

TAX ISSUES RELATED TO THE ADOPTION OF IFRS IN THE UNITED STATES

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ABSTRACT

There is a great deal of effort toward replacing U. S. GAAP with accounting standards promulgated by the International Accounting Standards Board. The SEC has outlined a roadmap in order to accomplish this task. If the International Accounting Standards are adopted, it will create a number of changes in how accounting is performed in the United States. It appears that, rather than adoption, there may be a convergence of the two sets of standards. This paper examines the issues related to the adoption, or adaption, of international accounting standards in the United States in the area of income taxes.

INTRODUCTION

There has been much discussion of, as well as movement toward, adoption of International Financial Reporting Standards (IFRS) in the United States, replacing the Financial Accounting Standards Board pronouncements as generally accepted accounting principles (GAAP).

On August 27, 2008, the Securities and Exchange Commission (SEC) announced its roadmap toward eventual adoption of IFRS for financial reporting in the United States [1]. This roadmap contains a proposal for a limited number of U. S. public companies to elect to adopt IFRS as soon as 2009. These companies would have to meet the screening process established by the SEC to qualify for adoption. Over a three-year period, the SEC would monitor progress against certain established milestones. The pool of eligible companies is 110 of the largest publicly-held companies in the United States, representing approximately 14 percent of the U. S. market capitalization [1]. Newly installed SEC Chair Mary Schapiro extended the comment period for the roadmap by two months and has expressed reservations about the independence of the IFRS and the quality of the rules coming from that body. She has also expressed concerns about the roadmap itself, especially the pace toward adoption [8].

At the conclusion of this three-year period in 2011, the SEC would consider whether to require use of IFRS by all U. S. public companies. Assuming a decision to proceed, implementation would be phased in between 2014 and 2016 [1]. It would appear that a positive decision to proceed would be forthcoming at this point. It is hard to imagine that companies representing up to 14 percent of U. S. market capitalization would follow a new set of accounting standards, then be compelled to switch back

to U. S. GAAP in only a few short years. While it once appeared a foregone conclusion that the U. S. would move in this direction, there are signs that full adoption may not occur. Some remain opposed, while others have moved toward convergence with IFRS, rather than adoption.

An additional factor from the income tax perspective is the March 31, 2009 release of the IFAS Exposure Draft on Income Taxes. This document, if adopted, would replace IAS 12 and move the IFRS closer to FAS 109 and FIN 48. This paper will compare tax differences in FASB standards with IAS 12 and the Exposure Draft. No date has been set for adoption of the new IFAS standard, but the current timetable is to issue the new standard in the second half of 2010. Normally, the effective date for a new IFRS standard is six to 12 months after adoption, so it would likely take effect sometime in 2011 [4]

WHAT IS THE IFRS?

The International Financial Reporting Standards (IFRS) are issued by the International Accounting Standards Board (IASB), which grew out of the International Accounting Standards Committee (IASC). IASC standards were issued between 1973 and 2001. In April 2001, the IASB adopted all outstanding pronouncements of the IASC (International Accounting Standards or IAC) and continued development of a body of international standards [17].

Presently, IFRS is used in over 100 countries for filings by listed companies. [10]. IFRS is generally considered to be a principles-based body of standards, as opposed to the rules-based standards of U. S. GAAP. As such, IFRS contains a less extensive body of literature than U. S. GAAP and does not contain a large amount of industry-specific guidance. IFRS does not include detailed implementation guidance, therefore giving rise to more circumstances where application of IFRS standards will require exercise of professional judgment.

IFRS STATUS IN THE UNITED STATES

The move toward convergence of U. S. GAAP with IFRS had its formal beginnings on October 29, 2002, with the adoption of the Norwalk Agreement. This document, agreed to by the FASB and the IASC, was a commitment by both organizations to work toward convergence of U. S. and international accounting standards. This two-page document, referred to as a “Memorandum of Understanding,” set four areas as “high priority.”

- Short-term projects aimed at removing a variety of individual differences between the two sets of standards.
- Removing other differences through coordination of future work programs.
- Continue progress on joint projects currently underway.
- Encourage their respective interpretative bodies to coordinate their activities [7]

Consequently, the two organizations have worked together on convergence since that time, making progress toward a unified body of accounting standards. However, there has become increased interest in not just convergence, but adoption of IFRS by the United States. In July and August, 2007 the SEC formally considered allowing foreign filers to file financial statements with the SEC in accordance with IFRS rather than GAAP. It also asked whether domestic filers should be permitted to use IFRS. Action was taken on this issue the following December when the SEC issued Release No. 33-8879

permitting foreign private issuers to file financial statements in accordance with IFRS. No reconciliation with GAAP was needed [10].

