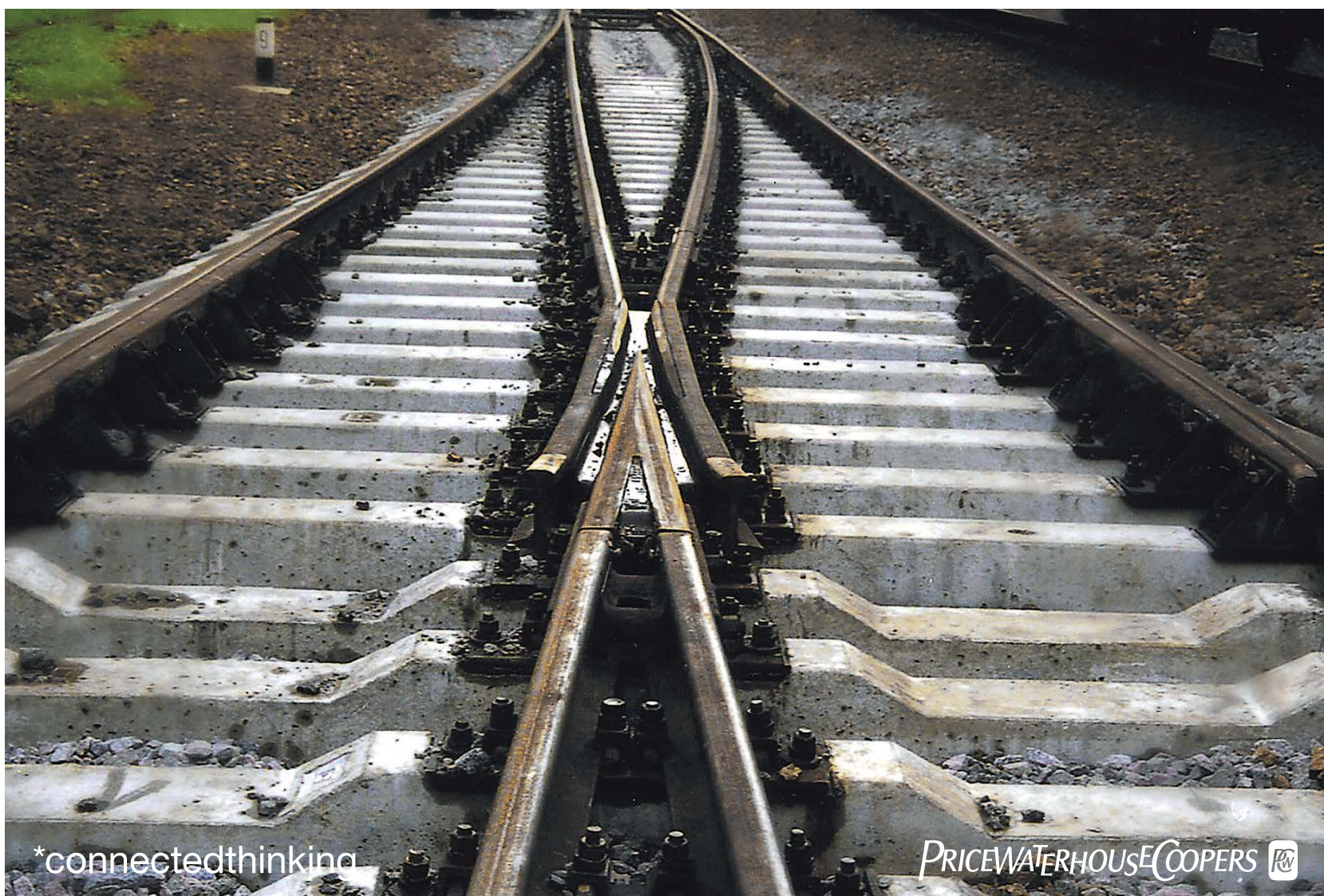


IFRS: The right move toward convergence*

What IFRS will mean to US tax executives



*connectedthinking

The question appears to no longer be “if” but “when”—when will the US join the rest of the developed world in adopting International Financial Reporting Standards (IFRS), as issued by the International Accounting Standards Board (IASB)?

What IFRS will mean to US tax executives

The conversion to IFRS will have a pervasive impact on today's global tax function . . . The involvement of tax professionals is important at every stage of the IFRS conversion process.

