COMING SOON: INTERNATIONAL FINANCIAL REPORTING STANDARDS[1]

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Abstract

For the past two decades, the Securities and Exchange Commission has been pushing for a single set of high-quality financial reporting standards. In an increasingly global business environment, uniform financial reporting allows for easier comparison between US domestic corporations and their foreign competitors, and will help to facilitate increased cross-border investment and capital market participation. These international financial reporting standards are known as IFRS. Given the magnitude of this change, a successful overhaul of financial reporting will require multilateral participation between regulators, standard setters, the private sector, and academia. MTC constituents, namely state tax administrators, should consider the following questions: (1) What are IFRS?; (2)How will IFRS affect corporate tax revenues?; (3)How will IFRS affect sales and use taxes, and gross receipts taxes?; (4)What steps need to be taken in order to prepare for this change?

I. **Introduction**

In an increasingly global business environment, uniform financial reporting standards that allow for easier comparison between US domestic corporations and their foreign competitors, and facilitate increased cross-border investment and capital market participation are necessary. For the past two decades, the Securities and Exchange Commission (SEC) has been pushing for the adoption of such a set of high-quality financial standards. These international standards are known as the International Financial Reporting Standards (IFRS). According to recent SEC guidelines, beginning in 2014, certain large, publicly traded U.S. businesses will have the option to transition from the current reporting standards -- the Generally Accepted Accounting Practices (GAAP) and to issue financial reports using IFRS. By 2016, all publicly traded companies may be using IFRS.

Today, over 100 countries around the world have adopted IFRS. Current users of the international standards include Australia, Israel, South Africa, Switzerland, and all the members of the European Union who list their shares on EU exchanges. All four of the BRIC countries- Brazil, Russia, India, and China have either adopted IFRS, set a firm deadline for the transition, or have committed to the convergence of their own standards to conform to IFRS. Canada, Korea, and Japan are in the process of converging to IFRS and will do so by 2011. The Mexican Comision Nacional Bancaria y de Valores has announced that all companies listed on the Mexican Stock Exchange must convert to IFRS by 2012.[2] It now appears that the United States will be among the last to convert, as the SEC has recently suggested a 2016 deadline for implementation. At this time, however, there is still uncertainty as to whether or not the U.S will ultimately make the transition.

Given the potential magnitude of this change, state tax administrators, should consider the following questions:

- **What are IFRS?**
- **How will IFRS affect corporate tax revenues?**
- **How will IFRS affect sales and use taxes, and gross receipts taxes?**
- **What steps need to be taken in order to prepare for this change?**

However, before we begin to answer those questions, we will digress and provide a brief history of IFRS.

Brief History of IFRS*:*

The development of international financial reporting standards (IFRS) began in 1973 with the formation of the International Accounting

Standards Committee (IASC). The stated purpose of this organization was to promulgate standards "capable of rapid acceptance and implementation world-wide". To that end, the IASC drafted a series of International Accounting Standards (IAS's) which were published in the year 2000 and collectively form the body of IFRS.[3] In 2001 the IASC underwent a significant restructuring. Presently, the ISAC Foundation is a non-profit private organization that is governed by 22 trustees who come from North America, Europe, Asia/Oceania and other regions of the world. Trustees are responsible for governance, oversight, and funding of the organization and are accountable to a monitoring board comprised of leaders from the International Organization of Securities Commission, the European Commission, the Japan Financial Services Agency, and the SEC. The IASC oversees the International Accounting Standards Board (IASB) which is responsible for drafting IAS's. The IASB is made up of 15 members from 9 countries, and the board is supported by an interpretations committee and advisory council.

