

IFRS Insights

Achieving a global standard

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Anniversary edition

Recognizing one year of *IFRS Insights*

We are pleased to present the one year anniversary issue of *IFRS Insights* with a new and updated look.

In 2008, we launched the newsletter in response to the growing interest among U.S. companies for the latest information on International Financial Reporting Standards (IFRS) and insights around implementation. Over the year, we covered a wide range of issues, including the Securities and Exchange Commission's (SEC) proposed IFRS roadmap, differences between U.S. Generally Accepted Accounting Principles (U.S. GAAP) and IFRS, the tax implications of an IFRS transition, systems considerations, and much more. We look forward to providing continued commentary and analysis in the year ahead as many companies not only anticipate an economic upturn, but also wait for further SEC announcements on the IFRS roadmap.

We recognize the importance of thinking ahead — to consider the implications and practical realities associated with IFRS change, as well as to evaluate approaches and solutions for companies based on their unique needs. In each issue, we draw on the perspectives from experienced IFRS professionals in the global network of member firms of Deloitte Touche Tohmatsu in the areas of accounting, tax, systems, and valuation. In this edition, we discuss the path of convergence, a proactive approach to addressing tax issues, International Accounting Standard (IAS) 12, *Income Taxes*, and an update on IFRS activity outside the U.S.

We hope you find *IFRS Insights* to be a useful resource for addressing your IFRS questions. As always, we welcome and invite your feedback.

Convergence: What it is and isn't

A look at the convergence path

While many in the financial reporting community recognize the importance and benefits of achieving a single set of high-quality global accounting standards, there is much debate about how to arrive at that ultimate goal.

Continuing with efforts to converge U.S. GAAP and IFRS is one way; adopting IFRS is another.

In this article, we consider the path of convergence to understand what it is, what it means in practical terms, and where it might lead. It is important to explore whether convergence represents the optimal route towards a single set of global accounting standards, or whether it has noteworthy limitations.

Convergence

The world's accounting standard-setters have been working on converging local and global accounting standards over the last ten years. Central to this initiative have been the efforts of the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to bring U.S. GAAP and IFRS closer together.

With convergence, the emphasis is on having similar general principles. The keyword here is *similar*, not *identical*. Many have confused convergence with meaning the development of the same or identical standards. Yet, convergence efforts were not undertaken with the sole purpose of developing identical standards. Indeed, the FASB and IASB have acknowledged that doing so would be too difficult to attain — and prominent differences remain between “converged” standards.

For example, the boards recently issued “converged” business combinations standards contain differences in certain areas, including contingent consideration and non-controlling interests. Given the boards' current thinking on topics such as consolidations and leasing, differences will likely exist in future converged standards.



Distinctions

The distinction between similar and identical is important to note in light of the comment letters recently submitted to the SEC, in response to its proposed IFRS roadmap. Some respondents argued that there is no need to transition U.S. public companies to IFRS because convergence eventually will result in the two sets of standards (U.S. GAAP and IFRS) being the same. While the standards would be similar, as mentioned, they would not necessarily be the same or identical, which could potentially create an obstacle to the use of a single, consistent set of standards globally.

Another area of divergence? The interpretations of standards. There's been little effort by standard-setters to converge interpretations, even on the converged standards. And divergence can occur when interpretive guidance is issued by one body, but not the other.

As long as areas of divergence among the standards exist, achieving a single set of accounting standards may remain challenging.

Historically, differences between U.S. GAAP and IFRS have not been a significant issue, but with recent events surrounding the financial crisis, these differences have become more problematic and the source of political debate. Consider the issue of a company's change in the classification of financial assets, which impacts the measurement of those assets. Prior to last year, the “technical differences” on classification between U.S. GAAP and IFRS were generally not considered a significant issue in practice. However, during the economic downturn, the IASB has been under tremendous pressure to conform IFRS to arguably a less rigorous answer under U.S. GAAP. This is one example of many differences between U.S. GAAP and IFRS that was not addressed by prior convergence efforts. This also helps demonstrate the importance of having a single set of standards.

While convergence efforts have been important over the years, areas of divergence and the limitations in achieving conformity between the standards may pose obstacles in obtaining a single set of standards. Of course, the other approach is full IFRS adoption, which may appear increasingly attractive. Although this approach is not without its challenges, full IFRS adoption would provide a single set of standards that would level the playing field for companies around the globe and eliminate accounting arbitrage between U.S. GAAP and IFRS.