Subsequently, in an SEC roundtable, participants discussed the potential IFRS adoption process in the United States. Three points emerged as dominant in this discussion:

- The objective should be a single set of high-quality, globally accepted financial reporting standards.
 - Both U. S. GAAP and IFRS are high-quality standards but much of the world has followed IFRS.
 - The SEC should set a “date-certain” for application of IFRS by U. S. public companies.
- [10]

Since that time, SEC actions and proposals have made it clear that the appropriate set of standards must be IFRS as issued by the IASB.

SEC ROADMAP

In addition to the timeline set by the SEC in announcing its roadmap for adoption of IFRS by the all U. S. public companies, the roadmap established four milestones. The first of these milestones is “continued improvement in IFRS and progress toward convergence of U. S. GAAP and IFRS.” [10] This would seem to indicate some concern about the quality of IFRS in its present state. It might also signal a desire to incorporate certain aspects of U. S. GAAP as a part of IFRS.

The second milestone deals with IFRS accountability and funding stability. There is some concern about the financial viability of IFRS, as its operations have been financed largely through voluntary contributions from companies, accounting firms, international organizations, and central banks. The roadmap seeks a funding mechanism that would enable the IASB to remain a stand-alone, private sector organization with the necessary resources [3].

Third, the SEC seeks improvement in the use of interactive data by IFRS. The SEC has invested heavily in XBRL and would expect IFRS information would be provided to the SEC in this format. The fourth milestone is somewhat related, as it deals with education and training in regard to IFRS. [3].

WHY IFRS?

Although there are significant obstacles to overcome, it would seem that the SEC regards IFRS as the wave of the future and is likely to be adopted in the United States. This is one compelling reason why the adoption of IFRS is seen by many as inevitable. There are two additional reasons why it is likely to happen.

A U. S. move to IFRS would place United States Accounting Standards in company with over 100 other nations that have adopted or permit these standards. This is a second reason why IFRS is likely to become the standard in the United States. With such widespread acceptance, IFRS is well on the way to being the single set of high-quality accounting standards desired by global market participants [2].

Third, adoption of IFRS is seen as necessary for the United States to compete in the global marketplace. Having the same set of accounting standards as much of the world would attract subsidiaries of foreign corporations to the U. S. It would facilitate the location of branches of U. S. companies on foreign soil. International investors would be more attracted to U. S. investments and it would become easier to make valid comparisons of U. S. and foreign entities [12].

TAX CONSIDERATIONS WITH IFRS

There is no doubt that adoption of IFRS would create change in the way financial accounting is done in the United States. The impact would be widespread over a number of financial statement items. This paper will survey some of the major effects that adoption of IFRS in the United States will have on the tax scene. There are five areas that will be covered by this paper – share-based payments, uncertain tax positions, inventory valuation method, interim reporting, and intraperiod allocations. These areas are not exhaustive of the differences in IFRS and U. S. GAAP, but they are among the more important issues. As mentioned, the existing IFRS standard will be examined, along with changes proposed in the Exposure Draft. Many of the important changes in the ED are related to uncertain tax positions [4].

EXPOSURE DRAFT TO REPLACE IAS 12

On March 31, 2009, the IASB published an Exposure Draft of a new standard designed to replace IAS 12. This proposal covers a number of topics related to accounting for income taxes. It is not the intent of this paper to deal with these changes, however they will be discussed as they relate to the topics covered in this paper. Two areas have pervasive impacts on the entire area of accounting for income taxes and will be covered briefly.

The new definition of tax basis in the Exposure Draft places less emphasis on management intent. Under the proposal, the tax basis of an asset is determined by the tax consequences of selling it for its carrying amount at the reporting date. Measurement of the tax basis is determined by tax law. This is a departure from the current practice of reflecting the manner in which the entity expects to recover the asset [4]. This brings the IASB more into line with current practice under U. S. GAAP.

Additionally, the Exposure Draft changes the IFRS definition of temporary differences. Under IAS 12 a temporary difference is the difference between the carrying amount of an asset or liability in the statement of financial position and its tax base. The Exposure Draft reflects that the tax basis is the amount that the entity expects will affect taxable profit when the carrying amount of the asset or liability is recovered or settled. The difference in IFRS and U. S. GAAP lies in the definition of a temporary difference [4].

SHARE-BASED PAYMENTS

Under U. S. GAAP deferred tax benefits are recorded for share-based payment awards that are expected to be deductible for tax purposes based on the amount of compensation expense recorded for the share award. This is true even if the award has no intrinsic value. IFRS recognizes deferred tax benefits only for those awards that currently have an intrinsic value that would be deductible for tax purposes [12]. The Exposure Draft makes no change in this approach.

Additionally, an award that becomes exercisable based on the achievement of a service or market condition is treated as a single award under U. S. GAAP. Under IFRS, such an award is treated as two awards with different service periods and fair values. Compensation costs associated with the service component would be reversed under IFRS if the condition was not met [12].