Although the Securities and Exchange Commission (SEC) has only recently established a formal timeline for public companies to transition from U.S GAAP to IFRS, the Commission began pushing for international accounting standards back in the 1980's. In its 1988 Policy Statement the SEC identified the need for a set of international accounting standards that would streamline the regulatory process while still providing useful information to the investment community.[4] The development of these standards was the result of multilateral cooperation between the International Organization of Securities Commission (IOSC) and the International Accounting Standards Committee (IASC). In response to the National Securities Market Improvement Act of 1996, the Commission was asked to issue a report to update Congress on the development of international accounting standards. This report included analysis of the structure and governance of the IASC and IOSC, and a description of the Core Standards Project which would eventually result in the creation of the IAS's comprising IFRS. The Commission also used this opportunity to reaffirm its position that IFRS were needed to facilitate global investment and reduce compliance costs and inefficiencies.[5] In the year 2000 the SEC began to identify and seek comment on the "elements necessary for developing a high quality, global financial reporting framework for use in cross-border filings."[6] The 2000 concept release included analysis of significant accounting differences in the areas of recognition, measurement, and reporting as well as a description of the IASC. These differences are described in detail elsewhere in the article. The commission also used the release to seek comment on the requirements for accepting, from foreign private issuers, financial statements prepared using IFRS with an accompanying GAAP reconciliation. In 2002 the FASB and IASB affirmed their commitment to converging U.S GAAP with IFRS with the Norwalk Agreement. In this agreement, the two boards decided to "undertake a short-term project aimed at removing a variety of individual differences between U.S. GAAP and International Financial Reporting Standards…"[7] A major event in the convergence of the two standards took place in January of the present year when the Commission passed a rule allowing foreign private issuers who normally file form 20-F to use IFRS based financials without a GAAP reconciliation. The reasoning for adopting this rule was two-fold; first, it creates cost savings for foreign issuers, and also because this move was consistent with the SEC's "…efforts to foster a single set of globally accepted accounting standards…"[8] The most recent development in this saga was the release of the proposed roadmap for the use of IFRS by U.S issuers. The milestones, summarized in exhibit 1, are the criteria by which the commission will evaluate the feasibility of the new standards.

Although the roadmap provides a sense of the direction we are heading in, it creates an element of uncertainty as to whether or not the U.S will make the switch to IFRS. Adding to this uncertainty is the increased pressure, scrutiny, and loss of credibility the Commission has faced as a result of the events of 2008- most notably the subprime-crisis and the Madoff scandal. Given the considerable investment of resources necessary to complete a conversion to IFRS, U.S companies and Tax Authorities may be reluctant to begin preparations for the transition- and are thereby more likely to be caught off guard if and

Table 1

Milestones 1-4 (issues that need to be addressed before mandatory adoption of IFRSs)

1. Improvements in accounting standards (i.e., IFRSs).
2. Funding and accountability of the International Accounting Standards Committee Foundation.
3. Improvement in the ability to use interactive data (e.g., XBRL) for IFRS reporting.
4. Education and training on IFRSs in the United States.

Milestones 5-7 (the transition plan for the mandatory use of IFRSs)

5. Limited early use by eligible entities - this milestone would give a limited number of US issuers the option of using IFRSs for fiscal years ending on or after 15 December 2009.
6. Anticipated timing of future rule-making by the SEC - on the basis of the progress of milestones 1-4 and the experience gained from milestone 5, the SEC will determine in 2011 whether to require mandatory adoption of IFRSs for all US issuers. If so, the SEC will determine the date and approach for a mandatory transition to IFRSs. Potentially, the option to use IFRSs when filing could also be expanded to other issuers before 2014.
7. Potential implementation of mandatory use.

Source: Deloitte

when the SEC decides to make the switch.

The next section discusses the major differences between IFRS and GAAP and tax issues raised by the adoption of IFRS. The third section discusses issues of possible concern to state tax agencies; and the fourth section is the summary and conclusion.

II. Differences between IFRS & U.S. GAAP and Resultant Tax Issues

When considering the effect an IFRS conversion may have on taxes, whether federal or state and local, it is important to take into account that U.S presently operates under a two-book system. This means that companies maintain one set of books to prepare financial statements in accordance with GAAP and another set for reporting to tax authorities. Therefore, significant changes to financial reporting numbers will not necessarily create a change in the amounts reported to tax authorities, because tax accounting is subject to statutory requirements.

A. Realization of Income

The key area where IFRS and GAAP differ with respect to revenue recognition is in the reporting of service revenue. Under U.S. GAAP revenue from service engagements which span multiple reporting periods is recognized in accordance with the proportional performance model ("PPM"). The PPM requires that revenue recognition be based on the output measures included in the service contract. In the absence of defined output measures, revenue is deferred until the service engagement is completed. In contrast, IFRS uses a percentage of completion

("POC") models for measuring service revenues. For GAAP purposes, the POC models are typically restricted to long-term construction contracts. Generally speaking, this allows for accelerated revenue recognition under IFRS.

