

An IFRS publication

Converting to International Financial Reporting Standards*

Planning considerations for US tax executives

*connectedthinking

PRICEWATERHOUSECOOPERS 

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The heart of the matter

The movement toward IFRS in the United States has begun... have you considered the impacts to your global tax function?

In November 2008, the Securities and Exchange Commission (SEC) released its proposed roadmap for the mandatory adoption of International Financial Reporting Standards (IFRS) in the United States. The proposed roadmap currently provides for the required use of IFRS by US issuers beginning in 2014, with the potential for voluntary adoption available to certain companies as early as 2009.

The proposed roadmap is expected to become final in 2009. Additionally, pursuant to the text of the proposed document, the roadmap will be revisited by the SEC in 2011. While the timeline and inherent uncertainty may suggest that an organization await further guidance before preparing for IFRS, the degree of potential change an organization may undergo in their conversion to IFRS will likely require IFRS readiness efforts to begin in advance of this date. In fact, many organizations have already begun the process of performing a preliminary analysis to determine the potential impact that IFRS could have on the company. However, the degree to which tax considerations are being addressed varies greatly. As we will discuss in this publication, the tax ramifications may be substantial.

The timeline provided in the SEC's proposed roadmap provides companies with the opportunity to develop a strategic, timely, and comprehensive plan to approach, analyze, and manage the conversion to IFRS in a measured and thoughtful manner. As will be discussed throughout this publication, there can be significant tax ramifications and related planning considerations inherent in a conversion to IFRS. Therefore, as organizations begin analyzing and planning for IFRS, it is important that US tax executives understand the impacts that an IFRS conversion could have on the company's global tax function and begin to plan accordingly. To assist US tax executives with their planning, PwC has developed this IFRS publication to help answer the following questions:

- *Why is it important to begin planning now for the conversion to IFRS?*
- *What are the most significant planning considerations for the global tax function?*
- *How and when should an organization start planning for the IFRS conversion process?*

An in-depth discussion

Mapping the conversion and understanding the impacts on the global tax function.

Mapping the conversion

Why is it important for US tax executives to begin planning now for the conversion to IFRS?

At first glance, it may appear that the proposed mandatory IFRS adoption date of 2014 is far down the road; however, consider this: SEC rules currently require US public companies to include an audited balance sheet for the two most recent fiscal year-ends, as well as audited statements of income, cash flows, and shareholders' equity for the three most recent fiscal years. Additionally, IFRS requires a company to prepare an opening IFRS balance sheet at the date of transition to IFRS, which increases the total number of required balance sheets to three. Figure 1 illustrates a sample timeline for converting to IFRS based on the SEC's proposed roadmap. Assume the first set of IFRS financial statements are filed for the year-ended December 31, 2014.

Figure 1. Sample timeline for converting to IFRS



As this example illustrates, for a company adopting IFRS in its financial statements filed for the year-ended December 31, 2014, the actual transition date would be January 1, 2012. As a result, companies would be required to provide IFRS-compliant financial reporting data for years 2012, 2013, and 2014 at the December 31, 2014 year-end reporting date.

PwC observation: In our experience, a well-designed and executed IFRS conversion project can take anywhere between 18 to 36 months to complete. Consequently, if a company seeks to fully embed IFRS in the company's financial reporting processes by 2012 (the beginning of the comparative reporting period), the conversion process for many companies may need to start as early as 2009, with initial planning efforts beginning in 2008.

While the movement to IFRS will principally be driven by financial reporting considerations, many domestic and international tax issues will be raised during the conversion. In order to proactively plan for these tax issues, it will be important for tax executives to begin analyzing and understanding the impact that IFRS will have on the global tax function. Many corporate tax executives execute long-range planning or forecasting related to tax payments, the effective tax rate, and the impact potential legislation may have on the organization. At times, these plans look forward three to five years and play a key role in assessing the value drivers of the tax function, often impacting contemplated changes to the company's business or legal structure. Given their long-term impact, these plans need to begin addressing the tax implications inherent in an organization's conversion to IFRS.

Additionally, while the current proposed timeline in the United States suggests 2014 will be the earliest mandatory adoption date for IFRS, the conversion to IFRS outside the United States may be more imminent. For example, Canada and Korea are both progressing toward a planned IFRS adoption date of 2011, while much of Asia and the European Union have already begun to allow or mandate IFRS for statutory reporting purposes. Given the close linkage that often exists between statutory and tax reporting in non-US jurisdictions, it is likely that these statutory conversions will have a significant impact on the related tax reporting. For US companies with subsidiaries in countries that have either already converted to IFRS or are contemplating a conversion to IFRS in the immediate future, it will be important to analyze and plan for the tax impacts well in advance of the actual conversion.