In transactions with non-employees U. S. GAAP allows valuation based on either the fair market value of the goods or services rendered or the FMV of the equity instrument. IFRS specifies that valuation should be based on the value of the goods or services rendered. The FMV of the equity instrument can be used only if the value of the goods or services cannot be reliably determined [13].

Both standards allow compensation cost awards to be recognized on an accelerated basis. U. S. GAAP, however, allows straight-line recognition. Each award must be separately measured under IFRS, but U. S. GAAP allows measurement of the whole in addition to separate measurement [13].

In cases where the award has an equity repurchase feature with an option by the employee, U. S. GAAP does not require recognition of a liability under certain circumstances. IFRS requires recognition of such liability in all cases [13].

The amount of deferred taxes to be recognized under GAAP is based on the cumulative GAAP expense recognized and trued up or down upon realization of the tax benefit. If the tax benefit exceeds the deferred tax asset, the excess is credited to shareholder equity. Any shortfall of tax benefit below the deferred tax asset is charged to shareholder equity, then to tax expense when the amount of benefit reaches zero. IFRS calculates the deferred taxes based upon the estimated tax deduction determined at each reporting date. If the tax deduction exceeds cumulative compensation expense, the deferred tax based on the excess is credited to shareholder equity. If the deduction is less than the cumulative compensation expense, deferred taxes are recorded in income [13]. At this time, there are no convergence activities in this area.

UNCERTAIN TAX POSITIONS

FIN 48 utilizes a two-step procedure for recognizing uncertain tax positions. This approach separates recognition and measurement. First, the entity must determine whether recognition of an uncertain tax position is appropriate, then the amount of the uncertain position must be measured. Measurement utilizes a cumulative probability model [14]. Uncertain tax positions are not currently explicitly recognized under IFRS as there is no specific guidance. The Exposure Draft contains no recognition threshold but requires the company to review and measure **all** uncertain tax positions [5]. This would likely result in more tax positions being recognized under IFRS than under U. S. GAAP.

Measurement under the Exposure Draft would use a probability-weighted average of expected outcomes, which differs from the cumulative-probability approach of FIN 48 [12]. The differences in these approaches are illustrated in Table 1.

TABLE 1

IFRS Probability Weighted-Average Approach

Estimated Outcome	Individual Probability	Probability-weighted Calculation
\$1000	10%	\$100
\$ 750	20%	\$150
\$ 500	30%	\$200
\$ 300	30%	\$ 90
\$ 0	10%	\$ 0
		\$540 Amount Recognized

FIN 48 U. S. GAAP Cumulative Average Approach

Estimated Outcome	Individual Probability	Cumulative Probability
\$1000	10%	10%
\$ 750	20%	30%
\$ 500	30%	60% (over 50%)
\$ 300	30%	90%
\$ 0	10%	100%
	100%	

Detection risk is not considered in the probabilities under GAAP or in the Exposure Draft. Also in line with FIN 48, re-measurement could only be done based on new information and not on a new interpretation of the facts [5]. Disclosures of uncertain tax positions (UTP) under IFRS are currently limited to “disclosing tax related contingencies such as disputes with tax authorities. [5]. This is expanded somewhat under the Exposure Draft to include:

- A description of the uncertainty.
- An indication of the UTP’s potential financial effects on the amounts recognized and the timing of those effects.
- The effect of tax rates, enacted or substantially enacted, after the end of the reporting period on all current and deferred taxes and liabilities.
- The effect on deferred tax expense of any change in the possible outcomes of a review by tax authorities [5].

Other disclosures mirror or closely resemble those under FIN 48. It should be pointed out that FIN 48 is much more prescriptive in the nature of the required disclosures. One observation on the IFRS disclosures is of note. IFRS allows inclusion of “substantially enacted” tax rates while FIN 48 is limited to enacted rates.

Regarding recognition of deferred tax assets (DFA), U. S. GAAP states that they are to be recognized in full. However, a valuation allowance is allowed to the extent that an amount is not expected to be realized. IAS 12 recognizes deferred tax assets to the extent that it is probable that taxable profit will be available to utilize the DFA. The amount is reassessed as of each balance sheet date. The Exposure Draft moves from the one-step approach to a two-step approach including a valuation allowance

such as with U. S. GAAP. Additionally, the standard for recognition has been changed from “probable” to “more likely than not,” reflecting the approach of FIN 48.

In calculating the amount of the deferred tax asset or liability, FIN 48 specifies that the enacted rates must be used while IAS 12 permits substantially enacted rates as of the balance sheet date. The Exposure Draft makes no change here, but it does clarify the definition of “substantially enacted” to indicate that for U. S. jurisdictions “substantially enacted” equates to when tax laws are enacted [13]. In this instance it would appear that convergence has been obtained by making the definition broad enough to fit U. S. practice.

