



Tax Considerations of Switching from U.S. GAAP to IFRS

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Agenda

- Accounting for income taxes
- Taxes incurred
- Systems and Processes
- People and Change Management



Accounting for Income Taxes

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Accounting for Income Taxes under IFRS

- IAS 12 *Income Taxes* provides guidance on accounting for income taxes under IFRS
 - Similar to FAS 109, IAS 12 is based on a balance approach
- Differences between the income tax amounts under U.S. GAAP and IFRS generally are a result of:
 - Tax-effects of pre-tax adjustments to the financial statements
 - Differences between IAS 12 and FAS 109
 - Differences in recognition and measurement exceptions
 - Presentation and disclosure differences

Convergence

- Statement 141(R) and IFRS 3 *Business Combinations*
- Income tax short-term convergence project
 - An exposure draft of an IFRS to replace IAS 12 is expected to be published by the IASB in the first quarter of 2009. A standard is planned to be finalized in 2010
 - The FASB has suspended indefinitely deliberations on the Income Tax project. The FASB has no plans to issue an amendment to Statement 109 at this time
 - The FASB intends to review its strategy for short-term convergence projects in light of the possibility that some or all U.S. public companies might be permitted or required to adopt IFRS at some future date. As part of that review, it will solicit input from U.S. constituents by issuing an Invitation to Comment containing the IASB's proposed replacement of IAS 12. At the conclusion of that review, it will decide whether to undertake a project that would eliminate differences in the accounting for taxes

Exceptions to the Temporary Difference Approach

Exceptions in Statement 109, not contained in IAS 12

- Intercompany transfers of assets
- Foreign nonmonetary assets and liabilities
- Leveraged leases
- Statutory reserve funds of U.S. steamship enterprises

Exception in IAS 12, not contained in Statement 109

- Initial recognition of assets

Expected Exposure Draft of a replacement to IAS 12

- The IASB has tentatively decided to replace the initial recognition exemption in IAS 12 and the simultaneous equations method required by EITF 98-11 with a new model based on fair value and a purchase discount allowance

Exceptions to the Temporary Difference Approach

Investments in subsidiaries, branches and associates, and interest in joint ventures

- US GAAP
 - A deferred tax liability for taxable outside basis differences is recognized for foreign subsidiaries and foreign corporate joint ventures unless evidence overcomes the presumption that one is needed (indefinite reversal criteria of Opinion 23)
- IFRS
 - The exception includes branches and associates, however, control of timing of reversal of the temporary differences is required to avoid recognition of a deferred tax liability
 - A deferred tax liability is recognized except to the extent it is “probable” that the temporary difference will not reverse in the foreseeable future
- Expected Exposure Draft of a replacement to IAS 12
 - The IASB has tentatively decided to move to the Statement 109 wording

Recognition of Deferred Tax Assets

Recognition of deferred tax assets

- Under Statement 109, all deferred tax assets are recognized and a valuation allowance is recognized to reduce the deferred tax asset to the amount that is “more likely than not’ to be realized
- Under IAS 12, a deferred tax asset is not recognized unless it is probable that it will be realized. ‘Probable’ is not defined in IAS 12, but in practice a level similar to ‘more likely than not’ is used

Expected Exposure Draft of a replacement to IAS 12

- The IASB has tentatively agreed ‘probable’ should be defined as meaning ‘more likely than not’ and to use the valuation allowance approach

Measurement of Income Taxes

US GAAP

- Measurement is based on an assumption that the underlying asset or liability will be settled or recovered in a manner consistent with its current use in business
- Enacted tax rates and laws at the reporting date
- US GAAP requires, for consolidated financial statements, the use of the distributed rate at the foreign subsidiary if the parent is not applying the indefinite reversal criteria of Opinion 23. If the parent is applying the indefinite reversal criteria, then the undistributed rate should be used at the foreign subsidiary to the extent that the parent has not provided for deferred taxes on the unremitted earnings of the foreign subsidiary as a result of applying Opinion 23