US companies may be able to elect to use IFRS as early as 2009. The implications to the tax executive go well beyond the potential impact on a company's effective tax rate or income tax related disclosures in the financial statements. The move to IFRS has broad implications to the tax function, potentially impacting a company's global cash tax obligations, international tax planning and underlying systems, processes and controls.

The potential for converting to IFRS is a topic being discussed at the executive and board of director levels of an increasing number of US multinational companies. Companies are organizing cross-functional teams to address the various aspects of a potential move to IFRS. **It is essential that the tax executive be part of the IFRS conversion process at a very early stage.**

Potential timetable for the US move to IFRS

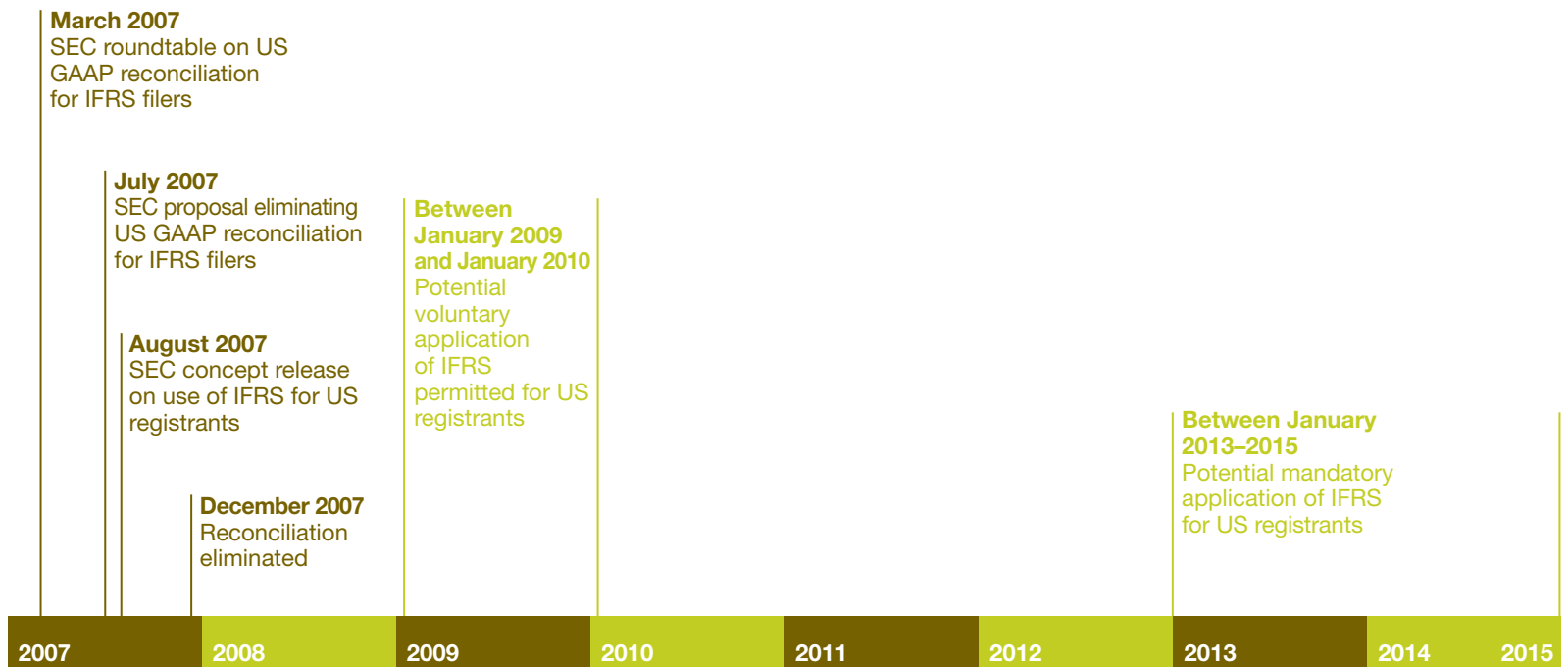
Since the European Union adopted IFRS in 2005, over 100 countries have moved to require or permit the use of IFRS. The European Union, Australia, Canada, Brazil, India, Japan, China and other major markets have either already converted to IFRS or are in the process of doing so. IFRS is also widely used in Eastern Europe and Russia.

