

New Tax IFRS Proposed

Britain's in-house corporate tax heads are under pressure. HMRC's Large Business Service (LBS) is breathing heavily down their necks, applying the new tax risk compliance framework and developing new risk-management guidelines. LBS Customer Relationship Managers are talking of systems audits and process mapping.

Finance directors of large companies are also under the spotlight. Finance Bill 2009 proposes that they should certify personally, either that the group had 'appropriate tax accounting arrangements' in place throughout each financial year, or that they have reported inadequacies to the company auditors. Failure to do so will attract a personal penalty of up to £5,000 in addition to penalties on the company.

As if this wasn't enough, interested parties have until 31 July to comment on a new exposure draft from the International Accounting Standards Board proposing significant changes to its current International Accounting Standard on accounting for income taxes. The exposure draft and the related guide to IASB's 'basis for conclusions' can be accessed at www.iasb.org.

This article examines key changes being put forward in this exposure draft and considers how the proposed new International Financial Reporting Standard might impact on tax department procedures and practices.

Key features of the exposure draft

Exposure draft ED/2009/2 emanates from IASB's income tax project, which aims to reduce the differences between IAS 12 (Income Taxes) and the US standard, FAS 109 (Accounting for Income Taxes), and related US GAAP. This follows broadly the Memorandum of Understanding between IASB and the US Financial Accounting Standards Board to achieve and maintain compatibility between their financial reporting standards.

IASB proposes to retain the existing

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'temporary difference approach' to accounting for income tax, recognising the future tax consequences of past events and transactions rather than waiting until the tax is payable. It plans to remove most exceptions from IAS 12, supposedly simplifying the accounting and strengthening the principle in the standard. IASB claims that the changes will make the standard easier to use.

It is fundamental that entities must recognise not only current tax, based on current and past periods, but also deferred tax expected to arise in future periods as a result of past transactions or events. Deferred tax arises from differences between accounting values used in the financial statements and the corresponding tax values recognised by the tax authorities, together with the carry forward of currently unused tax losses and tax credits.

In a significant change in approach the exposure draft replaces the requirement in IAS 12 that the tax base depends on whether the entity expects to recover the carrying amount of an asset by use or sale, or by a combination of the two. However, management's expectations regarding use or sale would still have a role in setting an initial threshold – since deferred tax assets and liabilities would not need to be recognised in cases where the expected use or sale would produce no tax consequences.

In all other cases the tax basis would be determined by the tax consequences which would arise if the entity sold the asset or settled the liability at its book value at the balance sheet date. The rate of tax used would depend upon whether use or sale was anticipated and could be particularly complex to calculate where use followed by sale was expected.

The differing tax consequences of different jurisdictions would add further complications.

In another big change, the exposure draft adopts (but also adapts) some of the principles from FASB's FIN 48 (Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No 109) on uncertain tax positions. By contrast, IAS 12 has been silent on how to account for uncertainty over whether tax authorities will accept the amounts reported to them.

The draft proposes that current and deferred tax assets and liabilities should be measured at the probability-weighted average of all possible outcomes, assuming that the tax authorities examine the amounts reported to them by the entity and have full knowledge of all relevant information. The existing probability-based threshold in FIN 48 would no longer apply, so in many cases it would become necessary to evaluate a much larger number of uncertain tax positions than hitherto – including many tax positions where the outcome is relatively certain but not completely free from doubt. It is unclear whether uncertain tax positions might be considered collectively by category, or whether they would each have to be evaluated individually.

Instead of accounting for deferred tax on the net basis used in IAS 12, the draft proposes that deferred tax assets should be recognised in full, less (if applicable) a valuation allowance to reduce the net carrying amount to the highest amount that is more likely than not to be realisable against taxable profit. This follows the approach taken by FAS 109 and would require companies to identify and measure all unrecognised

deferred tax assets. In a further move that follows US GAAP reporting entities would be required to classify deferred tax assets and liabilities as either current or non-current, on the basis of the financial reporting classification of the related non-tax asset or liability.

