



SHORT-TERM INTERNATIONAL CONVERGENCE

Financial Accounting Standards Advisory Council
March 2004

Background

At their joint meeting in September 2002, the FASB and the IASB affirmed their commitment to the goal of achieving convergence of accounting standards used internationally. Both Boards agree that *convergence* means development of a single set of high-quality accounting standards that could be used for both domestic and cross-border financial reporting.

The FASB believes that convergence is consistent with its mission and obligation to its domestic constituents. U.S. constituents are expected to benefit from convergence in many ways, such as:

- Efficient functioning of the global capital markets—decisions about the allocation of resources rely heavily on credible, transparent, and understandable financial information that is comparable across national borders. Today, members of the user community cannot easily compare the results of similar companies when those companies report results under different bases of accounting.
- Reducing the administrative burden on multinational entities that are currently required to prepare financial statements under several different bases of accounting and reconcile them for cross-border reporting.
- Enabling U.S. companies to access capital markets outside the United States without needing to “reconcile” their U.S. GAAP-based financial results to those that would have been reported under international accounting standards.

The Board’s convergence goal is supported by many. Indeed, the Trustees of the Financial Accounting Foundation and regulators such as the Securities and Exchange Commission have strongly encouraged the FASB to include convergence with the IASB among the organization’s highest priorities.

The short-term international convergence project is just one of several tactics the Boards are using to achieve their convergence goal. Others include coordinated

development of specific accounting standards (through joint projects such as business combinations and projects undertaken cooperatively such as share-based payment) and broader coordination of their standard-setting activities.

The purpose of the short-term international convergence project is to address certain narrow differences between U.S. GAAP and International Financial Reporting Standards (IFRS) that are not significant individually, but collectively reduce the comparability of financial information and contribute to the administrative cost of preparing financial statements in multiple jurisdictions. Candidates for inclusion in this project include:

- Narrow differences in the provisions of similar, existing U.S. GAAP and IFRS that represent high-quality accounting standards (for example, differences in the accounting for income taxes discussed later in this paper). The short-term convergence project is an opportunity in the near term to reduce or eliminate the noncomparability that results from those differences.
- Narrow differences in areas for which, between existing IFRS and U.S. GAAP, one of the existing standards is viewed as a high-quality accounting standard. Convergence would be achieved by both Boards adopting the similar high-quality standard.

While convergence is the catalyst for including a particular difference in the scope of the project, both Boards are committed to making a change to their standards only when they conclude that a change represents a high-quality solution to the issue being addressed.

Objective of the March 24 Council Meeting

At the March 24 FASAC meeting, the Board will provide Council members with an overview of its next steps in the short-term convergence project—to consider differences between U.S. GAAP and IFRS in accounting for income taxes and accounting for research and development costs.

ACCOUNTING FOR INCOME TAXES

Phase two of the short-term convergence project will consider certain differences in accounting for income taxes. International Accounting Standard 12, *Income Taxes* (IAS 12), is the prevailing IFRS guidance and is based on principles

similar to those of FASB Statement No. 109, *Accounting for Income Taxes* (SFAS 109). However, differences in the application of those similar principles result in noncomparability between entities applying SFAS 109 and those applying IAS 12. The Board's objective in undertaking this project is to reduce or eliminate that noncomparability by reconsidering the narrow set of differences that give rise to it. Those differences, while relatively few in number, are the source of the most common reconciling items between reported results under U.S. GAAP and international accounting standards.

At its meeting on March 16, 2004, the FASB agreed on the scope of the income tax portion of the short-term convergence project. The March Council meeting will include discussion of issues included in that scope. The main objective of the discussion is to provide Council members with the opportunity to communicate any conceptual or practical considerations they believe the Board should consider in its deliberation of those issues.

Summary Overview—Comparison of SFAS 109 and IAS 12

SFAS 109 and IAS 12 are founded on similar principles: both standards take a balance sheet approach to accounting for income taxes. Both standards account for taxes currently payable (or receivable) arising from current taxable income, and also account for future (deferred) taxes payable (or receivable) due to differences between the GAAP and tax bases of assets and liabilities.

Differences between U.S. GAAP and IFRS principally arise for the following reasons:

- Differences in the exceptions to application of those similar principles
- Certain narrow differences in the recognition, measurement, and disclosure criteria in the two standards
- Differences resulting from some specific application and implementation guidance related to SFAS 109.