Measurement of Income Taxes

IFRS

- Management intent as to the manner in which an entity will recover (settle) the carrying amount of an asset (liability) can affect the tax base of an asset or liability
- Enacted or substantively enacted tax rates and laws at the reporting date
- IFRS requires use of the tax rate applicable to undistributed profits

Expected Exposure Draft of a replacement to IAS 12

- IFRS will remove management intent guidance and clarify the definition of a temporary difference
- The IASB tentatively decided to clarify that 'substantively enacted' occurs when any future steps in the enactment process will not change the outcome
- An entity should use the rates that it expects will apply to the item being measured, incorporating the entity's past practices and future expectations of distributions

Example—Dual Intention

- Example: P acquires an asset as part of a business combination
- The following information is relevant for this example:
 - Fair value at acquisition date = 150
 - Depreciated for financial reporting over 5 years and expected to sell at residual value of 50
 - Not depreciated for tax purposes but will receive tax deduction of 100 at sale
 - Ordinary income tax rate 30 percent
 - Capital gain tax rate 10 percent

Example—Dual Intention (Cont'd)

- KPMG Guidance—use “blended rate” approach and our preferred approach is to treat the asset as having a single tax base of 100 with a single temporary difference of 50, resulting in a single DTL of 25

	Carrying amount	Tax base	Temp difference	Deferred tax
Use (tax rate = 30%)	100	0	100	30
Sale (tax rate = 10%)	50	100	-50	-5
Total	<u>150</u>	<u>100</u>	<u>50</u>	<u>25</u>

Uncertain Tax Positions

US GAAP

- An enterprise recognizes the financial statement effects of a tax position when it is more likely than not that the position will be sustained upon examination
- A tax position that meets the recognition threshold is measured as the largest amount of tax benefit that is greater than 50 percent likely of being realized upon settlement
- An amount is classified as current to the extent the enterprise anticipates payment (or receipt) of cash within one year or the operating cycle, if longer

IFRS

- No specific guidance provided in IAS 12 or elsewhere in IFRS
- No “reporting date” guidance exists. Accounting is subject to the normal subsequent events guidance under IAS 10
- No specific guidance on whether interest and penalties are accounted for under IAS 12 or IAS 37. The presentation of interest and penalties should be consistent with the accounting policy election of the company
- A payable is classified as current unless the entity has an unconditional right to defer settlement for at least twelve months

Uncertain Tax Positions

The IASB intends to include the following guidance in the exposure draft of a replacement for IAS 12:

- The entity has a stand ready obligation to pay tax but the amount is uncertain
- No probability threshold should be applied to the recognition of the stand-ready obligation
- Amounts should be measured on an expected outcome measure (i.e., the probability weighted average of the possible outcomes)

The preballot draft of a replacement for IAS 12, *Income Taxes*, would require measurement of tax assets and liabilities as described below:

- Uncertainty over whether the amounts submitted by the entity to the tax authorities will be accepted may affect the amount of current tax and deferred tax. An entity shall measure current and deferred tax assets and liabilities using the probability-weighted average amount of all the possible outcomes, assuming that the taxing authorities will review the amounts submitted and have full knowledge of all relevant information. Changes in the probability-weighted average amount of all possible outcomes must be based on new information, not a new interpretation of previously available information

Measurement of Tax Benefits

Possible Outcome of benefits	Individual Probability (%)	Cumulative Probability (%)	Weighted Average
\$ 1,000	35	35	350
800	20	55	160
100	30	85	30
0	15	100	0

	Weighted average	\$ 540
Single best-outcome/most-likely-outcome method		1,000
FIN 48 cumulative probability		800

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Measurement of Tax Benefits

Possible Outcome of benefits	Individual Probability (%)	Cumulative Probability (%)	Weighted Average
\$ 1,000	95	95	950
0	5	100	0

