Accounting for Income Taxes: A Misfit in the Convergence of Standards?

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As management accountants are well aware, the Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) have been working diligently to converge U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) to develop high-quality, principles-based global standards. As part of this process, the FASB and the IASB identified accounting for income taxes as a key short-term convergence project. In March 2009, the IASB issued an exposure draft (ED) for a new IFRS standard aimed at converging International Accounting Standard (IAS) 12, "Income Taxes," with GAAP.

Despite the Boards' good intentions, several comment letters received during the comment period indicated that the proposed standard had significant problems, including major rules-based changes to IAS 12. In November 2009, the FASB and the IASB scaled back the goal of the project, effectively bringing to a close the three-year effort that culminated in the ED. In March 2010, the IASB announced a limited-scope project, based largely on the ED, aimed at improving IAS 12 without introducing further divergence from U.S. GAAP.

This article analyzes the ED from a principles- and a rules-based standards perspective and demonstrates that converging international guidance on accounting for income taxes presents unique challenges in the movement toward a more principles-based set of global standards.

Principles-Based vs. Rules-Based Standards

Financial accounting regulators, preparers, users, and other interested parties have expressed growing concerns with the prevalence and adverse implications of rules-based standards in GAAP. Section 108(d) of the Sarbanes-Oxley Act of 2002 called for the Securities & Exchange Commission (SEC) to comprehensively study the adoption of a principles-based financial reporting system in the United States. The SEC report, issued in July 2003, found that principles-based accounting standards would be consistent with the "vision of reform that was the basis for the Sarbanes-Oxley Act"—and the FASB concurred with this recommendation. The IASB has often touted itself as taking a more principles-based approach to standards setting, and the standards issued by the IASB are generally considered to be less detailed and more principles-based in form. The debate over these two styles of accounting standards is focused on determining which will produce higher-quality financial reporting.

The SEC study characterized rules-based standards as having three key "commonly accepted" shortcomings: numerous percentage ("bright-line") tests, multiple exceptions to the purported underlying accounting principles, and a need for detailed implementation guidance to apply the standards. Principles-based standards, on the other hand, were defined as having a concise statement of the substantive accounting principle; few, if any, exceptions or internal inconsistencies; an appropriate amount of implementation guidance devoid of bright-line tests; and consistency with a conceptual framework of financial reporting.

The SEC study provided examples for each type of standard. Rules-based guidance is illustrated by the often-cited lease accounting literature (FASB *Accounting Standards Codification*™ (ASC) Topic 840), with its four bright-line tests for classifying a lease as operating or capital (two of which contain stated percentage thresholds). It gave as an example of principles-based guidance the literature for business combinations (FASB ASC Topic 805), which contains few scope limitations, no bright-line tests, and a limited amount of implementation guidance. The SEC study concluded that principles-based standards provide a better foundation for preparers to exercise professional judgment consistent with the intent of accounting standards and should result in more meaningful and informative financial statements.

Despite the appeal of the idea that principles-based accounting standards might avoid the shortcomings of rules-based standards, the SEC's *November 2008 Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers* expressed concerns that our complicated legal and regulatory environment may not align well with principles-based accounting standards.

Accounting for Income Taxes

Accounting for income taxes represents a crossroads for the profession's financial reporting, legal, and regulatory aspects. Tax departments of U.S. companies adjusted to the intricacies and prolonged implementation of FASB Interpretation No. 48 (now within FASB ASC Topic 740) and now would be faced with yet again adapting their tax life cycle—planning, compliance, accounting, provision, and controversy—if the United States were to adopt the existing IAS 12. Entities would not only have to adjust the many details of their tax processes, such as gathering and documenting data, but they may also have to restructure their technology, employee training, and internal controls. The Internal Revenue Code wouldn't be expected to change as a result of changes in accounting for income taxes; however, the intricate process that tax departments and auditors use to identify and compute book-to-tax differences would require adjustment for the effects of a new income tax accounting standard. For example, systems and processes for measuring the tax effects of stock options and uncertain tax positions would need to change to reflect different accounting under the ED. Of course, these items represent only a subset of the changes that would need to be made if international standards were to replace GAAP.

Part of the complexity of accounting for income taxes under GAAP is the sheer volume of guidance issued under the current rules-based approach. FASB ASC 740 includes references to seven Accounting Principles Board Opinions, three FASB Statements of Financial Accounting Standards (SFAS), two FASB Interpretations, four FASB Staff Positions, two FASB Technical Bulletins, 14 Emerging Issues Task Force abstracts or topics, and one American Institute of CPAs (AICPA) Statement of Position, as well as SEC Staff Accounting Bulletins and FASB Accounting Standards Updates. This guidance addresses the alternative minimum tax, insurance death benefits, payroll taxes associated with stock options, in-process research and development activities acquired in purchase business combinations, and a bevy of other specific exclusions and treatments. Given the complexity and variability of tax systems globally, if similar rules-oriented guidance were to become part of a standard for global accounting for income taxes, the number of specific exclusions and rules would make anything beyond a principles-based approach to this accounting challenge unreasonable.

