

IFRS AND YOUR TAX PRACTICE



INTERNATIONAL FINANCIAL REPORTING standards (IFRS) are coming, and tax advisers need to understand the implications for their clients. In May 2008, the AICPA Council approved IFRS for nonpublic companies. In November 2008, the Securities and Exchange Commission (SEC) released its proposed roadmap that would require registrants to use IFRS by 2014, with voluntary adoption available to certain companies as early as 2009. In February 2009, new SEC chair Mary Shapiro announced that she might slow the implementation of IFRS, in part because of the burden the change would place on the faltering economy. However, in a global economy, the question is more when IFRS will replace GAAP than if it will; the answer is that for planning and systems changes, it is coming quickly.

IFRS Overview

In general, IFRS places a greater emphasis on fair market value (FMV) than historical cost, and this has important implications for tax practitioners. It results

in new types of book income as certain assets are adjusted to fair value annually; cost basis becomes unimportant for reporting financial accounting gains and losses; and cost recovery for tax will be unrelated to book depreciation, possibly requiring separate accounting to be able to prepare tax returns. Unless the tax system is adjusted to accommodate IFRS, companies may have to prepare numerous Forms 3115, Application for Change in Accounting Method, to change tax accounting methods, or there will be a proliferation of Schedule M adjustments.

IFRS also relies more on professional judgment than on strict accounting rules, so accountants will have to take more responsibility for evaluating tax-related issues in financial statements and in tax planning.

Review of Tax Accounting Policies

The practitioner and the client should review each accounting policy for tax purposes. One approach to this analysis might be a spreadsheet similar to Schedule M but with an extra column to reconcile IFRS book, GAAP book, and taxable income. IFRS will become the new book method of accounting on Schedule M, and any differences between the IFRS column and the GAAP column in the spreadsheet will identify new Schedule M items to get from book to taxable income in the year of change. In addition, depending on how the IRS deals with the change to IFRS, the differences may indicate changes in tax accounting methods that underlie the change in methods of book accounting for which requests for

a change in accounting method must be filed.

Valuation Gains

Under IFRS, certain income-producing assets are valued annually, and any increase or decrease is reflected in book income. Recognizing gains and losses before a sale or exchange will require separate records and calculation of sales-based profits to comply with the tax law. This will also be a Schedule M adjustment.

For plants, property, and equipment, IFRS also allows an annual revaluation calculation, with any reflected gains or losses going directly to the balance sheet. Companies will have to prepare a separate calculation based on a sale or exchange for Sec. 1231 and capital gains and losses, along with Schedule M adjustments. Similarly, some intangibles may have to be revalued annually, along with amortization, requiring Schedule M adjustments.

Inventory

Under IFRS, inventories are carried at cost or at net realizable value, if lower. This differs from GAAP, which uses the lower of cost or market, limited by replacement cost. This may result in profit or loss on inventory value changes.

LIFO is not permitted under IFRS and will not be permitted for tax after the change to IFRS under the LIFO conformity rule. This will require affected companies to file a Form 3115 to change accounting methods for inventories, with income and taxes increasing dramatically for companies with older, lower-cost LIFO layers. Companies will reflect inventory valuation

changes in their books annually, and separate calculations will be required to determine the cost of goods sold, with a related Schedule M adjustment.

There is a major lobbying effort to repeal the LIFO conformity rule, but this will be a difficult effort with much of the revenue coming from large companies, including energy companies, and Congress hungry for revenue. In fact, the Obama budget includes a proposal to repeal LIFO altogether, which the Office of Management and Budget estimates would raise \$17.8 billion in revenue from 2012 to 2014. Opposition to this proposal is coming from a variety of businesses such as auto dealers, sporting goods and garden tool manufacturers, vineyards, and distillers as well as oil and gas producers. Interestingly, if Congress repeals LIFO, it could take budgetary credit for raising the revenue; this will not be the case if LIFO has to be dropped as a result of changing to IFRS. (For more on this, see Hoffman and McKenzie, "Must LIFO Go to Make Way for IFRS?" 40 *The Tax Adviser* 156 (March 2009).)

Cost Recovery (Depreciation)

IFRS provides a revaluation option for fixed assets, and this can allow calculation of depreciation based on FMV rather than cost. This would require separate accounting for fixed assets for tax purposes and Schedule M adjustments. Under IFRS, it is possible to depreciate assets in excess of their cost if the assets appreciate.

Change in Tax Accounting Method (Forms 3115)

The IRS is concerned that a significant number of taxpayers will make unauthorized changes in their tax accounting methods when GAAP is replaced by IFRS. Many taxpayers have tax methods that conform to book methods. If book methods change because of IFRS and drag tax methods along, the IRS will be hard pressed to find all the changes. Taxpayers who play by the rules and request permission to change their tax methods will present a different problem for the IRS: a flood of Forms 3115 into a National Office already struggling with the current backlog. For taxpayers who do not play

by the rules, the IRS can restate income and assess penalties.

FIN 48

The International Accounting Standards Board is expected to update International Accounting Standard (IAS) No. 12 on accounting for income taxes, possibly requiring evaluation of tax positions based on fair value, with no recognition threshold, a standard that may be more problematic for tax practitioners than Financial Accounting Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes*. The Financial Accounting Standards Board may continue to require FIN 48 for evaluating uncertain tax positions. The IRS has been training auditors to use FIN 48 disclosures and will likely want to continue to have that information in some form. Tax penalty standards will be different from IFRS requirements, possibly even more so than under FIN 48, so all uncertain tax positions may again have to be evaluated separately.

Changes in Income Statements

IFRS does not require the same categories of income reporting as GAAP, so there may be some difficulty in classifying IFRS income into the Form 1120, U.S. Corporation Income Tax Return. This may require some changes in accounting systems to capture income tax details required on the tax form but not reported on financial statements.

Other Areas

IFRS and tax differ in various other areas, including long-term contracts, contingencies, leases, foreign currency gains and losses, pension expenses, and business combination expenses. These and other accounting issues must be reviewed by the tax practitioner as part of tax planning and compliance with the change to IFRS. IFRS will make substantial changes to revenue recognition rules, and practitioners will have to follow developments closely to see how these will apply in the tax area.

Valuation Expertise

With the emphasis on the FMV of assets, companies will increasingly be calling on

CPAs (or competing professionals) to perform valuation work. This will offer an opportunity for accounting firms to provide new services to their clients; however, it will also require firms that do not currently have the required expertise in valuation either to provide training to their existing staff or to hire staff members that have the expertise.

Conclusion

Tax practitioners often tend to focus on tax law rather than on financial accounting standards, but IFRS will require tax accountants to learn a new set of standards to be able to assist clients with tax compliance and planning. CPAs will do additional work as they assist clients in changing to IFRS, including evaluating tax accounting policies and planning and preparing Forms 3115 and new Schedule M adjustments on tax returns. Tax accountants should be involved in setting up accounting systems to capture information that is required for tax purposes but that may not be required for financial reporting. Because of the emphasis on FMV and professional judgment in IFRS, CPAs have an opportunity to expand client services.

IFRS is coming in the near future, and tax CPAs need to start investing time in understanding how it will apply to their businesses or clients. The AICPA has courses on IFRS and runs the www.IFRS.com resource center, and there is plenty of other information available on the internet, including valuable studies by the larger, multinational accounting firms.

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EditorNotes

William Stromsem is communications director in the AICPA's Tax Division, an associate professor of accountancy at George Washington University, and a member of the board of DC Community Tax Aid. For more information about this column, contact Mr. Stromsem at wstromsem@aicpa.org.