Momentum toward the adoption of IFRS for US financial reporting accelerated in the wake of two SEC moves in the second half of 2007. The first was a decision to eliminate the requirement for foreign private issuers using IFRS as their primary reporting framework to provide a reconciliation to US GAAP as part of their filings with the SEC. The second was the issuance of an SEC concept release requesting comment on allowing US companies to use IFRS as a primary reporting framework. Responses to this proposal have been favorable, with approximately two-thirds of respondents favoring a mandatory adoption date.

A move to IFRS may be both inevitable and advantageous for US multinationals. One projected timeline estimates that IFRS could be mandatory in the US by 2013-2015, while early adoption options may be available as early as 2009.

IFRS offers a promise of a single worldwide standard for financial reporting. IFRS will enhance comparability and transparency, which will be beneficial to all stakeholders. A single standard should create cost efficiencies for global companies and, with fewer rules and exceptions, help to reduce complexity and the risk of errors.

Estimating the transition timeline



A pervasive change in framework

Gaining an understanding of IFRS is essential for the tax executive responsible for a company's global tax function. The move to IFRS involves a fundamental change in the framework of how US companies measure pre-tax income and the principles governing accounting for income taxes.

Tax executives recognize that the move to IFRS will potentially impact a company's effective tax rate and other aspects of tax accounting and reporting. However, the move to IFRS will have significantly broader implications to the tax executive. The pre-tax and other financial accounting aspects of IFRS have a myriad of tax method of accounting considerations. IFRS will have other implications on US taxes, international tax planning, state and local taxes and transfer pricing determinations. Additionally, processes, controls and systems for tax reporting and compliance will need to be modified as underlying accounting systems change to IFRS.

The involvement of tax professionals is important at every stage of the IFRS conversion process. Proper assessment of the tax impact of each potential accounting change requires insight into the applicable tax rules and regulations (in the various tax jurisdictions) as well as knowledge of the detailed differences among US GAAP, existing statutory accounting and IFRS.

Cash tax implications—US and non-US

The move to IFRS could have a significant impact on both US 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 US 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 US, 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 US 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, US 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-US 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.

International tax considerations

The cash tax implications go well beyond differences in accounting for items of revenue and expense. The move to IFRS may have an impact on international tax planning considerations as well.

In jurisdictions where statutory accounting forms the basis of classification of debt versus equity for tax purposes, a review will need to be made of financing structures and the impact IFRS has on them to determine the related tax implications. Similarly, in some jurisdictions, the characterization of a transaction as a lease is often dependent on the accounting for statutory purposes.

The use of fair value measurement is also an important aspect of IFRS and used more frequently in certain areas. For example, under IFRS companies can elect to measure property, plant equipment and investment property at fair value, and certain financial instruments may be required to be carried at fair value. These measurement concepts could have a significant impact on debt-to-equity and other balance sheet ratios, resulting in limitations on interest deductibility.

Conversion to IFRS is also likely to have a significant impact on other aspects of international tax planning, including cash repatriation. Changes in a foreign entity's cash tax liability will need to be reviewed for foreign tax credit implications, including Subpart F high-tax exception determinations. A review will also need to be made of E&P computations for consistency with existing accounting methods and, where appropriate, consideration given to changing E&P accounting methods to conform with the policies being adopted in the IFRS conversion process. Lastly, the ability to make distributions from foreign affiliates may be affected to the extent that the accounting under IFRS results in a significant change in distributable reserves on the statutory books of particular foreign entities.

The impact of these various international tax considerations will vary by company and by industry. Therefore, to the extent international tax and cash repatriation planning is an important aspect of a company's overall tax and treasury strategy, it will be important for the tax executive to gain insight into the potential pre-tax implications of IFRS, even if the move to IFRS for external reporting is on the longer-term horizon.

Tax accounting—the move toward convergence

Despite similarities in the approaches to accounting for income taxes under US GAAP and IFRS, there are still certain key differences between the two accounting standards.

While today there are approximately 15 to 20 differences between the standards, after convergence there may only remain 3 to 4 major differences, including FIN 48 and FAS 123R.¹ The remaining differences in policies and principles, combined with the impact of applying IFRS on pre-tax accounting income and shareholders' equity, could have a substantial impact on a company's tax provision and effective tax rate.

One of the more important tax accounting differences that will likely remain after the convergence is the accounting for uncertain tax positions. The IASB has indicated that its current intention is not to adopt the recognition, measurement and disclosure requirements of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). This means that US companies moving to IFRS may again need to change the way they account for and disclose uncertain tax positions.