Understanding the impacts on the global tax function

What are the most significant planning considerations for the global tax function?

The conversion to IFRS will likely have a significant impact on a company's global tax function. Some of the most potentially significant tax considerations include:

- Significant FAS 109 vs. IAS 12 differences
- First-year reporting requirements under IFRS 1
- Cash taxes—both US and non-US
- Domestic and international tax planning
- Transfer pricing
- Tax processes, systems, and controls

Significant FAS 109 vs. IAS 12 differences

Although there are many similarities between FASB Statement No. 109, *Accounting for Income Taxes* (FAS 109), and International Accounting Standard 12, *Income Taxes* (IAS 12), key differences also exist between the two standards. These differences could have a significant impact on the financial accounting and disclosure requirements associated with income taxes, including the effective tax rate.

In an attempt to alleviate many of the differences between FAS 109 and IAS 12, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began working jointly in 2004 on a project to develop a converged standard. However, in August 2008, the FASB updated its project plan and indefinitely suspended its efforts by indicating that it no longer had immediate plans to issue amendments to FAS 109. This decision was principally due to the overall movement toward IFRS in the United States. The IASB has continued forward with its efforts to amend IAS 12 and is expected to issue an income tax exposure draft in late 2008 or early 2009. It is expected that the proposed changes to IAS 12 that arose out of the Boards' prior joint project efforts will be included in this exposure draft.

Notwithstanding the FASB's actions, we expect that the FASB will continue to be an active participant in the IASB's deliberations. Without

its own exposure draft, however, the FASB will likely have less direct influence over the project's outcome.

PwC observation: Considering the likelihood that the standard ultimately adopted by the IASB will be the standard adopted by US registrants upon conversion, tax executives should start planning now to understand the differences between FAS 109 and IAS 12, as amended, and identify which differences could potentially have a significant impact on the company's financial reporting. This will place tax executives and their organizations in a position to comment on aspects of the IASB's exposure draft, if desired.

Approximately 10 to 15 significant differences currently exist between FAS 109 and IAS 12. However, through the work of the FASB and the IASB during their joint convergence project, most of these differences were planned to be eliminated by the joint actions of the Boards, with the exceptions being uncertain tax positions and share-based compensation. As a result of the FASB's decision to suspend issuing amendments to FAS 109, additional differences will remain with respect to intercompany transactions and the exception to recording deferred taxes for differences related to assets and liabilities that, under FASB Statement No. 52, *Foreign Currency Translation* (FAS 52), are remeasured from the local currency into the functional currency using historical exchange rates.

With regard to uncertain tax positions, the IASB previously indicated that it did not intend to adopt the recognition, measurement, and disclosure requirements of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* (FIN 48). Therefore, US companies moving to IFRS may again need to change the way they account for and disclose uncertain tax positions upon conversion.

Currently, there is no specific guidance within IFRS addressing the accounting for income tax uncertainties. In practice, a liability for tax uncertainties is typically recorded based on the amount of taxes expected to be paid to the tax authorities. This is unlike the benefit recognition model required by FIN 48. Additionally, current IFRS does not contain disclosure requirements as detailed as those found in FIN 48.

In its soon-to-be-released exposure draft, the IASB is expected to issue guidance for the first time on the accounting for income tax uncertainties. During the joint convergence project, the IASB had tentatively stated its intention to move toward a model with no recognition threshold for uncertainties and measurement using a weighted average probability approach, which may require companies to examine all possible outcomes in assessing tax uncertainties. Further, the IASB had tentatively stated that it would modify the general disclosure requirements for uncertain tax liabilities found in IAS 12. However, the proposed disclosure requirements are expected to remain less prescriptive than those found in FIN 48.

PwC observation: The need to look at all possible outcomes may be difficult to implement for many companies, as many tax positions will carry some risk. For example, under the tentative IASB model, if a position of \$100 was 80 percent certain of being realized, there would still be a reserve recorded for \$20, while under the FIN 48 model, the full benefit of \$100 would be recognized. It will be interesting to see the response outside the United States upon the release of the exposure draft, since this will be the first time guidance has been issued in this area by the IASB, and it will likely result in a different answer than what companies are doing today.

With respect to share-based compensation, a number of pretax accounting differences exist between Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment* (FAS 123(R)), and International Financial Reporting Standard 2, *Share-Based Payment* (IFRS 2). Examples include awards with graded vesting, definition of grant date, awards with a choice of settlement between cash and equity, share-based payments to nonemployees, and social charges.