Technical corner: IAS 12

Accounting for income taxes

Accounting for income taxes is complex and often considered by companies to be an area of significant risk. Not surprisingly, when comparing the predominant standards that govern this topic for U.S. GAAP (FASB Statement No. 109, *Accounting for Income Taxes*) and IFRS (IAS 12, *Income Taxes*) several differences are identified even though they both follow the temporary difference approach. Areas of notable difference include:

- Recognition and classification of deferred taxes
- Uncertain tax positions
- Share-based payments
- Intercompany sales transactions
- Tax rate changes

U.S. entities considering a conversion to IFRS should research the differences between U.S. GAAP and IFRS and identify those that are applicable to them. Additionally, management should be aware that income taxes is one of the short-term convergence projects outlined in the Memorandum of Understanding (MoU) entered into by the FASB and IASB in 2006. In September 2008, the FASB and IASB issued an updated MoU that described the status and next steps of the short-term convergence projects and the priorities and milestones necessary to complete their major projects by 2011. As part of the update, citing the possibility that U.S. public companies may be required to transition to IFRS in the near future, the FASB decided to defer its income tax project until it has the opportunity to evaluate its strategy on the ongoing short-term convergence efforts.

Meanwhile, on March 31, 2009, the IASB issued an exposure draft (ED) containing proposals for a new IFRS on income taxes that would replace IAS 12. The ED proposes significant changes to IAS 12 that individually represent varying degrees of convergence with U.S. GAAP. These changes include:

- Deferred Taxes
 - Classification — Deferred Tax Assets (DTA) and Deferred Tax Liabilities (DTL) will be classified based upon the balance sheet classification of the underlying asset or liability generating the temporary difference. This is consistent with U.S. GAAP, thus representing an area of full convergence. IAS 12 requires all deferred taxes to be recorded as noncurrent.
 - Realization of DTA — Recognize full DTA with a valuation allowance to reduce the asset to the amount more-likely-than-not to

be realized. This is another instance of full convergence as U.S. GAAP requires this same gross presentation, while under IAS 12, DTA's are recorded under a single step approach at the amount for which realization is probable (i.e., net presentation).

- Uncertain tax positions
 - Approach — One-step with no recognition threshold. Measurement will be based upon a probability weighted-average of all possible outcomes, assuming tax authorities will examine the position. Convergence in this area was not reached because the underlying principles for treating uncertainties are not consistent between the two sets of standards. U.S. GAAP (FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*) requires a two-step approach: 1) determine whether the tax position is more-likely-than-not to be sustained upon examination by the taxing authority; and 2) for tax positions that meet the recognition threshold, measure the benefit at the largest amount over 50% likely to be realized. IAS 12 does not specifically address accounting for tax uncertainties, and tax consequences are recognized based upon management's expectations of whether outflows of economic resources will occur.
- Intercompany sales transactions
 - Convergence was not reached in this area, because although the ED added a disclosure requirement, no exception to recording deferred tax effects on transfers was proposed. Therefore, IFRS will continue to record the deferred tax effects of intercompany transfers of assets. Meanwhile under U.S. GAAP, tax expense is deferred until the related asset is sold or disposed of, and no deferred taxes are recognized for the purchaser's change in tax basis.

Understanding the income tax accounting differences and proposed changes is important for companies looking to convert from U.S. GAAP to IFRS. Even though the FASB has yet to decide how it will proceed with convergence for income taxes, there are several options they may consider, including: a wholesale adoption of the IASB's new standard on income taxes to replace FASB Statement No. 109; piecemeal amendments to Statement 109; or eliminating the convergence project altogether. Therefore, it is important for accounting, finance, and tax professionals to keep apprised on the income taxes project as considerable change could occur.

Making it happen

IFRS: A catalyst for change in the tax function

As companies consider a conversion to IFRS, it likely becomes obvious that accounting for income taxes should be addressed. But it is also important to look beyond financial accounting to the downstream impact that a conversion will likely have on the tax function. The downstream effects could include changes in tax accounting methods, existing or contemplated tax planning initiatives as well as new implications for tax compliance and provision processes. A proactive approach to addressing these issues may yield an opportunity to optimize the tax positions and the efficiency of the tax function.