Income tax transactions are by definition subject to the rules, regulations, and jurisdiction-specific nuances of local taxing authorities. One concern with the rules-based nature of the ED is that, in an effort to converge with GAAP and the U.S. tax environment, the proposed standards failed to consider the variety of other taxing jurisdictions around the world. The international diversity of income tax laws and the rigid way in which they're applied in many jurisdictions create an environment where it becomes tantamount that an accounting standard must be principles-based or the volume of exceptions is bound to squelch any attempts to issue a meaningful standard that can be applied globally. The IASB Staff Paper 8B, issued in November 2009 as part of the income tax project, describes jurisdiction-specific issues brought to the attention of international standards setters, including long-term leasehold investment properties in jurisdictions with no capital gains taxes, tax on dividends under Estonian income tax laws, and discounts on current taxes where payments are made in periods that exceed 12 months. Each of these examples of very specific tax law requires either that a rules-based standard be prepared to address all current and future exceptions or that a principles-based standard be crafted in such a way as to minimize exception-based treatments.

Examining the IASB Exposure Draft

The IASB ED proposed significant changes to IAS 12 (summarized in paragraph IN8 of the ED). In Table 1, we summarize the affected areas of the changes, the substance and explanation for the changes, and our analysis of whether each particular change is rules-based or principles-based.

Seven of the proposed changes represent a shift to a more rules-based approach to accounting guidance. One key example is the accounting for temporary differences that arise when the carrying amount (book basis) of investments in subsidiaries, branches, and associates, or interest in joint ventures, becomes different from the tax basis (item 6 in Table 1). Under IAS 12, entities must recognize a deferred tax liability associated with those types of investments unless the parent entity could control the timing of reversal and it was probable that the temporary difference wouldn't reverse in the foreseeable future. On the other hand, guidance under SFAS No. 109, "Accounting for Income Taxes" (now part of FASB ASC 740), prohibits the recognition of a deferred tax liability on the temporary difference related to an investment in a foreign subsidiary that is essentially permanent in duration. In both, the perceived uncertainty and complexity in measuring the deferred taxes associated with what represents a long-term investment in the earnings of a subsidiary arguably creates the need for an exception to the general principle.

The IAS 12 response to this challenge was to establish the probability of reversal using management's hegemony and intent to reverse. The GAAP approach is similar (control and intent are examined through the lens of permanently reinvested earnings) but is restricted to only foreign subsidiaries. In supporting its conclusion, the IASB explicitly rejected the IAS 12 approach. The ED adopts the GAAP model but in doing so moves toward the more restrictive rule. A number of parties expressed reticence toward a foreign-subsidiary-only approach to this exception for deferred tax liabilities and suggested a more principles-based approach. In its response to the ED, the European Financial Reporting Advisory Group (EFRAG) suggested that a more principles-based approach would consider "the difficulties and complexities [that] result from the tax laws of certain countries and apply regardless of the location of the parent."

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Other examples of rules-based guidance include measuring the tax basis of an asset assuming it was sold at year-end, treatment of tax-planning strategies, and intraperiod allocation of tax expenses. In each case, a specifically prescribed method of accounting is being proposed rather than allowing the overarching principle or objective of the guidance to stand alone. All three represent a change away from principles-based standards. Specifically, the latter two examples represent changes that are a simultaneous step toward convergence with GAAP. When commenting on the tax strategies proposal (item 8 in Table 1), EFRAG stated, "We think that this is yet another very rules-based requirement, which we believe will not be an improve-

Table 1: Proposed Changes to IAS 12

AREA OF CHANGE	SUBSTANCE OF CHANGE	RULES VS. PRINCIPLES ANALYSIS
1. Definition of tax basis	Added language regarding "substantially enacted tax rates."	Rules-based
2. Definition of tax basis	Requires tax basis to be measured assuming asset is sold at year-end.	Rules-based
3. Requirements to qualify as a temporary difference*	Requires that temporary differences exclude any difference not expected to affect taxable profit.	None
4. Definition of tax credit and investment tax credit	Provides definitions of tax credit and investment tax credit but no additional guidance as to accounting treatment.	Rules-based
5. Exception for assets/liabilities with differing tax bases and carrying values at initial recognition	Prescribes the treatment for measuring assets or liabilities not acquired in business combinations that have different tax bases and carrying values.	None
6. Deferred taxes associated with investments in subsidiaries	Provides an exception only for foreign subsidiaries that the investment is essentially permanent in duration.	Rules-based
7. Value of deferred tax assets*	Provides for use of valuation allowance against deferred tax assets.	Principles-based
8. Effect of tax-planning strategies on deferred tax assets	Significant tax-planning strategy costs should be included in the valuation allowance.	Rules-based
9. Uncertain tax positions*	Provides for a probability-weighted approach to possible outcomes of uncertain tax positions.	Rules-based
10. Distributed or undistributed tax rates	Tax rate used to measure deferred taxes should be the rate expected to apply when the tax asset/liability is realized or settled, including entity expectations of future distributions.	Principles-based
11. Intraperiod allocation of tax expense	Adopts SFAS No. 109 (FASB ASC 740) allocation of tax expense to income, other comprehensive income, and equity that prohibits the use of backward tracing.	Rules-based
12. Classification of deferred assets and liabilities as current and noncurrent	Adopts SFAS No. 109 (FASB ASC 740) classification of deferred tax items consistent with the classification of the underlying asset or liability.	None
13. Classification of interest and penalties	Adopts classification policy consistent with FIN 48 (FASB ASC 740), but does not adopt disclosure requirements.	Principles-based