In addition to these pretax accounting differences, US GAAP and IFRS also differ significantly with respect to the tax accounting for share-based compensation. Examples of these differences include:

- Similar to US GAAP, IFRS requires a company to record an expense for employee stock option awards based on the fair value of the stock option at the grant date. Tax benefits (and resulting deferred tax assets) reported under IFRS, however, are based on the estimated future tax

deduction at the reporting date (i.e., the recorded tax benefit will not correspond to the respective compensation expense in the profit and loss statement). In most jurisdictions, the tax deduction would be based on the “intrinsic value” of the stock option (i.e., the stock value in excess of the option exercise price).

- Under IFRS, any excess in the estimated tax deduction over the recorded compensation expense (subject to a recognition test) at each reporting date is credited to equity (versus the income statement).
- Under US GAAP, only the excess tax benefit realized at the time of exercise is credited to equity. This could result in significantly different impacts on equity and deferred taxes during the life of the stock option.
- Conversely, if either the estimated or final tax deduction is less than the recorded compensation expense, the tax shortfall under IFRS is charged to equity only to the extent that “excess” tax benefits related to that individual stock option award have previously been credited to equity. IFRS does not apply the US GAAP concept of a windfall “pool” that enables tax shortfalls to be offset against aggregated prior windfalls.

PwC observation: Companies that convert to IFRS will likely have greater volatility in their deferred tax accounts and tax provision over the life of an award because of the required adjustments for stock price movements in each reporting period. Under IFRS, no windfall pool is available to absorb the tax effect of any excess of book compensation expense over the tax-deductible amount. As a result, the amount of shortfalls that are charged to expense will likely increase under IFRS. For more information on the impact of IFRS on existing and new share-based payment plans, refer to PwC’s IFRS publication, *Stock option awards under IFRS: An analysis of the potential impact*.

With regard to intercompany transactions, during the joint convergence project, the FASB had tentatively decided to eliminate the FAS 109, par. 9(e) exception, as no similar exception exists under IFRS. The FAS 109, par. 9(e) exception essentially provides that (1) income taxes paid on intercompany profits will be deferred on assets remaining in the group and (2) recognition of deferred tax for the difference in basis for the buyer is prohibited on such intercompany transfer.

The impact of eliminating the FAS 109, par. 9(e) exception upon conversion to IFRS could be significant. Companies that have deferred charges currently recorded on their books and records will have to make an adjustment directly to retained earnings upon conversion. On subsequent intercompany transactions, the seller will no longer be able to defer the recognition of the tax charge. In addition, the buyer will recognize deferred tax at the buyer's tax rate based on the difference between the "consolidated" book value of the asset as compared with the buyer's tax basis in the asset at the time of the transaction. Because of rate differentials between jurisdictions, this change may impact a company's effective tax rate.

Lastly, during the joint convergence project, the FASB had also tentatively decided to eliminate the FAS 109, par. 9(f) exception, as no similar exception exists under IFRS. The FAS 109, par. 9(f) exception prohibits the recognition of deferred taxes for differences related to assets and liabilities that, under FAS 52, are remeasured from the local currency into the functional currency using historical exchange rates. By eliminating the FAS 109, par. 9(f) exception, companies that operate in jurisdictions where the local currency is not the functional currency will be required to record deferred taxes on exchange rate movements where the asset or liability is carried at historical cost for financial reporting, which could also cause volatility in the effective tax rate. It may also be difficult to track and could require system modifications to obtain the necessary information.

First-year reporting requirements under IFRS 1

IFRS 1, *First-Time Adoption of International Financial Reporting Standards*, is the standard governing initial reporting under IFRS. Briefly summarized, IFRS 1 requires companies to:

- Identify the first IFRS financial statements
- Prepare an opening balance sheet at the date of transition to IFRS (i.e., the beginning of the earliest period for which full comparative information is presented in accordance with IFRS)
- Select accounting policies and apply those policies retrospectively to all of the periods presented in the first IFRS financial statements
- Consider whether to apply any of the optional exemptions from retrospective application
- Apply the mandatory exceptions to retrospective application
- Make extensive disclosures to explain the transition to IFRS

PwC observation: A common question is: What are the first IFRS financial statements? These will be the first financial statements to contain an explicit and unreserved statement of compliance with IFRS. Even if a company has historically prepared financial statements using IFRS standards for internal purposes, unless the financial statements were released either externally or to the parent company, they would not be considered IFRS financial statements. This is important because it means that the first time these financial statements are released either externally or to the parent company, IFRS 1 applies, which allows for new accounting choices to be made.