Weighted average	\$ 950
Single best-outcome/most-likely-outcome method	1,000
FIN 48 cumulative probability	1,000

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Tax Consequences of Share-based Payment Arrangements

US GAAP

- A deferred tax asset is recognized as compensation expense is recognized based on the grant-date fair value of an equity-classified share-based payment award. The effect of subsequent changes in the share price are not reflected in accounting for the deferred tax asset until settlement
- Excess tax benefits for share-based compensation are determined under a portfolio approach

IFRS

- IFRS requires that deferred tax assets be remeasured based on the share price at each reporting date
 - Accordingly, a deferred tax asset is recognized only if and when the share options have intrinsic value that could be deductible for tax purposes. Therefore, an entity that grants an at-the-money share option to an employee in exchange for services would not recognize tax effects until that award was in-the-money
- IFRS requires an individual instrument approach in determining excess tax benefits of equity awards to recognize in paid-in capital

Intraperiod allocation

US GAAP

- US GAAP provides that the effect of a change in the beginning-of-the-year balance of a valuation allowance concerning the realizability of the related deferred tax asset in future years ordinarily is included in income from continuing operations
- US GAAP provides that the effect of a change in deferred tax liabilities and assets for a change in tax law or rate is included in income from continuing operations
- All items should be considered for purposes of determining the amount of tax benefit that results from a loss from continuing operations

IFRS

- Tax is included in profit or loss, except to the extent that the tax arises from a transaction recognized directly in equity
- IAS 12 requires subsequent changes in amounts originally recognized in equity to also be recognized in equity

Expected Exposure Draft of a replacement to IAS 12

- The IASB decided to amend IAS 12 to adopt the intraperiod allocation requirements of Statement 109

Presentation

Current taxes

- Under US GAAP, an amount is classified as current to the extent the enterprise anticipates payment (or receipt) of cash within one year or the operating cycle, if longer
- Under IFRS, a receivable is classified as current if the entity expects to realize the asset within twelve months or the normal operating cycle
- Under IFRS, a payable is classified as current unless the entity has an unconditional right to defer settlement for more than twelve months

Deferred taxes

- Under US GAAP, deferred tax assets and liabilities are classified as either current or noncurrent based on the classification of the related asset or liability giving rise to the temporary difference
- Under IFRS, all deferred tax assets and liabilities are classified as noncurrent

Expected Exposure Draft of a replacement to IAS 12

- The IASB decided to amend IFRS to converge with FAS 109 on the presentation of deferred taxes

Disclosures

IFRS has certain disclosure requirements not identical to US GAAP, including:

- Both IFRS and US GAAP require significant components of tax expense to be disclosed. IAS 12 specifically mentions adjustments recognized in the period for current tax of prior periods as an example. Statement 109 has no such example
- The rate reconciliation has certain differences including:
 - The domestic rate will aggregate national taxes with the rates for local taxes
 - It may be more meaningful to use the average statutory tax rate applicable to the group, calculated on a weighted average basis
 - The rate reconciliation may include discontinued operations and the tax of equity accounted investees
- The amount of deferred tax income or expense recognized in profit or loss for each type of temporary difference is required to be disclosed. This may result in disclosure of a rollforward of the entire table of deferred tax assets and liabilities

Disclosures

IAS 12 is silent with respect to tax uncertainties. However, IAS 12 requires the application of IAS 37 disclosure guidance for tax-related contingent liabilities and contingent assets

- Unless the possibility of any outflow is remote, contingent liabilities (i.e. amounts for which a liability is not recognized) require:
 - An estimate of its financial effect
 - An indication of the uncertainties relating to the amount or time of any outflow,
 - The possibility of any reimbursement; and,
 - An exception is provided for the extremely rare cases in which disclosure can be expected to prejudice seriously the position of the entity

The exposure draft to IAS 37 has proposed the following amendment to IAS 12:

