The Impact of International Financial Reporting Standards on Taxation

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Abstract

Accounting is shaped by economic and political forces. It follows that increased worldwide integration of both markets and politics (driven by reductions in communications and information processing costs) makes increased integration of financial reporting standards and practice almost inevitable. The connection between tax and accounting is a complex topic with many dimensions. One explanation for this is changes within accounting on the international level. This creates a challenge for tax law and a need to revisit the theoretical and practical foundations for the use of accounting as a starting point for taxation of companies. International Financial Reporting Standards (IFRS) is a standard format of financial reporting that is gaining momentum worldwide and is a single consistent accounting framework and is likely to become predominant Generally Accepted Accounting Practice (GAAP) in times to come. The aim of this study is to research International literature to gain an insight into the basis and form of divergence between accounting transactions and taxation accounting in relation to International Financial Reporting Standards.

Keywords: Taxation, International Financial Reporting Standard, International Accounting Standards Board, Tax Law

Introduction

International accounting literature provides evidence that accounting quality has economic consequences, such as costs of capital (Leuz and Verrecchia, 2000), efficiency of capital allocation (Bushman, Piotroski, and Smith, 2006; Sun, 2006), and international capital mobility (Young and Guenther, 2002). With the globalization of world economy and trade liberalization, international trade barriers are being eroded. Doing business across borders is now possible and investors could invest their money anywhere in the globe. However, to convince them to part with their capital, the financial statements of prospective investments should be transparent, reliable, and comparable. Previously, an objective comparison of financial statements was almost impossible with the different accounting standards implemented in different countries.

IFRS are accounting rules ("standards") issued by the International Accounting Standards Board (IASB), an independent organization based in London, UK. They are set of rules that ideally would apply equally to financial reporting by public companies worldwide. Between 1973 and 2000, international standards were issued by the IASB's predecessor organization, the International Accounting Standards Committee (IASC), a body established in 1973 by the professional accountancy bodies in Australia, Canada, France, Germany, Japan, Mexico, Netherlands, United Kingdom and Ireland, and the United States.

During that period, the IASC's rules were described as "International Accounting Standards" (IAS). Since April 2001, this rule-making function has been taken over by a newly-reconstituted IASB. The IASB describes its rules under the new label "International Financial Reporting Standards" (IFRS), though it continues to recognize (accept as legitimate) the prior rules (IAS) issued by the old standard-setter (IASC). The IASB is better-funded, better-staffed and more independent than its predecessor, the IASC. Nevertheless, there has been substantial continuity across time in its viewpoint and in its accounting standards.

The connection between tax and accounting is a complex topic with many dimensions. It is a very dynamic area. One explanation for this is changes within accounting on the international level. The most important change has been the adoption of International Financial Reporting Standards (IFRS) as the mandatory standard for consolidated accounts in listed companies within EU. But the introduction of IFRS also might affect financial accounting in unlisted companies.

This creates a challenge for tax law and a need to revisit the theoretical and practical foundations for the use of accounting as a starting point for taxation of companies. Financial accounting and Taxation accounting have different purposes and requirements. Accounting involves the preparation of information for the purpose of control and decision making and may require interpretation as well as simply recording factual information. The main purpose of taxation is usually to raise revenue but it is also used as an instrument of government economic and social policy. For a tax system to operate successfully within the law, it requires a degree of certainty that may not always be appropriate for financial and commercial accounting. Furthermore there may be alternative methods of preparing accounts that are equally acceptable in terms of accounting standards but the choice of which might be inappropriately influenced by taxation implications.

IFRS and Quality of Accounting Information

The fundamental economic function of accounting standards is to provide "agreement about how important commercial transactions are to be implemented" (Ball, 2001). Ensuring disclosure quality of financial information is also mandatory for reducing information asymmetry and solving agency problem in corporate sector. Existing literatures document improvements in accounting quality following voluntary IFRS adoption (Barth et al., 2006; Gassen and Sellhorn, 2006; Hung and Subramanyam, 2007; Barth et al., 2008) to reduce information asymmetry between managers and shareholders and it can be evidenced by proper assets and earnings management, lower cost of capital, and high forecasting capability by the investors about firm's future earnings. Gordon (2008) listed the benefits from adaptation of IFRS over the world as- (1) Better financial information for shareholders (2) Better financial information for regulators; (3) Enhanced comparability; (4) Improved transparency of results; (5) Increased ability to secure cross-border listing; (6) Better management of global operations; and (7) Decreased cost of capital.