Exceptions to the Basic Principles of Income Tax Accounting

Both SFAS 109 and IAS 12 make certain explicit exceptions to the basic principle of comprehensive recognition of deferred taxes, and those exceptions are the primary source of the noncomparability that results from the application of those similar standards. SFAS 109 has six explicit exceptions to the basic principle, IAS 12 contains three explicit exceptions to the basic principle, and there is some overlap in the exceptions in both standards. The Boards plan to reconsider some or all those exceptions as part of this project in its efforts to move toward convergence. The staff notes that any decisions by the FASB to achieve convergence through elimination of those exceptions might also be viewed as consistent with the FASB's stated goal of adopting more "principles-based" standards.

Some of the exceptions in SFAS 109 to the principle of comprehensive recognition of deferred taxes were made to ease transition to that accounting standard (exceptions relating to bad debt reserves, policyholders' surplus, and steamship enterprises). Based on initial staff research, it is not expected that those exceptions will be changed by this project, as they have limited current applicability and thus do not give rise to fundamental noncomparability.

Other exceptions to the basic principle relate to matters being addressed in other major Board projects (those relating to goodwill, certain equity transactions, and leveraged leases). The Board plans to consider those exceptions or differences in the context of those major projects rather than the short-term convergence project.

The following three exceptions to the basic principles in SFAS 109 represent significant differences between that Statement and IAS 12 and, thus, will be the focus of the Board's deliberations in this phase of the project. Those areas were significant issues in the FASB's original deliberations of SFAS 109. Prior to deliberating those issues again, the Board anticipates devoting a significant

amount of staff time to thoroughly research the issues, including reviewing prior Board deliberations and constituent comments.

- Foreign subsidiaries and undistributed earnings. The SFAS 109 exception relates to foreign subsidiaries, while the IAS 12 exception relates to all subsidiaries, foreign and domestic. The core issue is whether to make the exceptions similar so simple convergence is achieved, or to remove the exception so that convergence and a more principles-based standard are achieved.
- Intercompany transfers. This exception arises from the FASB's decision not to revise ARB 51 for the difference that is created between GAAP and tax basis when an asset is moved between tax jurisdictions and income tax is paid, but no deferred tax asset is recognized. Additionally, there were two examples in SFAS 109 (inventory and fixed assets), but the emergence of items not contemplated by SFAS 109 (for example, cross-border intellectual property transfers) has created significant practice issues. Those areas created both divergence in practice between IAS 12 and SFAS 109, but also impair comparability among U.S. issuers.
- Foreign currency translation. SFAS 109 prohibits recognition of deferred tax assets or liabilities for differences arising from foreign currency translation using historical rates (for example, inventory, plant, intangibles) that result from changes in tax rates or indexing for tax purposes.

Differences in Recognition, Measurement, and Disclosure Criteria

There are several narrow yet important differences between the recognition, measurement, and disclosure criteria in SFAS 109 and IAS 12. Some of those differences are subtle and may principally arise due to the choice of language. Some of those differences result from more fundamentally differing views of asset recognition and measurement.

The following other differences important to achieving convergence are anticipated to be less significant, but the staff will research and present to the Board for consideration:

- Interperiod allocation (backwards tracing). SFAS 109 requires that subsequent changes in tax rates, valuation allowances, and tax status be accounted for in income from continuing operations, regardless of where the initial income tax was recorded (for example, discontinued operations, extraordinary items, cumulative effect of an accounting change, or other comprehensive income). IAS 12 requires that when taxes are recorded directly to equity, subsequent changes in rates or valuation allowances be allocated to equity to the extent determinable. As a result of constituent requests, the FASB considered but previously declined to redeliberate this provision (in 1993 and again in 1996). However, for purposes of convergence, the FASB will redeliberate this issue.
- Tax rate
 - Enacted rate issue. SFAS 109 measures deferred tax balances using the enacted tax rate, while IAS 12 measures those balances using the “substantively enacted rate.” For example, in some jurisdictions, legislation to change the tax rate becomes effective only with the monarch’s signature. However, because the monarch cannot change or veto that legislation, that signature is not viewed as substantive. Thus, once a bill is passed by both houses, that tax rate change is deemed to be “substantively enacted” and would be used to measure deferred tax balances under IAS 12. This difference most likely can be addressed by clarifying language only.
 - Distributed rate issue. This difference arises from fundamental differences in taxation schemes. In the United States, taxes are incurred when income is earned. In some EU countries, there is a two-rate scheme (income is taxed at a basic rate and dividends have an incremental rate).