- An entity would be required to disclose the following information about the key estimation uncertainties relating to taxes:
 - A description of the uncertainty; and,
 - An indication of its possible financial effects on amounts recognized for taxes and the timing of those effects

Disclosures

IAS 1 has further guidance that may apply

- The judgments that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognized in the financial statements
- The assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year

Interim Financial Reporting

US GAAP

- The estimated annual effective tax rate is used to allocate expected annual income tax expense to interim periods
 - When subject to multiple jurisdictions, generally one overall effective tax rate should be computed unless:
 - The company anticipates a loss for which no benefit can be recognized, or
 - It is unable to make an estimate of ordinary income or related tax

IFRS

- Income tax expense is recognized in each interim period based on the best estimate of the weighted average annual income tax rate expected for the full fiscal year
 - A separate estimated average annual effective income tax rate is determined for each taxing jurisdiction
 - A separate rate is applied to each individual category of interim period pre-tax income
 - Tax benefits that relate to a one-time event are recognized in computing income tax expense in that interim period
- If management's estimate of the recoverability of unused tax losses changes during an interim period, in our view it is acceptable for this change to be reflected in calculating the expected annual effective tax rate and apportioned between the interim periods
- Our preferred approach is to recognize the benefit of a change in tax rates in the interim period it becomes substantively enacted. However, we also would accept including this amount in the expected annual effective tax rate and apportioning the amount between interim periods



Taxes Incurred

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IRS Initiatives

- IRS is aware of companies using an “other comprehensive basis of accounting” and those changing their basis of accounting
- IRS already analyzing tax issues raised by IFRS
- Some taxpayers already on IFRS or switching to IFRS
 - U.S. subsidiaries of foreign corporations
 - CFCs of U.S. corporations
- Form M-3 instructions now require disclosure of accounting standards used
 - GAAP, IFRS, Statutory, Tax-basis, Other
- Form 1120, Schedule B asks whether the corporation made any change in accounting principle for financial accounting purposes

IRS Initiatives

- Earnings & Profits
 - Requirements to use and report in U.S. GAAP
- Transfer Pricing
 - Primarily extends issue of comparability
- Revenue Recognition
 - Rules are different on an industry-by-industry basis
- Inventory Accounting
 - Might Congress take LIFO away in any event
 - Lower of cost or market in FIFO
- Change in Accounting Method Rules
 - One change or many changes
 - Can administrative difficulties be avoided to benefit of taxpayers and IRS

Domestic tax method of accounting examples

- LIFO inventory
 - What will a company use as their post-LIFO tax method
- Advance payments for goods and services under Rev. Proc. 2004-34
- Development expenses
 - Expenses that meet the “technical feasibility” standard are capitalized
 - Expenses that meet the “technical uncertainty” standard are expensed
- Component depreciation

Foreign tax examples

- Distinguish public company reporting from statutory accounts
- Australia
 - Adopted Australian Equivalents to IFRS in 2005
- Spain
 - Royal Decrees 1514/2007 and 1515/2007, both dated 16 October 2007 and in force since 1 January 2008, adapted the Spanish GAAP applicable to the Spanish entities to IFRS (New Spanish GAAP)
- Brazil
 - Law 11,638/07 changed the Corporate Law – gradual transition to an accounting standard closer to IFRS
- Other jurisdictions
 - Mauritius, Hong Kong, UK and the Netherlands



Systems and Processes

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Systems and Processes

- Systems ability to handle multiple GAAPs simultaneously
- Remapping of accounts to tax compliance and tax provision software
- Tax reporting packages
- Systems to handle new computations, such as the tax-effects of share-based payments
- Revisiting SOX 404 controls over tax reporting



People and Change Management

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People and Change Management

- IAS 12 technical skills
- New tax policy and procedure training
- Cultural resistance to change
- Concurrent processing of multiple GAAPs may introduce incremental effort to the reporting process



Questions?

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