THE REQUIREMENT FOR ALL EU LISTED COMPANIES TO USE IFRS FOR THEIR CONSOLIDATED ACCOUNTS AS OF 1 JANUARY 2005 WILL HARMONISE FINANCIAL REPORTING ACROSS EUROPE. BUT WHAT ARE THE TAX IMPLICATIONS OF THIS MOVE FOR EUROPEAN CORPORATES? **MOHAMMED AMIN** INVESTIGATES.

IFRS ASKS SOME TAXING QUESTIONS

The EU Regulation 1606/2002/EC's requirement for the use of International Financial Reporting Standards (IFRS) for the consolidated accounts of group companies raises a number of important tax questions for corporates in Europe. In most countries of the world, companies do not pay taxes based on their consolidated group accounts. Instead, they file tax returns, based upon the profits reported in their own individual company accounts. Accordingly, the first question to ask is whether companies will now start preparing their individual entity accounts under the new accounting standards.

Although there is no uniform answer, the approach of using IFRS for consolidated accounts and local Generally Accepted Accounting Principles (GAAP) for individual company accounts is unlikely to be sustainable in the long run. Once account users become familiar with IFRS consolidated accounts, they may question the continuing relevance of local GAAP. Over a period of time IFRS is, therefore, most likely to become the standard way of preparing individual company accounts in Europe.

But if companies do prepare their accounts under IFRS, will this be acceptable for their tax returns? Or will they be required to recompute their profits under the local GAAP of their country? If IFRS can be used for individual company accounts or tax returns, a number of issues arise.

FIRST TIME ADOPTION CHANGES. If an EU-listed company prepares its accounts on a calendar-year basis, its last local GAAP accounts will be for 2004, and its last local GAAP balance sheet will be for 31 December 2004. On 1 January 2005, however, companies will be required to restate their balance sheets as if they had always used IFRS.

Figure 1 illustrates how a typical company might be affected by first time adoption of IFRS. For example, inventory may increase due to the fact that IFRS requires more costs to be inventoried than local GAAP. Similarly, it is assumed that local GAAP depreciation for property plant and equipment has been faster than IFRS depreciation.

The complexities arising from IAS 39 also present tax questions. The figure shows that under local GAAP, the company held two derivatives off balance sheet, and owned a bond that was being carried at amortised cost under local GAAP. Upon first-time adoption of IFRS, both derivatives are restated to fair value, while the bond is revalued for interest rate changes (assuming that derivative B was an effective fair value hedge for the bond under local GAAP). The overall effect is an increase in shareholders' funds of €220 – but will part or all of this increase be taxable?

PREPARING ACCOUNTS IN FOREIGN CURRENCIES. IFRS also adds complexity to the tax treatment of profits when accounts are prepared in a foreign currency. This is largely because it distinguishes between the currency used to present the accounts (the 'presentation currency') and the currency which best represents the business environment of the company (the 'functional currency').

This can be illustrated by taking the example of a Dutch company in Amsterdam which buys and sells oil that is priced in dollars. To protect itself against adverse exchange rate fluctuations, the company may finance itself with dollar borrowings; this hedges the exchange risk of holding oil inventory priced in dollars. It would make sense for this company to prepare its accounts in dollars, but some countries do place restrictions on companies' producing accounts in a foreign currency.

If such restrictions existed, the oil company's 'functional currency' under IFRS would be dollars, but its 'presentation currency' would be the euro as it is a Dutch company. The functional currency is critical here, because foreign exchange (FX) gains and losses are measured against the functional currency. If the oil trading company held cash in a euro bank account, its financial statements presented in euros would report FX gains or losses that had been computed by re-measuring the euro bank account in dollars. How will taxable profits be determined in this situation?

CASHFLOW HEDGES. The calculation of cashflow hedges also raises tax issues when IFRS is adopted. In *Figure 1*, for example, swap A is a cashflow hedge of the floating rate bond liability D. Presuming that the company is able to meet the IAS 39 hedging criteria going forward, at each balance sheet date, the swap must be stated on the balance sheet at its fair value, with revaluation differences taken to equity. Will such revaluation differences be taxable immediately, or deferred until they are recognised in the income statement?

FAIR VALUE HEDGES. Similar tax uncertainties arise as a result of IFRS requirements to 'fair value' hedges. In *Figure 1*, swap B operates as a fair value hedge of the bond investment C. As the value of the bond has fallen due to interest rate changes, from €600 to €450, the fair value of the swap rises from zero to €150, providing a perfect hedge. While these changes would be recorded on first-time adoption of IFRS, similar changes in future periods will be reflected in the company's income statement providing the criteria for continued hedging are met under IAS 39, and being equal and opposite, cancel out. Will the tax treatment operate in the same way?

Figure 1. Example of a first-time adoption balance sheet

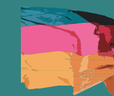
	Notes	Local GAAP	Restated to IFRS
Inventories		€100	€120
Property, plant and equipment		€400	€500
Pay fixed/receive floating interest rate swap	A	€0	€100
Pay fixed/receive floating interest rate swap	B	€0	€150
Fixed rate bond investment	C	€600	€450
Total assets		€1,100	€1,320
Shareholders' funds		€700	€920
Floating rate bond liability	D	€400	€400
		€1,100	€1,320

A is a cashflow hedge of D and B is a fair value hedge of C

GAAP prevails in Europe

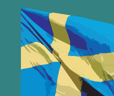
A small survey of European countries in July 2004, conducted to assess what is happening to local corporate law and tax law in relation to IFRS, revealed that many countries have deferred the problem by requiring continued use of local GAAP.