Practical implications for in-house tax departments

Computing deferred tax under IAS 12 has become a familiar headache for corporate tax departments and has placed heavy demands on their ability to gather and manipulate data. The requirement to consider whether the book value of an asset would be recovered by sale or use has involved cumbersome record-keeping and decision-making processes; in many cases the appropriate method has involved a combination of the two approaches.

If the new IFRS follows the current exposure draft companies would have to reassess the need to provide deferred tax by reference to specific assets and liabilities, based on a re-examination of their circumstances. For example, where a company previously computed deferred tax under IAS 12 on a particular asset on the assumption that it would not sell that asset, it might instead have to recalculate the position on a hypothetical sale. Groups owning large number of properties could be particularly affected by this change.

Currently IAS 1 (Presentation of Financial Statements) allows all deferred tax to be classified as non-current, so reporting systems might be stretched by a new requirement to track deferred tax relating to any asset or liability reclassified between current and non-current, so that the deferred tax in question could be reclassified accordingly.

The proposed requirement to consider uncertain tax positions is likely to present substantial practical challenges. This would be a relatively new concept for companies that have not had to comply with US GAAP; for those that have it will extend to a larger number of tax positions than they have had to consider before. At this stage there are significant doubts about how some aspects of the exposure draft should be interpreted.

Companies that have developed and refined a streamlined approach to computing their deferred tax under IAS 12 face significant changes if the exposure draft is adopted. Information-gathering processes and tax reporting



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systems designed to address the needs of IAS 12 might have to be redesigned and extended – within a timescale that is not yet clear.

Many corporate tax departments rely heavily on spreadsheets for their information-gathering and tax reporting processes. These can give tax personnel useful flexibility but this comes at a high cost where it creates difficulties in controlling the quality of multiple spreadsheets, or providing appropriate audit trails. The changes to tax reporting requirements proposed in the exposure draft could prove to be the last straw for many such spreadsheet applications. Attempts to modify them might fail to provide adequate functionality for analysing uncertain tax positions, leading to unexpected crises and embarrassing faux pas in tax accounting.

Tax departments that employ alternative database-driven approaches – whether workflow systems designed to meet their current requirements, or off-the-shelf solutions that have been configured to meet their needs – should be better placed to cope with implementing the proposed changes. However, this would require timely support from software providers, who would need to understand the potentially far-reaching impact of the proposals on existing processes that bring together group tax figures and manage related aspects, such as tracking tax histories of heritable properties and other relevant assets and liabilities. Since suppliers of such software are predominantly US-based, they might concentrate foremost on the migration from existing US GAAP, which would not bode well for

their UK customers.

For some heads of tax the recent publication of the exposure draft may provide the impetus for a long-overdue review of their tax department systems. This could focus on appraising the current tax compliance and reporting processes, identifying key risk areas and recommending improvements to the processes and technologies used within the tax department to mitigate those risks.

Conclusions

The exposure draft seems to lean heavily towards meeting the needs of the US – perhaps more so than seeking to achieve the intent expressed in the Memorandum of Understanding between IASB and FASB that efforts should focus on the development of high-quality, common standards, rather than on simply trying to eliminate differences between two standards that are in need of significant improvement.

Companies should consider now how they are likely to be affected by IASB's proposals. They should assess whether they would be able to meet the demanding new disclosure requirements and whether the resulting financial statements would be acceptable. They are encouraged to submit their views on the exposure draft to the IASB – either directly or through appropriate professional bodies.

Companies should also start now to weigh up the issues and difficulties their in-house corporate tax departments might face in implementing the proposed new standard. An independent tax process review could be crucial in helping to put the work of the department on a sounder footing, ensuring that it is better able to cope with the forthcoming tax reporting demands and minimising tax compliance risk. A tax process review might not only help prepare for the proposed new IFRS; coincidentally, it might also help protect the finance director from personal penalties under the new Finance Bill provisions.

Although changes to IAS 12 are afoot, this process is unlikely to be the end of the road. A joint venture of national standard-setters, including those from the UK and Germany, is currently undertaking a fundamental review of income tax accounting. So watch this space!

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