Unlike the benefit recognition model of FIN 48, under IFRS today, a liability for tax uncertainties is based on the amount of taxes expected to be paid to the tax authorities. IFRS does not specify a two-step process of recognition and measurement, nor does it prescribe a specific approach to measurement. The IASB has tentatively decided to move to a model with no recognition threshold for uncertainties and measurement using weighted average probability.

IFRS currently has no specific disclosure requirements for uncertain tax liabilities. However, there is a proposed exposure draft that would modify IAS 12 to provide general disclosure guidance for uncertain tax positions. This proposed disclosure is less prescriptive than FIN 48.

Other tax considerations

State and local tax

The move to IFRS will have other important implications for the tax executive. It may affect a company's overall state and local tax position. State and local taxes will be impacted by the changes in the federal income tax base. Fair value measurement and other changes in the balance sheet may impact net worth and affect franchise and property taxes where the book accounting treatment forms the basis for taxation. Additionally, changes in revenue recognition policies and fair value measurement may affect various state apportionment factors.

¹ After the current FASB/IASB convergence project with regard to income taxes becomes effective, there may still be differences between IFRS and US GAAP in tax accounting principles. Examples include accounting for uncertain tax positions, deferred taxes on share-based payments, deferred taxes related to the effect of a change in an entity's tax status and specific exemptions applicable under FAS 109, such as those for leveraged leases and disclosure requirements.

Systems, processes and controls

For US multinational companies, systems, processes and controls used within the tax department have been primarily designed to deliver information to meet the financial statement reporting requirements of US GAAP, along with various tax compliance and reporting requirements. Recent developments in tax and financial reporting have increased the importance of these systems and processes as companies have sought to automate and enhance their tax processes to reduce risk and increase efficiency. A change in the underlying accounting to IFRS will require tax departments to perform a review of their systems and processes for gathering tax-related data. Systems and processes that have been used to track or compute book-tax differences, record the tax treatment of stock-based compensation, or calculate the tax provision will need to change. Transfer pricing documentation, as well as APA's and tax rulings that may have been based on US GAAP or local statutory accounting, may need to be recast onto an IFRS basis in order to provide comparability between pre-adoption and post-adoption periods. Along with the changes in systems and processes, public companies will need to review and update internal controls around tax accounting and reporting for compliance with Sarbanes-Oxley.

Compensation, benefits and human resources

Compensation and benefit plans must also be addressed in view of the differing tax systems worldwide and their impact on tax deductibility of stock options and other compensation-based rewards. A switch from US GAAP to IFRS could affect the processes required to calculate results-based compensation in an organization's worldwide subsidiaries. Pensions will also be affected as there are differences between the two sets of standards in accounting for unrealized gains and losses and in the treatment of vested prior service costs. The tax executive will need to work closely with human resources and other groups to review the potential tax implications of IFRS conversion on global compensation, equity and pension plans.

Finally, the tax executive will need to focus on training and development of people to address the change to IFRS. This will include not only education around the pre-tax and tax accounting differences, but also any associated changes in the systems, processes and controls utilized in the tax function. Given the current demand for tax resources, it will be important for tax executives to invest in people to ensure that the tax function is prepared to meet the challenges presented by a conversion to IFRS.

Moving forward

The move to IFRS in the US is rapidly building momentum. Over 100 countries have moved to require or permit the use of IFRS. With recent SEC developments, the optional or mandatory use of IFRS for US companies may only be a question of time.

Financial reporting is going through a dramatic change with the move to IFRS. However, a conversion to IFRS is more than a financial accounting exercise. The conversion to IFRS will have a pervasive impact on an organization.

For the tax executive, the conversion to IFRS will affect major aspects of the tax function. It will require a detailed understanding of the interaction between financial reporting, local country statutory accounting and tax. It will be imperative for the tax executive to be involved from the start of an IFRS conversion project in order to analyze the implications on the company's reported effective tax rate, cash taxes, tax planning, and systems, processes, controls and resources.

Adoption of IFRS may include both tax opportunities and pitfalls. As the impact on your company's taxes may be substantial, you should prepare now in order to influence the outcome.

Contacts

The white paper is intended not just to inform but to raise questions. Clients of PricewaterhouseCoopers may want to open a dialogue about IFRS with their PwC engagement partner or the primary authors of this paper who welcome any questions about the tax implications of IFRS:

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