*Items also considered as part of the limited scope project as outlined by the IASB in May 2010.

ment to IAS 12 and is once again giving preference to a U.S. GAAP requirement and simply adopting that existing requirement, without the IASB having considered other possible alternatives to the accounting." In short, in order to obtain a single set of global accounting standards, many users might have to begrudgingly accept a shift toward some rules-based standards.

Table 1 shows that the ED contains three changes that represent a shift toward a more principles-based approach. For example, the two-step measurement process (stating the deferred tax asset at gross value and then deducting a valuation allowance) and the accounting policy choice on classifying interest on uncertain tax positions (in Table 1, items 7 and 13, respectively) are both consistent with the underlying financial statement framework. Other changes represent neither a shift away from nor toward rules- or principles-based guidance. For example, both IAS 12 and the ED provide for prescriptive guidance on classification of deferred taxes on the balance sheet (item 12 in Table 1).

IASB's Limited Scope Project

The IASB felt that the changes instituted through the ED warranted a substantive effort on the part of constituents but weren't justified by the level of improvement achieved. As a result, in November 2009, it effectively abandoned the ED in favor of a limited scope project to make changes to IAS 12. In the spirit of the convergence process, the accounting issues included in the limited scope project, which the IASB approved in May 2010, were selected because they represent improvements to existing guidance without introducing further divergence from GAAP. These practice-related issues arose from the application of IAS 12 and a subset of the improvements proposed in the ED.

Thus far, an exposure draft issued in September 2010 regarding deferred taxes on the remeasurement of property at its fair value represents the only formal guidance issued as a result of the limited scope project. This particular guidance provides an exception to the general principle of presumption of recovering an asset through sale and allows for an alternative treatment of recovery presumed through consumption of the asset over its economic life. This ED is an acknowledged exception, albeit narrow, to the principles of IAS 12.

What Now?

This examination of the ED is one example of how the process of setting global standards may be affected by opportunities to converge with existing country-specific accounting standards. It's clear from the volume of GAAP and significant proposed changes to IAS 12 that accounting for income taxes is difficult for the accounting profession. The ED attempted to remedy complications and fill gaps in the existing international guidance, yet the major proposed changes that result in rules-based guidance raise questions about the IASB's ability to maintain its principles-based approach and still achieve convergence for income taxes.

At their joint meeting in October 2009, the IASB and the FASB reviewed a summary of the comments the IASB received in response to the ED. During this meeting, then IASB Board Member Jim Leisenring said, "I don't think we can justify some of the exceptions. In fact, I know I can't and call ourselves [the IASB] principles-based in any way." He continued, "I think we've [IASB and FASB] made random exceptions that...can't be reconciled as to why."

In November 2009, the IASB and the FASB issued a joint statement indicating the income tax project won't proceed in its current form. The IASB has now elected to consider only limited amendments to IAS 12.

Regardless of the outcome, the effects of convergence with GAAP on accounting for income taxes resulted in an ED with a more rules-based approach than the IASB and its constituents prefer. As a result, the ED appears to have failed in its quest to achieve convergence. Creating a single set of high-quality global accounting standards remains a challenge for regulators. As we hope this article has demonstrated, accounting for income taxes provides a unique environment in which the need for convergence may outweigh the need for a strong principles-based standard. **SF**

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Short-term convergence â€¢ Since 2002, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) have been committed to the convergence of IFRS and U.S. GAAP. â€¢ Preparers and others, including regulators, have called for convergence to simplify financial reporting and to reduce the burden of compliance for listed companies, especially those with a stockmarket listing in more than one jurisdiction.Â The limited scope project resulted in the 2010 amendment to IAS 12 addressing the accounting for deferred taxes associated with investment properties measured at fair value in accordance with IAS 40.Short-term convergence â€¢ As a result of the feedback received. International Accounting Standards (IAS) 12, Income Taxes. This IFRS standard mandates the allocation of taxes between periods as determined by the recognition of transactions in periods governed by the application of IFRS. The differences in recognition for financial statements and for tax purposes are reconciled through deferred taxes. IAS 12 describes recognition and measurement of deferred taxes using a temporary difference approach, similar to the method of FAS 109, Accounting for Income Taxes. Although there are significant differences in the treatment of tax basis, uncertain tax positio