IFRS 1 essentially provides a company with an opportunity to re-examine all of its accounting policies and “start over” or “adopt” new accounting methods for book purposes. Conversion to IFRS gives a company a one-time opportunity to revisit all of its accounting policies and procedures and to potentially adopt different accounting methods that better reflect the economic reality of its business transactions.

During the conversion to IFRS, it is very important that tax executives be involved in the selection of financial accounting policies because the policies may have a number of tax implications, including when and how much tax is paid related to business transactions. IFRS offers many accounting policy elections, and assessing the tax impact of each one requires insight into tax laws in multiple tax jurisdictions, local statutory accounts in different jurisdictions, and the detailed differences between US GAAP and IFRS.

The tax implications of particular accounting policy elections may impact a company's ultimate choice. For example, changes in a company's pretax accounting for various items may result in a different amount of deferred tax assets/liabilities, the creation of new deferred tax assets/liabilities, and cash flow consequences. These changes may impact valuation allowance determinations and, therefore, may also impact the company's effective tax rate.

PwC observation: Conversion to IFRS is a one-time opportunity to review a company's worldwide accounting methods and policies and take a "clean sheet of paper" approach. In light of this opportunity, tax departments will need to be engaged to understand the proposed changes and assess the tax impacts in each jurisdiction. It may be an opportune time to review tax accounting methods, as well. To address this opportunity, tax executives should begin planning efforts now to identify which potential accounting method changes will most likely have a significant impact on their organization's global tax strategy.

Cash taxes—both US and non-US

The move to IFRS could have a significant impact on both US and foreign cash taxes. In most jurisdictions, book income is the starting point in determining taxable income. Therefore, as financial accounting policies change from a jurisdiction's local GAAP to IFRS, tax executives will need to consider the implications of such changes on taxable income.

While in some cases there may be hundreds of changes to pretax accounting methods, we believe that the number of tax accounting method changes typically will be far fewer. Overall, the accounting method changes resulting from the adoption of IFRS will most often affect the computation of book-tax differences, rather than taxable income. However, some accounting method changes could have a direct impact on a company's US cash taxes, including LIFO, leases, and advance payments.

LIFO

Unlike US GAAP, IFRS does not permit the use of the last in, first out (LIFO) inventory method. US federal tax law currently permits the use of the LIFO inventory method; however, the law requires that a company utilize the LIFO method for financial reporting purposes in order to utilize the method for tax purposes. This is typically referred to as the book-tax conformity rule. As a result of this conformity requirement, US companies currently obtaining a tax benefit by utilizing the LIFO inventory method in computing taxable income will face a potentially significant cash tax cost upon conversion to IFRS, as they will be required to cease utilizing the LIFO inventory method for tax purposes. Under current law, the effect of changing from LIFO to the FIFO (first in, first out) inventory method may be spread over four years.

PwC observation: In recent years, Congress has considered numerous proposals repealing or curtailing the LIFO method, irrespective of any movement to IFRS. Some of these proposals have provided for a longer spread period for the change to reduce the economic burden of any repeal or curtailment of LIFO benefits. With the recent developments in the capital markets, and the continued focus on competitiveness and tax policy in the United States, interested parties should closely monitor any legislative or regulatory developments related to the LIFO inventory method and potentially seek to engage in the debate on this tax issue.

Leases

US GAAP generally requires a "form-driven" or "rules-driven" classification for leases. By contrast, under IFRS, the classification of a lease as

operating or capital depends more on the substance of the transaction than on the form of the contract. US tax law is currently more closely aligned with IFRS; it requires a substance-over-form analysis to determine which party has the benefits and burdens of ownership of the property.

PwC observation: The move to IFRS may impact the characterization of leases for financial reporting purposes in the United States and many other jurisdictions that currently require a form-driven or rules-driven classification. Given the tax rules in the United States, which appear to more closely follow IFRS, many of the existing book-tax differences related to leases may be eliminated. Additionally, it is likely that some organizations may seek to modify existing or future lease terms to achieve a desired financial accounting treatment for leases. These changes may impact the tax treatment of leases. As a result, tax executives should begin assessing the potential accounting changes related to leases and analyze and plan for any cash tax implications resulting from the effects of these changes.