Barth et al. (2006) suggest that accounting quality could be improved with elimination of alternative accounting methods that are less reflective of firms' performance and are used by managers to manage earnings. They compare earnings management for firms that voluntarily switch to IFRS with firms that use domestic accounting standards. They find that after IFRS adoption, firms have higher variance of changes in net income, a higher ratio of variance of changes in net income to variance of changes in cash flows, higher correlation between accruals and cash flows, lower frequency of small positive net income, and higher frequency of large losses. Barth et al. (2006; 2008) also found that an international sample of firms that voluntarily adopted IFRS up to 2003 exhibits lower levels of earnings management and more timely loss recognition than a matched sample of firms using local GAAP. As an extension of these findings, Daske et al. (2007) focus on the heterogeneity in the consequences of voluntary IFRS adoption and find that on average capital markets respond modestly to voluntary IFRS reporting.
Overall the evidence on the association between voluntary IFRS adoption and accounting quality is mixed, although papers applying more recent data generally find relatively better accounting quality among the firms that adopt IFRS. (Christensen et al. 2008). A common feature of these studies is that, much of the previous studies on IFRS compliance relates to voluntary adopters, which by definition suffer from selection bias (Asbaugh 2001). This raises the question as to whether we can attribute the improved quality to the application of IFRS per se.

That is, does the application of IFRS have an incremental effect on accounting quality, or is the observed quality improvement a result of other changes implemented simultaneously by the adopting firms? In a study, Daske et al. (2007) examine the capital market effects of mandatory IFRS adoption. They find evidence that is consistent with reduced information asymmetry in association with mandatory IFRS adoption.

They argue that the effect could be driven by network effects rather than accounting quality improvements. In a similar spirit, Lee et al. (2008) argue that if IFRS matters, then firms in countries that had lower disclosure quality and dependence on equity financing prior to mandatory IFRS should experience a greater impact after mandatory adoption. However, using implied cost of equity capital as an indicator, they find no effect among such countries even after two years under the new accounting standards. By eliminating many international differences in accounting standards, and standardizing reporting formats, IFRS eliminate many of the adjustments that analysts historically have made in order to make companies' financial information more comparable internationally. IFRS adoption therefore could make it less costly for investors to compare firms across markets and countries (e.g., Armstrong et al., 2007; Covrig, Defond, and Hung, 2007). Thus, a common set of accounting standards would reduce information asymmetries among investors and/or lower estimation risk by increasing comparability between lower and higher quality firms. The gain would be greatest for institutions that create large, standardized-format financial databases. Similarly, accounting diversity could be an impediment to cross-border investment (Bradshw, Bushee, and Miller, 2004).

Thus, reducing international differences in accounting standards assists to some degree in facilitating international integration of capital markets (Covrig, Defond, and Hung, 2007) by removing barriers to cross-border acquisitions and divestitures, which in theory will reward investors with increased takeover premiums (Bradley, Desai and Kim, 1988). To signify the effect of IFRS on investors' ability to forecast earnings; some researchers argue that better accounting standards make reported earnings less noisy and more accurate, hence more "value relevant." (Ashbaugh and Pincus (2001), Hope (2003)). Other things equal (for example, ignoring enforcement and implementation issues for the moment) this would make earnings easier to forecast and would improve average analyst forecast accuracy. Though some researchers (Ball, Kothari and Robin (2000) and Ball, Robin and Wu (2003)) thought oppositely that managers in low-quality reporting regimes are able to "smooth" reported earnings to meet a variety of objectives, such as reducing the volatility of their own compensation, reducing the volatility of payouts to other stakeholders (notably, employee bonuses and dividends), reducing corporate taxes, and avoiding recognition of losses.

The Purposes of Accounting and Taxation

The purpose of accounting is usually stated to be the provision to interested parties of information relevant to stewardship, control and decision-making. The interested parties may be internal (management) or external (such as shareholders, creditors, tax authorities). Further elaboration of the concepts behind the development of accounting standards is to be found in the Framework for the Preparation and Presentation of Financial Statements published by the International Accounting Standards Committee (IASC). This is summarized, for example, by Nobes and Parker (2002). As they indicate, the Framework supposes that the main purpose of financial statements is to provide information to various users to improve their financial decision-making. The requirements of a tax system can be quite different. This has been made very clear, for example, in a case before the US Supreme Court, Thor Power Tools Company v. Commissioner of Internal Revenue 58L Ed. 2d.785 at 802 (1979). The case was concerned with matters related to inventory accounting procedures and additions to bad debt reserves and that accountant might be more conservative for commercial reasons than was appropriate for the assessment of tax. It was stated that:

> The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect, maintain and expand sources of revenue for public finance. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets'. In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

Furthermore, there are other reasons why taxation might deviate from accounting concepts of income. While the most obvious purpose of taxation is to finance public expenditure, taxation in modern economies also makes it a powerful instrument of government economic and social policy in its own right.

While it is true that some taxation measures might be introduced to improve economic decision-making, others are implemented for very different reasons. There may therefore be all manner of modifications to income as it might be normally understood before arriving at the appropriate figure for tax purposes. Surrey's (1973) concept of tax expenditures ably describes the situation that 'those provisions of the federal income tax containing special exemptions, exclusions, deductions and other tax benefits were really methods of providing governmental financial assistance'. Even when such tax provisions exist for purely economic reasons, it does not mean that they will necessarily coincide with the purposes of financial accounting since the government may be taking account of wider public economic interests rather than the specific economic reasons that pertain to that tax provision.