Despite the differences between the two standards, acceleration or deferral of revenues is unlikely to affect income, sales, or gross receipts taxes. Income tax is unlikely to be affected because Internal Revenue Code (IRC) §451 states that income is recognized when it is due, paid, or earned. The percentage of completion model is not allowed for service contracts for tax purposes. Therefore the tax liability arises from payments received or full performance of a service. Similarly, gross receipt taxes are based on cash payments, as opposed to accrual accounting revenues. In New Mexico, gross receipts are defined as "the total amount of money or other consideration received…"[9] This suggests that revenues booked under the PPM or POC methods would not be taxable until payments were received. Sales tax receipts should not be affected because, for services that are taxable, the tax is generally levied when payments are received. For example, in Florida sales tax is payable "at the time of each transaction"[10]. This would seem to suggest that sales tax remittances would not be affected by revenues accrued solely for financial reporting purposes.

B. Repeal of LIFO

There are differences in inventory accounting under IFRS which will have a significant impact on the valuation of inventory accounts. The changes that take place will affect a company's book value and cost of goods sold. This in turn will affect income taxes, franchise and net worth taxes, as well property apportionment factors.

The main difference between GAAP and IFRS with respect to inventory accounting is that the later does not allow the use of the last-in first-out method ("LIFO"). For the most part, the LIFO method results in higher amounts reported for cost of goods sold (COGS), because in periods of rising prices recently purchased inventory is more expensive than older inventory items. Presently U.S. tax law allows for the use of LIFO only when there is book-tax conformity, see IRC §471. This situation will likely result in higher effective tax rates for manufacturers, merchandisers, chemical or petroleum companies and other inventory intensive businesses which use LIFO. One problem with that is it places publicly traded companies at a disadvantage to their privately-owned competitors who will not be required to comply with IFRS. Exhibit 2 provides a comparison of income statements prepared using LIFO to a non-LIFO method.[11]

The book value of inventory will generally increase when LIFO is repealed, and this will affect state income tax property apportionment factors. According to Uniform Division of Income for Tax Purposes Act (UDITPA,) "Inventory of stock of goods shall be included in the factor in accordance with the valuation method used for federal income tax purposes."[12] Businesses could see an increase in their state income tax liability if they have substantial inventory in states which have higher values assigned to property apportionment factors.

Ultimately, it may not be IFRS that puts an end to LIFO. The Office of Management and Budget's most recent proposal includes a provision to repeal LIFO. A section titled "Other revenue changes and loophole closers" includes an estimate that repealing LIFO will decrease the budget deficit by $61 billion between 2010-2019.[13]

C. Accounting for Property, Plant, and Equipment

Perhaps the best way to illustrate how substantial differences between U.S GAAP and IFRS may not affect tax treatment is to examine the 2006 Bayer AG 20-F filing. The 20-F is the annual financial report filed by foreign private companies with U.S. subsidiaries. Prior to the 2007 rule allowing foreign private issuers to file financial statements prepared using IFRS; companies were required to include U.S GAAP reconciliation in the notes accompanying their financial statements. Exhibit 3 is an excerpt from one these reconciliations; it shows adjustments to Bayer's 2006 income statement.[14]

The difference in reported earnings is primarily due to the treatment of the in-process research

Table 2		
Example	**Without LIFO**	**With LIFO**
Revenue	$35,000,000	$35,000,000
Cost of Goods Sold (COGS)	$30,000,000	$30,000,000
LIFO Adjustment	-	$600,000
Gross Profit	$5,000,000	$4,400,000
Expenses	$1,500,000	$1,500,000
Operating Profit	$3,500,000	$2,900,000
Income before Taxes	$3,500,000	$2,900,000
Income Tax	$1,225,000	$1,015,000
Extra Cash	**$0**	**$210,000**