Advance payments

Under US tax law, taxpayers may defer the recognition of many advance payments received, to the extent of the amounts deferred under the taxpayer's book method of accounting for the payment. This deferral is generally provided through certain administrative exceptions prescribed by the IRS or US Treasury. However, under IFRS, the treatment of certain elements associated with advance payments (e.g., up-front fees) may not be deferred where there is no uncertainty as to collection and there are no further performance obligations linked to the fee. As a result, depending upon the situation, companies may need to recognize advance payments earlier for tax purposes than they do today (i.e., no deferral for tax if no deferral for book purposes).

PwC observation: Tax executives should begin analyzing the potential ramifications of the acceleration of book revenue associated with advance payments, or multiple element arrangements, and specifically assess the impact this could have on the amount and timing of cash taxes paid. This will ensure that these tax economic considerations are factored into the overall assessment of book accounting method or policy elections.

Cash taxes—non-US

Similar to the United States, changes to book accounting policies must also be considered with respect to a company's non-US operations. As more foreign jurisdictions permit or require the use of IFRS for statutory reporting purposes, the related cash tax implications will need to be considered. The degree of impact on cash taxes will ultimately depend on the extent to which each individual taxing authority is willing to embrace IFRS principles in their tax law. As there is an increasing trend in the number of countries adopting IFRS principles into local tax law, more attention will need to be focused on the impact that the various financial accounting policy decisions made during the conversion to IFRS will have on cash tax liabilities.

Domestic and international tax planning

The adoption of IFRS will impact an organization across the globe. Therefore, the foreign components of the company's global tax footprint must be considered throughout the entire conversion process, as some of a company's most significant international tax strategies could be impacted by IFRS.

While adoption of IFRS may not be mandatory in the United States until 2014, many companies have foreign subsidiaries that have either already adopted IFRS or are currently considering adoption. Therefore, it is critical for companies to get out in front of these conversions in order to align their corporate policy elections with those being made at the subsidiary level and ensure that any tax ramifications are appropriately considered during the conversions.

PwC observation: It is important to note that a subsidiary that has issued statutory financial statements under IFRS has already adopted IFRS for the purposes of IFRS 1. This may have important implications for companies in which foreign subsidiaries are ahead of the US conversion to IFRS. It is important to understand these situations when planning for the conversion.

Global structuring

One of the first things US tax executives should do when assessing the impact of IFRS on their global structure is to consider the need for multiple legal entities, especially within the same jurisdiction. Efforts required in conversion are, in part, a function of the number of legal entities involved. Reducing the number of legal entities could produce time and cost savings; however, liquidating or merging existing legal entities could have significant US and foreign tax implications when not done with proper diligence and care.

PwC observation: US tax executives should consider entity rationalization studies to determine how the existing structure could be simplified prior to beginning the IFRS conversion process.

Debt planning

In jurisdictions where statutory accounting forms the basis of classification of debt versus equity for tax purposes, companies must review existing financing structures and consider the impact IFRS may have on interest deductions for tax purposes. US tax executives should consider the following issues when assessing the impact of an IFRS conversion on the company's current debt planning:

- Classification of financial instruments as liabilities vs. equity
- Hybrid instruments
- Fair value measurement under IFRS

From a US GAAP perspective, the definitions of what qualifies as, or requires treatment as, a liability are narrower than the definitions under IFRS. Under IFRS, certain instruments may be classified as debt, although previously classified as equity/mezzanine equity under US GAAP.

A change in classification from equity to debt will affect the income statement, as the payments may be treated as interest rather than as dividends. Further, the trend of more financial instruments being classified as liabilities under IFRS may also impact the calculation of net assets and the debt-to-equity ratio. For some companies, finding the appropriate debt-to-equity capitalization ratio under the new definitions of what qualifies as debt will require careful study. Managing through the process, while considering current debt covenant requirements, may also add additional complexity. Lastly, tax executives should consider how debt-to-equity ratio and interest coverage changes will affect the deductibility of interest for local country income tax purposes.

Hybrid instruments are common in debt planning for international operations. These instruments are treated as debt in one jurisdiction, giving rise to interest deductions for tax purposes, and as equity in another jurisdiction, allowing for potential exemption from tax (of dividend payments). As entities convert to IFRS, this difference in treatment may be eliminated (if the jurisdiction adopts IFRS for statutory reporting and local tax reporting is tied to statutory reporting), resulting in a higher effective tax rate on the interest income in the creditor jurisdiction. Likewise, the timing of conversion to IFRS in different jurisdictions could lead to planning opportunities, as instruments could be treated differently in jurisdictions that have not converted to IFRS.