- Deferred tax asset recognition. The U.S. GAAP standard is “more-likely-than-not,” while the IFRS standard is “affirmative judgment.” The core issue relates to the definition of “probable” in U.S. GAAP and IFRS and the relationship between “probable” and “more-likely-than-not.” This may be an issue of language and definition clarification.
- Balance sheet classification. U.S. GAAP requires that deferred tax assets and liabilities be classified consistent with the balance sheet classification of the underlying asset or liability, while IFRS requires classification to be noncurrent.

Differences from Specific Application and Implementation Guidance

In asset acquisitions that are not business combinations, there are instances in which there is a difference between the GAAP and the tax basis of an acquired asset. EITF Issue No. 98-11, “Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations,” provides the applicable accounting guidance and prescribes a simultaneous equations method to allocate the cash purchase price between the initial asset basis and the deferred tax asset or liability. The IASB is considering an approach similar to that in Issue 98-11 that will also be considered by the FASB.

Timing

The FASB’s current goal is to issue an Exposure Draft in the fourth quarter of 2004. The FASB and IASB anticipate contemporaneously issuing final Statements that would amend SFAS 109 and IAS 12 in ways that would significantly reduce any differences between the application of those standards. The final document may be issued in the form of an amending Statement or as 109(R).

RESEARCH AND DEVELOPMENT and INTANGIBLE ASSET RECOGNITION

Background and Status

Another significant source of noncomparability between U.S. GAAP and IFRS is differences in the accounting for research and development costs. U.S. GAAP requires both research and development costs to be expensed as they are incurred. IFRS distinguishes between *research* and *development*—research costs are expensed as incurred but development costs are required to be capitalized under certain circumstances.

On November 13, 2002, the FASB included the consideration of differences in accounting for research and development in the scope of phase II of the short-term convergence project. On January 14, 2004, the FASB directed the staff to develop a recommendation on whether to expand the project's scope to consider other differences between IFRS and U.S. GAAP in the initial recognition and subsequent accounting for intangible assets.

The staff is analyzing¹ the differences that exist and will explore the possible alternatives for resolving them within the scope of the short-term convergence project, that is, to determine whether convergence around a high-quality solution would appear to be achievable in the short-term.

The staff plans to discuss the proposed scope of this project with the Board in April. The objective of the March 24 Council meeting is for Council members to provide input to Board members on factors they believe should be considered in making that scope decision.

¹ This analysis will take into account recent decisions of both the FASB and the IASB in their business combinations projects. In phase I, both Boards have considered the recognition requirements for intangible assets that are acquired externally. In phase II, the FASB reconsidered the accounting for in-process research and development (IPR&D) acquired in a business combination. The IASB has yet to begin deliberations in phase II. Neither Board has reconsidered the recognition requirements for internally generated intangible assets. The Exposure Draft of Statement 141(revised) is due to be issued in the second quarter of 2004. The IASB expects to publish IFRS 3, IAS 36 (revised) and IAS 38 (revised) in March 2004.

Nature of the Differences between US GAAP and IFRS

The differences in accounting for intangible assets, including research and development costs, can be looked at according to the way in which the intangible asset is acquired or created.

Intangible assets acquired in a business combination

Some differences in recognition requirements for acquired intangibles remain because each Board has reached slightly different conclusions regarding recognition criteria in their business combinations projects.² In particular, IFRS retains reliable measurement as a specific recognition criterion and provides guidance on when this criterion may, or may not, be met, which means that U.S. GAAP will require the separate recognition of different intangible assets from IFRS.

Differences in the assumptions regarding reliable measurement

- U.S. GAAP presumes that the estimated fair value of all intangible assets acquired in a business combination that meet the contractual-legal criterion or the separability criterion can be measured reliably, except for an assembled workforce.
- In some situations, IFRS will permit an intangible asset that would be recognized separately under U.S. GAAP to be subsumed within goodwill or within another class of asset if its fair value cannot be measured reliably or cannot be measured reliably except in combination with another complementary asset.

Intangible assets acquired outside a business combination

When intangible assets are acquired outside a business combination, there are two types of situations in which U.S. GAAP will require the recognition of different intangible assets from IFRS.

² In phase II, the FASB did not reconsider the conclusions reached in phase I regarding accounting for intangible assets, except for IPR&D acquired in a business combination.