and development acquired in Bayer's purchase of Schering AG. At the time of the filing U.S GAAP required acquired IPR&D to be expensed immediately, unless the research has a future alternative use. Under IFRS these costs are capitalized and treated as an intangible asset. Clearly, such a large difference in reported earnings has a significant impact on key financial metrics and would likely be an item of concern for investors. However, the €1.375 billion write-down would not have lowered Bayer's taxable income because for tax purposes acquired IPR&D costs are capitalized and amortized over time. [15] So then, accounting for IPR&D under U.S GAAP created a book-tax difference that would not have occurred under IFRS. It is important to note that standards have changed since 2006, and under recently adopted FAS 141(R) companies are no longer required to write off IPR&D. In a summary of statement no. 141 posted on its website the FASB describes the revision as part of a "…joint effort by the FASB and the IASB to improve financial reporting about business combinations and to promote the international convergence of accounting standards."[16]This revision is consistent with the FASB's recent efforts toward convergence of GAAP with IFRS.

III. Concerns for State Tax Administrators

As mentioned previously, the transition from GAAP to IFRS raises several important issues and concerns for state tax administrators. In this section we will look more closely at how the transition can affect state tax systems.

A. Changes in Apportionment Factors

In it simplest terms, the net business income of a company is apportioned to each state in which the company does business according to the relative amounts of sales payroll and property that the firm has in each state. Of major concern is the reclassification of certain equity accounts as liabilities, and other changes, can result in higher interest expense which could effect the entire amount of net income that is to be apportioned.

Furthermore, there is a possibility that greater volatility of revenues will ensue because firms would have greater scope regarding the timing of the recognition of revenues under IFRS than they had under GAAP. In addition, firms may alter compensation policies as a result of the new standards for accounting for stock-based compensation; thereby affecting the geographic distribution of payroll. New standards for valuing property, plant, equipment, and inventories may result in greater volatility of the property factor. However, if a state has adopted a substantial portion of UDITPA, and continues to apply it after the conversion; it may not experience significant changes to its apportionment factors.

B. Elimination of FIN 48

In June, 2006, the Financial Accounting Standards Board (FASB) issued interpretation No. 48 - Accounting for Uncertainty in Income Taxes (FIN48). Briefly, FIN 48 calls for the recognition and measurement of **all** tax positions taken or

Table 3 Adjustment to Bayer AG Income Statement 2006 (€ million)	
Income after taxes reported under IFRS	**€1,695**
Business combinations	79
Pensions and other post-employment benefits	(168)
In-process research and development (IPRD)	(1,375)
Asset impairment	23
Early retirement program	(27)
Revaluation surplus	4
Minority interest	(12)
Other	(17)
Deferred tax effect on U.S. GAAP adjustments	*67*
Income after taxes reported under U.S. GAAP	**€269**

expected to be taken by **all** U.S. companies. FIN 48 requires companies to determine whether or not a tax position will be sustained upon examination by the taxing authority. Upon completing this "more likely than not" assessment on each position taken, companies are required to determine the amount of benefit to recognize in the financial statements. Any differences between tax positions taken in a tax return and amounts recognized in the financial statements will result in an increase in liability for income taxes payable (or reduce income tax refunds receivable) and/or reduce the company's deferred tax assets or increase their deferred tax liabilities.

Under IFRS, a tax liability must be booked if there is **any** chance of a tax position being rejected by the tax authority. Each tax position is then multiplied by the probability that it will be rejected by the tax authority; the total tax liability is the weighted sum of all the probable tax liabilities. State revenue agencies may need to acquire additional resources in order to cope with the increased demand for pre-filing assistance including: (1) advanced pricing arrangements; (2) letter rulings; or (3) technical bulletins.

C. Other Issues

In addition to revenue concerns, state tax agencies may encounter the need for additional resources in order to accommodate the transition. For example, IFRS will **not** apply to privately held companies so that agencies any need to maintain legacy systems to accommodate taxpayers who will continue to use GAAP. In addition, revenue agencies will be looked upon to provide guidance regarding their positions on the tax implications of IFRS issues. Perhaps the greatest concern to state tax agencies is the need for additional training and staff or the use of outside consultants and third party experts, as well as computer system development to implement the transition to IFRS. These additional needs will come at a time of constrained state budgetary resources.