Present rules under IFRS specify that all deferred tax assets and liabilities are classified on the balance sheet as non-current regardless of the underlying items to which they relate [9]. U. S. practice mandates that they are classified as current or non-current based on the nature of the related asset or liability. The Exposure Draft brings the IFRS in line with U. S. practice using a current/non-current classification system. However, it also specifies that any deferred tax item not related to an underlying asset or liability should be classified according to the expected reversal date [5].

INVENTORY COSTING

Much of the attention in inventory costing has been focused on the lack of LIFO inventory valuation in IFRS. The IFRS Exposure Draft makes no changes in this area. It would appear that this issue will be a moot point in any convergence issues between U. S. GAAP and IFRS. President Obama included LIFO repeal in his 2010 budget proposal. This would take effect in 2012 and is estimated to increase tax revenues by \$61 billion through 2019 [Whitehouse]. Regardless of the method utilized, IFRS requires that the same cost formula be applied to all inventories. U. S. GAAP does not explicitly make this requirement [13]

In terms of measurement, IFRS allows inventory to be carried at the lower of cost or net realizable value (NRV). NRV is the best estimate of the net amounts that inventories are expected to realize. This may or may not equal fair value. U. S. GAAP utilizes the lower of cost or market approach, in which market is defined as current replacement cost but not greater than NRV. IFRS allows a reversal of previously recognized impairment losses while U. S. GAAP takes the position that write-downs create a new cost basis that cannot be reversed [13]. It should also be noted that the Obama budget calls for the repeal of the lower of cost or market for tax purposes [15].

A final significant difference in inventory methodology relates to the use of the retail inventory method (RIM). U. S. GAAP specifies that permanent markdowns do not affect the gross margins used in applying RIM. These markdowns reduce the carrying cost of the inventory. Under IFRS permanent markdowns do affect the average gross margin calculation [13].

FAS 151 was issued by FASB in 2004 to address the issue of accounting for inventory costs in regard to abnormal amounts of idle facility expenses, freight, handling costs, and spoilage. This was intended to address a difference between U. S. GAAP and IFRS in this area. No additional convergence efforts in this area are planned at this time [13].

INTERIM REPORTING

There are more similarities than differences between U. S. GAAP and IFRS for Interim Financial Reporting. It should be observed that the U. S. standard precedes the Financial Accounting Standards Board as Interim Financial Reporting is covered in APB 28. The FASB has plans to address the issue of presentation and display of interim financial information. The IAS anticipates an Exposure Draft on this topic in the second quarter of 2010 with a new IAS to be issued in 2011 [18].

This statement, along with IAS 34, requires that the same accounting policies that were used in the prior year be used in the interim statements, subject to adoption of new policies that are disclosed. Neither standard mandates which entities are required to issue interim statements.

U. S. GAAP views interim periods as integral parts of an annual cycle, allowing certain costs to be allocated among the interim periods that benefit more than one of those periods. IFRS takes a discrete-period approach to interim financial statements, treating them as separate and distinct accounting periods. IFRS specifies that income taxes are accounted for based on an annual effective tax rate. This is similar to treatment by U. S. GAAP [12]. With both bodies examining this issue, it should be anticipated that the differences will be eliminated or reduced.

INTRAPERIOD ALLOCATION OF DEFERRED INCOME TAXES

There are three elements to the U.S. GAAP approach for intraperiod allocations of deferred income taxes as outlined in FAS 109:

- The effect of a change in the valuation allowance from the beginning of the year is included in income from continuing operations.
- The effect of a change in deferred tax assets or liabilities due to a change in the tax rate is included in income from continuing operations.
- All items should be considered in determining the amount of tax benefit that results from a loss from continuing operations [11].

The IFRS approach under IAS 12 includes the tax in profit or loss unless the transaction is recognized directly in equity. Any changes in amounts originally recognized directly in equity are also recognized in equity. The Exposure Draft adopted the FAS 109 approach but also included an alternative.

CONCLUSION

Someone once said that the only constant is change. This statement certainly applies to accounting standards as we know them in the United States. Based on recent events, it would appear that convergence is more likely than a blanket adoption of IFRS. It would seem that the Exposure Draft to replace IAS 12 is a precursor of things to come. Under this scenario, IFRS seems to be moving toward adapting to the “best” of U. S. GAAP. In cases where U. S. GAAP cannot be adapted or it is seen as not feasible to adapt, IFRS broadens its definitions to include U.S. GAAP under its umbrella. There will be changes in accounting for income taxes in the United States. Specifically what these changes will be, or the extent of the changes, can be known only as they unfold.

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