The use of fair value measurement is also an important aspect of IFRS. For example, under IFRS, companies can elect to measure property, plant, and equipment, as well as investment property, at fair value. Further, certain financial instruments may be required to be carried at fair value. These measurement concepts could introduce volatility in asset balances and, therefore, may have a significant impact on the debt-to-equity and other balance sheet ratios. As discussed above, in some jurisdictions, this may give rise to limitations on (or conversely, opportunities for) interest deductions for tax purposes.

PwC observation: Regardless of the timing of any US conversion to IFRS, the deductibility of interest is an issue today for many companies. Where IFRS is in use in jurisdictions outside the United States for tax purposes, the debt-equity ratio may have already been impacted by the conversion to IFRS, and, as a result, the tax

deductibility of interest may have been impacted. The classification of debt and equity can also impact more than just the deductibility of interest. Changes in equity may impact the distributable reserves of a company, thereby affecting the company's ability to repatriate cash.

Cash repatriation strategies

Many non-US jurisdictions look to the financial statements to determine the level of earnings available to be distributed. The ability of US companies to receive distributions from non-US affiliates may be impacted to the extent that the accounting under IFRS results in significant differences from prior statutory accounting. As a result of the first-time adoption rules under IFRS 1, these differences may result in an immediate increase or decrease in distributable reserves on the statutory books upon adoption.

PwC observation: Many tax executives prepare their cash repatriation planning or forecasting on a three-to-five-year time horizon. Given the movement toward IFRS, both in the US and the rest of the world, it will be critically important to anticipate these changes and consider their impact in assessing the company's global cash and repatriation planning—particularly in light of tight credit conditions and liquidity concerns many US corporations are currently experiencing.

Earnings & profits

As a result of converting to IFRS, a company's books and records—the starting point in calculating E&P for US tax purposes—will clearly change, while the end result—tax E&P—may not change. Therefore, companies may need to track new or revised differences between book income and E&P. Additionally, companies may contemplate other adjustments as a result of changes to book accounting methods.

PwC observation: Companies should review their E&P computations for consistency with existing accounting methods and, where appropriate, consider changing E&P accounting methods to conform with the policies being adopted in the IFRS conversion process.

Foreign tax credits

One of the major areas of planning for many companies is in connection with the utilization of foreign tax credits on their US federal income tax returns. The amount of foreign tax credits generated and utilized in any given year depends on a number of factors, including the amount of E&P, the local taxes paid in different jurisdictions, and the amount of income classified as “foreign source income.” The allocation of expenses between domestic and foreign sources also affects the ability of a company to utilize foreign tax credits. Since a conversion to IFRS may affect the amount of cash taxes paid and the amount of income booked in non-US jurisdictions, tax planning in this area may be impacted.

State and local tax planning

The move to IFRS will also require tax executives to consider the impact on the company’s state and local tax liabilities, as these taxes will be impacted by changes in the federal income tax base. In addition, changes to the company’s balance sheet may also have cash tax implications in those jurisdictions that impose a net worth or asset-based tax. State apportionment factors could also be impacted (e.g., by changes in revenue recognition or fair value accounting for fixed assets), thereby affecting a company’s effective tax rate and cash tax liabilities. Further, a company’s property tax liabilities may also be impacted (e.g., by the company’s use of fair value accounting for fixed assets).

Transfer pricing

For many US-based companies, at first glance, the adoption of IFRS could be viewed as the means to simplify the pricing of intercompany arrangements between group entities. Theoretically, global harmonization of accounting standards has the potential to level the international playing field and reduce the potential areas of transfer pricing dispute among companies and taxing authorities. On closer inspection, however, it is clear that many implementation and risk management challenges and opportunities may arise for US-based companies in their transition to IFRS in connection with transfer pricing planning and documentation.

Converting to IFRS will have many important implications to the transfer pricing policies of companies, as these policies often reference US or other local GAAP in determining targeted prices, targeted operating results, and ranges of arm's-length results for the tested party. Such policies are typically memorialized in intercompany agreements, contemporaneous transfer pricing documentation, Advance Pricing Agreements (APAs), and/or tax rulings—each of which may require revision upon the conversion to IFRS.

The potential changes in revenue and expense recognition criteria under IFRS may affect a number of transfer pricing issues that are closely scrutinized by the Internal Revenue Service (IRS) and foreign taxing authorities. For example, in the area of cost-sharing arrangements (CSAs), accounting policy changes will likely impact (1) reasonably anticipated benefit calculations, (2) the definition of intangible development costs subject to CSAs, and (3) the treatment and accounting for share-based compensation in the cost-share pools.

Other key areas of consistent scrutiny by taxing authorities include the allocation of headquarter selling, general, and administrative (SG&A) expenses; shared services arrangements; and other intercompany transfers of services. The potential impact on commission agent/commissionaire arrangements will also need to be addressed.