IV. Summary and Conclusion

The development of international financial reporting standards (IFRS) began in 1973 with the formation of the International Accounting Standards Committee (IASC). Today, over 100 countries around the world have adopted IFRS. Current users of the international standards include Australia, Israel, South Africa, Switzerland, and all the members of the European Union who list their shares on EU exchanges. All four of the BRIC countries- Brazil, Russia, India, and China have either adopted IFRS, set a firm deadline for the transition, or have committed to the convergence of their own standards to conform to IFRS. Canada, Korea, and Japan are in the process of converging to IFRS and will do so by 2011. It now appears that the United States will be among the last to convert, as the SEC has recently suggested a 2016 deadline for implementation. The IASB and the U.S. FASB have confirmed their commitment to the improvement and convergence of U.S. GAAP and IFRS in order to produce a single set of high quality financial reporting standards. Support for this effort was expressed by the leaders of the Group of 20 nations at their summit meeting in Pittsburgh earlier this year. The Financial Crisis Advisory Group of the FASB and IASB, and the Monitoring Board of the IASC Foundation also support this effort. At this time, however, there is still uncertainty as to whether or not the U.S will ultimately make the transition.

State tax administrators would be faced with several issues if the U.S. adopts the convergence of GAAP and IFRS. The primary issue concerns state corporate income taxes. The adoption of IFRS would change the Federal definition of net income, which would change the amount that would be apportioned to the states. In addition the payroll and property apportionment factors may change under IFRS if firms alter their compensation policies as a result of new standards for accounting for stock-based compensation; and, the transition to fair value accounting may alter the distribution of the property apportionment factor. The change in the ability of firms regarding the recognition of revenues can change the level and distribution of the sales apportionment factor. Furthermore, changes in firms' balance sheets can affect state franchise or net worth taxes; and changes in the ability to recognize revenues can affect gross receipts taxes.

In addition to the revenue aspects of the convergence of GAAP and IFRS, state tax administrators will incur other problems. For example, the agencies may be required to maintain legacy systems to serve taxpayers who will continue to use GAAP. Additional costs can include further training and system development costs, and the use of outside consultants and other experts.

While it may appear that the transition form GAAP to IFRS would impose significant burdens on state tax agencies, there are countervailing forces that could reduce the impact. For example, the need for more uniform accounting measures by end users -- securities analysts and share/bond holders, regulatory agencies, and other government and non-government users could put enough pressure on the accounting boards that IFRS would become more rules-based in the future so that the transition would not seem so traumatic.

ENDNOTES

[1]A version of this article was presented at the Federation of tax Administrators' Revenue Estimation and Tax Research Conference in Des Moines, IA on September 15, 2009. See: "Tax Expenditure Implications of Changes in State Corporate Income Tax Apportionment Formulas," Elliott Dubin, Multistate Tax Commission and Jim Landers, Indiana Legislative Services Agency, http://www.taxadmin.org/fta/meet/09rev_est/pres/dubin-landers.pdf
[2]http://www.iasplus.com/country/useias.htm
[3]http://www.icaew.com/index.cfm/route/156901/icaew_ga/en/Technical_and_Business_Topics/Guides_and_publications/Knowledge_guides/Knowledge_Guide_to_IAS_IFRS#history
[4]See "Regulation of the International Securities Markets" Securities Act Release No. 33-6807 (November 14, 1988) (the 1988 Policy Statement).
[5]http://www.sec.gov/news/studies/acctgsp.htm
[6]http://www.sec.gov/rules/concept/34-42430.htm
[7]http://www.fasb.org/news/memorandum.pdf
[8]http://sec.gov/rules/final/2008/33-8879fr.pdf
[9]http://www.tax.state.nm.us/pubs/fyi_105.pdf
[10]http://dor.myflorida.com/dor/taxes/sales_tax.html
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[12]UDITPA Reg. IV.11. (a).
[13]http://www.gpoaccess.gov/usbudget/fy10/pdf/fy10-newera.pdf
[14]Bayer AG 2006 form 20-F filing from SEC Edgar Database
[15]IFRS, US GAAP, and US tax accounting methods PWC whitepaper
[16]http://www.fasb.org/st/summary/stsum141r.shtml