Use of the contractual-legal and separability recognition criteria

- IFRS applies the contractual-legal and the separability recognition criteria to *all* intangible assets. They form part of the definition of an intangible asset.
- U.S. GAAP only applies those criteria in a business combination and presumes that an intangible asset acquired individually or with a group of other assets outside a business combination *will* meet the Concepts Statement 5 recognition criteria without the need to apply any other recognition criteria. U.S. GAAP may, therefore, require recognition of some intangible assets that IFRS will not.

In-process research and development

- GAAP requires that tangible and intangible assets acquired outside a business combination that are *to be used in* a particular research and development project (“IPR&D”) and that have *no alternative future use* be expensed immediately. This is not the same as the proposed treatment in a business combination.
- IFRS requires such IPR&D to be capitalized regardless of whether it has an alternative future use. In a business combination the IFRS treatment is the same as the proposed U.S. GAAP treatment.

Internally generated intangible assets

This is the area with the most differences, and includes research and development costs, the initial area of concern.

Capitalization versus charging as an expense

- U.S. GAAP does *not* specify the accounting treatment for intangible assets that are separately identifiable, that have determinate lives, or that are not inherent in a continuing business and related to an entity as a whole. U.S. GAAP applies different recognition criteria to different types of expenditures on internally generated intangible assets and to expenditures by different industry groups. For example, research and development costs must be expensed as incurred; some costs of developing computer software, exploring for oil and gas, films, music, and title plant must be expensed, and

some must be capitalized when certain criteria are met. Some of those criteria have common themes, but are not the same.

- IFRS applies the same recognition criteria to all expenditures on the internal generation of intangible assets, including research and development costs. *Research*-type costs must be expensed as incurred and *development*-type costs must be capitalized if they meet certain criteria. For circumstances in which U.S. GAAP requires the capitalization of costs, some of the recognition criteria are similar to those required under IFRS.

Recognition prohibited in certain circumstances

- U.S. GAAP prohibits the recognition of internally generated intangible assets that are not separately identifiable, have indeterminate lives, or that are inherent in a continuing business and related to an entity as a whole.
- IFRS prohibits the recognition of internally generated goodwill, brands, mastheads, publishing titles, customer lists, and similar items, the costs of which cannot be distinguished from the costs of developing the business as a whole. Intangible assets that are not “identifiable” by reference to the contractual-legal or separability criteria are not recognized under IFRS.

Possible alternative approaches

U.S. GAAP deals with different types of intangibles differently (for example, research and development costs, film costs, exploration costs in oil and gas producers) and also deals with the same type of intangible differently depending on how it is acquired (for example, research and development costs and IPR&D). In addition, U.S. GAAP does not specify a required accounting treatment for internally generated intangible assets not covered by specialized guidance.

Short-term convergence

U.S. GAAP currently uses many of the elements that IFRS uses in its recognition criteria but not in a consistent way. Convergence to IFRS could represent a higher quality solution than exists in current U.S. GAAP. However, any changes to current practice, particularly for internally generated intangibles, would need to

consider many fundamental recognition and, likely, measurement issues such as the following:

- Does an asset exist?
- Can appropriate recognition criteria be specified?
- What is the appropriate measurement basis?
- Is it reliably measurable?
- Is it representationally faithful?

Those issues have all been considered for acquired intangibles in the business combinations project.

Other short-term improvements

U.S. GAAP could be improved in the short-term by removing inconsistencies, removing choices of accounting treatment, and codifying the current requirements. Some of those improvements, particularly those relating to acquired intangibles, could be achieved through consideration in other FASB projects, such as the business combinations project.

Longer-term project

The IASB has designated the Australian Accounting Standards Board to lead a comprehensive review of accounting for intangible assets. Any additional substantive changes could be deliberated within this project, which is unlikely to be completed for several years. The project should be considered for adoption as a joint FASB-IASB project.

DISCUSSION QUESTIONS

Income tax

1. Would elimination of exceptions to the principle of comprehensive recognition of deferred taxes result in more useful information to users of financial statements?
2. Are there practical implications the Board should be aware of as it begins its deliberations?
3. Should the Board consider the SFAS 109 scope exceptions in the context of this project?

Research and development and intangible asset recognition

4. Are the current IFRS recognition requirements a higher-quality solution than current U.S. GAAP toward which the FASB should consider moving? Is there a better solution that the Board should strive for?
5. Should the FASB consider making improvements to the recognition requirements to remove inconsistencies and codify U.S. GAAP?
6. Should some or all changes and improvements to the recognition of intangible assets be postponed for consideration in conjunction with a wider project on intangibles, possibly in cooperation with the IASB, which may be many years away from completion?