bomar said IASB has made clear that it doesn't want to prescribe a lot of guidance on measuring and recognizing tax uncertainties, so IFRS is likely to give companies a lot more latitude.



Batavick

FASB member George Batavick, speaking at FASB's mid-year update in June, said that the accelerated move to IFRS will soon have big consequences for tax accounting rules. For example, FASB is considering whether to adopt International Accounting Standard No. 12, *Income Taxes*, in its entirety, rather than make further revisions to FAS 109, *Accounting for Income Taxes*.

"Instead of convergence, which means we're moving to IFRS ... why not just go ahead and adopt their standard lock, stock, and barrel?" he said. "It will give experience in adopting an IFRS standard and it will be one more step forward toward convergence."

Batavick acknowledged that how to measure uncertainties is one major issue that must be resolved, since GAAP and IFRS now treat uncertainty quite differently. "We have to resolve that one particular issue, so the path forward is not exactly clear," he said.



Dohrer

Bob Dohrer, a partner at the auditing firm McGladrey & Pullen, says there is still a great deal of uncertainty about how tax reporting itself might change in a switch IFRS. "Our tax code is based on GAAP," he says. "I don't think it will have a material impact on the tax revenues to switch to IFRS, but if the Internal Revenue Service said, 'We're going to base taxation on IFRS,' that would certainly accelerate the extinction of U.S. GAAP."

Bomar says that even with the uncertainties, it's not too soon for tax executives to begin assessing the effect of adopting IFRS and preparing for a switch, considering the extensive changes in systems, processes, training, and staffing likely to follow.

"If you haven't already done readiness, you need to jump on it pretty quickly," he says. "Take advantage of time. Time is usually something that is your ally."

**The following excerpt from PwC examines some of the implications of adopting IFRS for tax reporting at U.S. companies.**

The move to IFRS could have a significant impact on both U.S. and foreign cash taxes of a company. In most jurisdictions, financial reporting is often the starting point in determining taxable income for tax filing purposes. As financial accounting policies change from existing GAAP to IFRS, companies will need to consider the implications of such changes on cash taxes.

To start, there are a significant number of potential differences between IFRS and U.S. GAAP which could materially affect pre-tax accounting income. Examples of such differences include the accounting for revenue, leases, asset impairments, classification and measurement of financial instruments, hedging activity and stock-based compensation, to name a few.

In the U.S., tax methods of accounting do not necessarily follow the “book” method of accounting. As a result, a conversion to IFRS will require an analysis of each new accounting policy for its related tax implications, including a determination as to whether it is permissible or advisable to conform the related tax method of accounting to the new book accounting method. It is important to remember that a tax accounting method does not automatically change because the book accounting method changes. Rather, the consent of the IRS Commissioner must be obtained to change an accounting method for U.S. tax purposes.

IFRS also is a major tax issue for companies using the LIFO method to value inventories. IFRS does not permit the use of LIFO, and the tax law does not permit the use of LIFO unless the method is used for financial reporting purposes. Unless this LIFO conformity requirement is changed through legislation, U.S. companies currently using LIFO will face a tax cost with a change to IFRS for financial reporting. Under current law, the effect of the change from LIFO to FIFO (known as the §481(a) adjustment) may be spread over four years, though Congress is considering repealing the LIFO method and allowing a longer spread period. Tax executives with companies using LIFO should be closely monitoring the debate in Washington on this issue.

Similar accounting method considerations will need to be given to a company’s non-U.S. operations. As more jurisdictions permit or require use of IFRS as the basis for statutory reporting, the related cash tax implications will need to be analyzed. For those countries that pursue an “independent approach” (i.e., requiring that a set of “tax accounts” be prepared “independently” from the IFRS accounts), the impact will primarily be felt in the deferred tax area with rather limited impact on cash taxes.

Examples of countries with an independent approach include the Netherlands, Poland and Norway.

In contrast, for those countries that have a “(quasi-)dependent approach” (i.e., the measure of a company’s taxable profits is computed mainly in accordance with its financial accounts), and which permit or require adoption of IFRS at the legal entity level, it is likely that the adoption of IFRS will have an impact on a company’s cash tax position. Examples of countries with a (quasi-)dependent approach, include the UK, Spain, Portugal, Switzerland and Luxembourg.

The degree of impact on cash taxes will ultimately depend upon the extent to which each individual tax authority is willing to embrace IFRS principles in the tax law. As there is an increasing trend in a number of countries adopting IFRS principles into local tax law, more attention will need to be focused on the cash tax implications of the various financial accounting policy decisions made during the conversion to IFRS.

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**Source**

PwC on the Move Toward Convergence (2008).

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