Research and Development Credit — Companies, for example, may be faced with additional data requirements to comply with the capitalization of development costs for IFRS reporting. The R&D challenge for financial accounting can create an opportunity for tax. In order to gather the data necessary for the conversion, a new process may be required for tracking project level development expenditures and may involve the adoption of new financial accounting software systems or accounting policies. The tax department may benefit from the adoption of a new system that improves the quality of data collection around development expenditures to optimize the R&D tax credit, or provide the basis for doing an R&D credit study. Combining the tax needs with the policy or systems changes within the financial accounting function can produce better documentation and potentially better tax results.

Inventory Valuation — Another potential opportunity resides in inventory valuation. IFRS does not allow for LIFO and U.S. tax law requires conformity between book and tax when LIFO is used. For many companies, this has been a concern as the loss of LIFO can have a significant cash tax implication. However, proper planning and a thorough analysis may provide an opportunity, in limited situations, to preserve the LIFO method or identify a next-best alternative that preserves much of the tax benefit that LIFO previously provided. For example, a U.S. subsidiary of a foreign company should consider whether there is an opportunity to remain on LIFO for tax purposes even when the foreign parent does not issue financial statements on LIFO. Retail companies should consider the potential benefits to adopting the Retail FIFO Inventory Method for tax purposes. Companies should also

consider if the current treatment of items such as variances, trade discounts, and vendor rebates have been optimized for tax. Further, the timing of a LIFO conversion can be critical. Depending on the company's facts, there may be an advantage to terminating LIFO in the year before or the year after the IFRS conversion. These are just a few of the items that should be considered when evaluating the tax impact of an IFRS conversion on inventory.

Tax Process — For many companies, a conversion to IFRS will require modifications to existing ERP systems. Financial accounting methods are likely to change, which may impact tax as the information it has historically used may become inaccessible or might be stored in a new format or location. For example, development expenditures for the R&D credit may now be capitalized on the balance sheet rather than expensed. Changes to how financial numbers are derived and where they are recorded will likely have an impact on the data that the tax department uses for the provision and compliance process. These changes will likely impact existing provision software, spreadsheets, the computation of differences between book and tax income, and other calculations performed by the tax function. Additionally, the tax department may need to establish a provision system for dual accounting under both U.S. GAAP and IFRS for the transition years.

Facing such a pervasive change within the organization can be overwhelming; however, it can also be a great opportunity to enhance processes and create a more efficient tax function. Substantial IFRS process changes within the financial accounting function may serve as a way to enhance existing tax systems to more closely align with the enterprise accounting systems. If an automated tax provision system does not exist, implementing a new system in connection with an IFRS conversion may offer a chance to improve the efficiency and controls related to the tax provision and compliance processes.

These are just a few areas where tax may be affected by a conversion to IFRS. It is important for the tax function to be involved early in the IFRS assessment and conversion process so that these and other opportunities can be identified and proactively addressed.

Updates: IFRS developments around the world

Here is a brief recap of IFRS activities outside the U.S:

- **G-20 Summit** – On April 2, 2009, after its summit in London, the G-20 issued a declaration indicating, among other things, that there needs to be a strengthening of financial supervision and regulation. According to the G-20, major failures in the financial sector and in financial regulation and supervision were fundamental causes of the crisis. The G-20 agreed to call on the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards. The goal of achieving a single set of high-quality global accounting standards was established in their November 2008 summit and reaffirmed at their April 2009 summit. The next summit meeting is scheduled for September 2009.
- **XBRL** – On April 3, 2009, the International Accounting Standards Committee Foundation (IASCF) issued the IFRS Taxonomy 2009 and published the Due Process Handbook for XBRL Activities for public comment. The comment period ends June 26, 2009.
- **Joint Meeting** – Sir David Tweedie reported to the IASCF trustees that at the joint meeting of the IASB and FASB, the standard setters agreed to undertake an accelerated project to replace their existing financial instruments standards with

a common standard that would address issues arising from the financial crisis. This project is expected to result in a proposal being published within six months.

- **5th meeting of Financial Crisis Advisory Group (FCAG)** – The FCAG was established by the IASB and FASB in response to the recent global financial crisis. Its purpose is to advise the boards of both organizations on the role of accounting during the crisis and potential changes. The FCAG held its fifth meeting in London on May 22, 2009. Unofficial notes can be found on Deloitte's IASPlus.org.

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