Germany



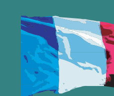
German companies are not presently allowed to prepare their accounts under IFRS. Accordingly, while the 2005 consolidated accounts of listed groups will be published under IFRS, the accounts of all German subsidiaries, and the company non-consolidated accounts of the parent, must be prepared under German GAAP. Specific changes would be needed to corporate law and tax law before IFRS could be used for individual company accounts or tax returns, but such changes have not yet been initiated.

Sweden



The situation in Sweden is exactly the same. The Swedish Council of Law is studying whether the position should change, and a clearer indication of the position is expected around October/November 2004. There appears to be some possibility that Swedish companies preparing accounts under Swedish GAAP under the Swedish Annual Accounts Act may be allowed to use certain accounting principles based on IFRS. However no details are expected until October/November this year.

France



The French authorities are still considering whether to allow French companies to prepare their legal entity accounts under IFRS, and the changes to tax law that would be needed. If changes are made, they may be announced with the new draft tax law expected in October 2004.

NET INVESTMENT HEDGING. In some countries, it is common to hedge balance sheet translation risk. For example, a British company that purchases a US company for US$100m may borrow US$100m (rather than borrowing the equivalent in British pounds). This ensures that future FX movements on the debt will offset FX movements arising when translating investment in the subsidiary onto the British company's consolidated balance sheet. If the purchase was financed from existing sterling cash reserves, on the other hand, the company may hedge this translation risk by entering into a £:US$ currency swap.

IFRS recognises hedging of translation risk (referred to as the "hedge of a net investment in a foreign operation" in IAS 39) when the consolidated accounts are prepared, with FX differences on the hedge and on translating the foreign operation both being taken to equity. However, this treatment is not followed in the entity accounts of the company owning the shares in the foreign subsidiary. Such shares are usually carried at historic cost in a local currency, and not adjusted for FX movements. Accordingly, in the entity accounts, FX differences on the hedge will go to the income statement, but are they taxable?

EMBEDDED DERIVATIVES. Under local GAAP (e.g. UK GAAP), convertible bonds are usually treated as a single asset or liability, with no separate recognition of the option to convert into shares. Conversely, under IFRS, instruments with embedded derivatives must be bifurcated (unless the embedded derivative is 'closely related' as defined in IAS 39) with the derivative and the host contract accounted for separately.

Local tax law may well treat debt assets/liabilities and equity derivatives in a different way, but will such bifurcation be respected for tax purposes. Or will the tax law insist on treating the host contract with its embedded derivative as a single debt instrument?

DOES THE UK HAVE THE ANSWERS? For companies in the UK, many of the questions raised here can already be answered. This is because the UK Department of Trade and Industry has proposed that almost all UK companies should be free to adopt IFRS for their company accounts. With rare exceptions, the choice would be one way – companies would not be able to change back from IFRS to UK GAAP. All group companies would also have to use the same accounting basis as used in the legal entity accounts of the parent (whether IFRS or UK GAAP) except where there is 'good reason' for the contrary.

The UK tax authorities have been consulting with taxpayers and professionals for about a year now and, as a result, they have a good appreciation of the tax issues involved with IFRS. The *Finance Bill*, published in April 2004, permits the use of IFRS accounts when filing tax returns, and makes various changes to tax law to accommodate IFRS. It also enables the government to make further detailed changes by issuing statutory instruments (which have legal force but are quicker and simpler to effect than passing legislation through Parliament).

Accordingly, the UK is hence well ahead of some other European countries in adapting its corporate and tax law for IFRS.

‘THE UK DEPARTMENT OF TRADE AND INDUSTRY HAS PROPOSED THAT ALMOST ALL UK COMPANIES SHOULD BE FREE TO ADOPT IFRS FOR THEIR COMPANY ACCOUNTS’

The change in inventory valuation brought about by IFRS will be taxable. However, the changes to property plant and equipment will not be taxable, as the UK gives tax depreciation by a statutory code (‘capital allowances’) which is not linked to accounting depreciation.

The changes to the financial instruments A, B, C and D, meanwhile, will be taxable, subject to the hedge accounting concepts. The tax authorities are still considering whether the first time adoption adjustment should be taxable immediately or spread over several years. The likelihood is that it will be spread because the adjustment may be negative (a tax deduction). This may be due to replacing bad debt reserves which are sometimes non-deductible with IFRS impairment calculations.

UK companies can already prepare their accounts in any currency. The ‘functional’ currency will be used for tax purposes, even if it is not the ‘presentation’ currency of the accounts.

HEDGING IN THE UK. Specific tax rules are being introduced in the UK which recognise a much wider range of hedges for tax purposes than IFRS permits for financial accounting. The intention is that companies should be in the same position for tax purposes under IFRS as they were under UK GAAP. Accordingly, as well as a tax system that follows IFRS accounting treatment of effective hedges, UK tax law will also recognise some hedging relationships as effective for tax purposes – even where they are ineffective for IFRS. For example, net investment hedging will be respected so that gains on the hedging instrument are not taxed on a current basis, even though they are taken to the income statement in the financial accounts.

In the UK, the bifurcation of the host instrument into a simple instrument plus a separate derivative will also be followed for tax purposes, with the embedded derivative being taxed in the same way as a standalone derivative with the same characteristics.

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