The treatment of inventory under IFRS could also have a significant impact on transfer pricing determinations. As LIFO is not permitted under IFRS, an assessment will be needed to determine the impact that an alternative inventory valuation method could have on the company's ability to manage the targeted results of arm's-length transactions.

It is also important for tax executives to monitor APAs during the transition period, as well as those that will be initiated and executed prior to conversion, as there may be uncertainty regarding the results achieved under IFRS, as well as uncertainty associated with the critical assumptions relating to accounting standards. If a change in accounting standards represents a violation of the critical assumptions, tax executives will need to assess the most appropriate course of action in relying on or renegotiating the APA. Similarly, tax executives who currently rely on active tax rulings/holidays should assess the impact

of IFRS adoption and plan accordingly. The tax executive should also consider whether the changes in accounting policy will create new or impact existing issues for which an agreement was previously reached with taxing authorities in current and prior year audits.

Tax processes, systems, and controls

An IFRS conversion will not just change numbers; it will require significant changes to a company's financial and tax reporting processes, systems, and controls. Specifically, as IFRS policy changes are integrated into enterprise-wide financial reporting systems, tax accounting and compliance systems will simultaneously need to be updated. Further, resources within the tax function will need to be trained and controls will need to be evaluated and potentially updated. Tax executives must identify the impact of these and other related changes to the tax function early in the conversion process in order to manage the change process effectively and to avoid instances of data disruption that could lead to possible errors and other inefficiencies.

Consider this. When converting to IFRS, several new, potentially significant, book-tax differences may originate or amounts related to existing book-tax differences may change. In addition, the book data required to compute book-tax differences may no longer be captured, may change in format, or may move to a new or upgraded system. Therefore, tax systems must be aligned with financial reporting systems to ensure that correct information is gathered and calculated. For example, with respect to depreciation, US GAAP allows, but IFRS requires, the use of component depreciation. Under component depreciation, an asset is broken down into its significant components for purposes of determining depreciation, disposals, and repairs. US tax law, on the other hand, defines the relevant unit of property more broadly, generally examining whether a component is functionally interdependent with another component. As a result, it is likely that the unit of property used for financial reporting purposes under IFRS will differ substantially from the unit of property used for US tax purposes. It is critical that tax systems are updated during the conversion process in order to gather and calculate the local GAAP-IFRS-Tax data associated with this potentially complex book-tax difference, as well as other book-tax differences impacted by the adoption of new IFRS policies.

Converting to IFRS could also affect the processes required to calculate results-based compensation, as well as pensions, in an organization's subsidiaries worldwide. The tax executive will need to work closely with human resources and other groups to review not only the potential tax implications of IFRS on global compensation, equity, and pension plans, but also the systems that generate the data critical to the tax reporting process.

PwC observation: Significant data disruption issues could arise during the IFRS conversion process, as operationally several systems will be simultaneously impacted by the changes in financial accounting/reporting and tax planning. These changes may cause a significant strain on, or expose significant gaps in, the tax department's systems (e.g., tax accounting and tax compliance systems) as they often rely on data or systems operated outside of the tax department to calculate taxable income.

From a resource perspective, individuals will need to be trained and allocated to assist with the IFRS conversion, while simultaneously meeting the other competing priorities of the tax function. Tax executives will need to evaluate the size, competencies/training, roles and responsibilities, reporting lines, and geographic location of personnel during the conversion process to avoid turnover, loss of institutional knowledge, and replacement costs, as well as to avoid potential errors, omissions, and inconsistencies.

Converting to IFRS also requires that the existing control environment around taxes be re-evaluated. Evaluating the existing controls over financial reporting, as well as tax compliance, is critical to ensure sufficient time is available to review the design of the existing framework and to implement new controls, generate proper documentation, and perform the appropriate testing and review.

PwC observation: Up-front planning around the existing control environment will better enable a tax department to operate its revised IFRS controls effectively throughout the conversion process, as well as allow for time to assess the process and address inefficiencies prior to the filing of the first IFRS financial statements. Because of the Sarbanes-Oxley requirements of US registrants, more emphasis will be placed upon the embedding of revised IFRS processes into the internal control environment during the conversion.

What this means for your business

Getting started.

Start the planning process

How is it recommended that tax executives start planning for the IFRS conversion process?