For example with depreciation, where the amounts allowed for capital expenditure may be adjusted for the purposes of taxation in order to encourage private sector investment. On the other hand the government might decide that certain activities normally considered perfectly acceptable for commercial purposes should not be given tax concessions. One UK example consists of the tax treatment of certain expenses. For business reasons it is desirable to take account of all the costs incurred in generating revenue. However, some expenses may not be allowable for tax purposes. For instance, the cost of entertaining customers and the cost of gifts, unless it is a modest amount and for the purposes of advertising, are not allowed for tax purposes. The original reason seems to have been to prevent extravagance and tax avoidance.

Effects of financial accounting standards on tax accounting

How relevant IFRS is from a tax perspective depends on three things; assuming no changes is undertaken in tax legislation in a country. First, to what extent is financial accounting connected to tax accounting in specific country. Second, if a country chooses to use the "full IFRS" option for annual accounts of companies. Third, to what extent national accounting standard setters take IFRS into consideration when setting standards for national Generally Accepted Accounting Practice (GAAP) and what choices of accounting principles companies can make within national GAAP. In countries where there is no connection between financial accounting and tax accounting, there should be no impact of IFRS on tax accounting, of course. In countries where there is some degree of connection between financial accounting and tax accounting there are a number of alternative outcomes. If "full IFRS" is mandatory for annual accounts it will affect the tax accounting in connected areas (but this is very rare). If the company has an option to either apply "full IFRS" or national GAAP the effect depends on the choice of the company and whether tax law recognizes IFRS as a tax base. But in substance the effects of IFRS depend on the degree at which national GAAP incorporates IFRS accounting principles.

Changes in tax legislation

From the discussion above assuming that changes were made in tax law because of IFRS. The key question is: how will tax systems handle the shift from a transaction-based approach to a value-based approach in financial accounting from a tax perspective? Should unrealized profits be taxed and deduction for unrealized losses allowed? Or to put the question on a more theoretical level – should tax accounting move from a transaction-based approach (based on "old accounting" theory) to a value based-approach (based on "new accounting theory")? There are of course arguments for and against. The main argument in favour is that a use of IFRS as a tax base moves tax accounting closer to the "real economic income" of companies. The arguments against are numerous. (1) Fair value accounting is highly subjective. It is not easy to control for tax purposes. (2) Another argument is that the use of IFRS will lead to a situation where (unrealized) income is taxed which in turn will affect the liquidity of companies. (3) IFRS-standards are complicated and difficult to understand. (4) The complexity of standards and the high number of subjective judgments that have to be made will increase the risk of tax disputes. (See for example Knutsson, 2005).

Uneven implementation

In the presence of local political and economic factors that exert substantial influence on local financial reporting practice, and in the absence of an effective worldwide enforcement mechanism, the very meaning of IFRS adoption and the implications of adoption are far from clear. Uneven implementation of IFRS seems inevitable. Accrual accounting (and fair value accounting in particular) involves judgments about future cash flows and thereby provides leeway in IFRS implementation. Powerful local economic and political forces determine how managers, auditors, courts and regulators respond to that leeway. Uneven implementation curtails the ability of uniform standards to reduce information costs and information risk.

It could increase information processing costs, by burying accounting inconsistencies at a deeper and less transparent level than more-readily observable differences in standards. It threatens to curtail many of the potential benefits of IFRS adoption. One concern is that allowing unfettered use of the IFRS 'brand name' by any country discards information about reporting quality differences, and does not allow high-quality financial reporting regimes to signal that they follow better standards than low-quality regimes. The incentives of preparers (managers) and enforcers (auditors, courts, regulators, politicians) remain primarily local, and inevitably will create differences in financial reporting quality that will tend to be 'swept under the rug' of uniformity. Another concern is that international standards reduce competition among alternative financial reporting systems, and hence reduce innovation.

Finally, while the IASB and its promulgated standards historically have enjoyed – and currently do enjoy – a strong 'common law' orientation, over time the IASB risks becoming a politicized, polarized, bureaucratic, UN-style body (Ball, 2006).

Conclusions

The idea of using financial accounting as a starting point for tax accounting is based on both theoretical and practical motives. But apart from the idea to tax "the real economic income" of companies, the theoretical foundation is rather vague from a tax standpoint. Tax accounting in many countries has not developed independently from financial accounting.

Instead, there has been a reciprocal influence, in many countries also mixed with influences to and from company law. The effect has been that both financial accounting and tax accounting has developed around some common principles (historical cost, realization, prudence etc.). The details in national GAAP might differ from rules for tax accounting, but the definition of income will be built on the same approach. When financial accounting starts to develop in the lines of IFRS, with an income concept built on a balance sheet approach allowing fair value accounting, this can change the content of national GAAP in a significant way and therefore also indirectly affect tax accounting in a country. But, to what degree there will be any major changes in national GAAP depends on legislators and standard setters. Since this is a tricky question, a commonly endorsed alternative is to allow the companies to choose accounting principles within GAAP.

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