Based on the timeline set forth in the SEC's proposed roadmap, companies, including their respective tax executives, have the opportunity to appropriately plan for the conversion to IFRS. Therefore, we recommended that companies start planning for the IFRS conversion process by performing the following:

- Implement a phased conversion approach
- Perform a Phase 1 preliminary impact assessment

Implement a phased conversion approach

Some companies may be inclined to “wait and see” how the adoption of IFRS in the United States proceeds. With a “wait-and-see” strategy, organizations may overlook issues that should be planned for and considered up front. This approach adds the unnecessary risks of making only partially informed decisions, underestimating the magnitude of the task, and incurring excess costs. A wait-and-see approach could lead to a large-scale effort that is likely to involve maximum disruption, heavy reliance on external resources, increased risks of errors on adoption— including missed one-time opportunities— and significant costs.

A phased approach provides organizations, including tax executives, with the opportunity to most efficiently and effectively plan for an IFRS conversion. By following a phased approach, organizations will be afforded time to plan and identify issues, while appropriately managing resource needs and costs, minimizing the level of business disruption, and maintaining alignment with other company initiatives. Given a possible conversion timeframe of 18 to 36 months, companies that start planning now can do it right the first time and reduce the likelihood of unforeseen consequences, including errors and missed opportunities.

The phased approach is the cornerstone of *TransitionIFRS*, PwC's proven, proprietary methodology for performing high-quality, well-controlled IFRS implementations. *TransitionIFRS*, which is described in detail in the PwC publication, *Mapping the change, IFRS implementation guide*, has been

used successfully in many territories across the world to help companies convert from their local GAAP to IFRS.

The three phases of *TransitionIFRS* can be applied to the tax function as follows:

Phase 1: Preliminary impact assessment—During this phase, a company performs a broad-based assessment of the impact IFRS will have on the tax function. This assessment allows tax executives to understand the big picture of how an IFRS conversion will potentially impact the tax function, equipping them with the knowledge they need to begin to plan for (i.e., identify and prioritize) the most significant issues, such as identifying potential changes in accounting methods or required amendments to the company’s intercompany arrangements.

Phase 2: Initial set-up and conversion—A company does most of the legwork of the conversion during this phase, as the focus now shifts from big picture to detailed work. Phase 2 represents the initial conversion to IFRS, including the development of shell IFRS financial statements, as well as the in-depth analysis, calculations, and documentation for all items within the global tax function impacted by the conversion.

Phase 3: Integrating change—Critical to the conversion process is incorporating IFRS changes into the day-to-day operations, processes, and systems of the tax function (known as “embedding”). This phase helps to ensure a smooth transition to the new reporting framework so the company, including its tax function, can use its new IFRS language on a sustainable basis in a well-controlled environment as of the IFRS adoption date.

Perform a Phase 1 preliminary impact assessment

By performing a phase 1 preliminary impact assessment, and including appropriate tax considerations in this assessment, organizations can get their arms around how IFRS will potentially impact their company’s global tax function and footprint. Specifically, this assessment will allow tax executives to understand IFRS, identify the key tax areas of concern, and prioritize the actions to move forward. As described in this publication, there are many potential tax accounting and tax planning issues that could potentially arise in the conversion to IFRS.

Plan now

The remaining question is “when.” *When should tax executives begin planning for an IFRS conversion (i.e., performing a phase 1 preliminary impact assessment)?*

We recommend now. As the mandatory IFRS adoption year is projected to be 2014 for large accelerated SEC filers, these companies may be required to provide IFRS-compliant financial reporting data for years 2012, 2013, and 2014. Although the length of an IFRS conversion varies on a company-by-company basis, for many companies, converting to IFRS takes, on average, 18 to 36 months. Therefore, for companies preparing to fully embed IFRS in the company’s financial reporting processes by 2012, the conversion process may begin as early as 2009, with initial planning efforts needed beginning in 2008. Further, since many tax executives forecast tax planning three to five years in advance, they should also begin planning for the effects of IFRS within these analyses.

The SEC’s proposed timeline for the mandatory adoption of IFRS provides companies with sufficient time for a measured and successful conversion. Through a well-planned, phased approach, tax executives can be involved at the outset and throughout the entire conversion process to ensure all issues impacting the company’s global tax function are properly addressed. The best way to manage the quality, benefits, and overall cost of an IFRS conversion is to be prepared and begin the planning process now.

PricewaterhouseCoopers is committed to helping companies navigate the conversion from US GAAP to IFRS. With that in mind, please visit www.pwc.com/usifrs to view a complete list of our comprehensive IFRS thought leadership, webcasts and additional tools addressing the business and technical issues that companies should be considering in anticipation of the inevitable move from US GAAP to IFRS.

To have a deeper conversation about how this subject may affect your business, please contact:

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