THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Faculty of Taxation

Tax Representation

TAXREP 27/03

THE IMPLICATIONS OF ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) FOR THE UK TAX SYSTEM

A DISCUSSION PAPER

Prepared by the ICAEW Tax Faculty and the CBI
1 August 2003

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A DISCUSSION PAPER

1 SUMMARY OF ISSUES

1 The introduction of IFRS will have major implications for the UK tax system. This paper examines what these are likely to be.

2 This paper is based on the assumption that tax will continue to follow the accounting treatment. This is in accordance with existing statutory provisions and recently stated government policy. We believe that this continues to be a reasonable basis for the determination of taxation liabilities.

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13 The tax implications of a change in accounting policy need to be considered and whether the current relief in paragraph 9, Schedule 22 FA 2002 is adequate.

Financial Reporting Standard for Smaller Entities (FRSSE)

14 Smaller reporting entities need not be subject to the full range of accounting standards if they opt to comply with the FRSSE. The implication of the new accounting standards for smaller entities operating under FRSSE will need to be ascertained and the tax implications evaluated. In principle it would seem sensible for the taxation liabilities of all companies to be based on their accounts, whichever particular regime that particular company follows.

Current and future developments in IFRS

15 Each current IFRS/IAS and any proposed revisions need to be examined specifically to identify their tax implications.

Reform of Corporation Tax

16 At the present time (the beginning of August 2003) a further Consultation Document is anticipated. Any prospective changes in the tax system as a result of this Consultation process need to take full account of changes in Accounting Standards and must not be carried out in isolation from these changes.

2 BACKGROUND

17 A European Union Regulation (Regulation (EC) No 1606/2002) requires listed companies to draw up their consolidated accounts in accordance with international

financial reporting standards (IFRS) for accounting periods beginning on or after 1 January 2005.

18 To apply for the purposes of this Regulation, individual standards must be 'adopted' in accordance with a procedure set out in the Regulation. In accordance with the adoption procedure, the European Commission, acting on advice from an accounting technical committee of experts, makes a proposal for adoption to the Accounting Regulatory Committee (ARC), a committee of member state representatives. The ARC votes on the adoption proposal under qualified majority voting rules, the endorsement mechanism. As at 16 July 2003 the ARC endorsed all existing IAS/IFRS except for the two standards on accounting for financial instruments, IAS 32 and IAS 39.

19 The Regulation gives Member States the option to extend the application of the Regulation, on a compulsory or voluntary basis, to the individual as well as the consolidated accounts of publicly traded companies, and to the accounts of non-publicly traded companies.

20 The DTI issued a Consultation Paper at the beginning of September 2002 on whether the EC Regulation should be extended to the individual financial statements of listed companies, the individual financial statements of their subsidiaries and the consolidated/individual financial statements of all other companies (including 'small' companies). It has also consulted on whether this extension should be on a voluntary or mandatory basis.

21 On 17 July 2003, the DTI announced that for financial statements with periods commencing on or after 1 January 2005 the ability to prepare those accounts using IFRS will be extended to:

- publicly traded companies individual accounts in the UK; and
- other companies (i.e. unlisted companies) and limited liability partnerships in the UK will be permitted to use IFRS in both their individual and consolidated accounts.

22 The UK's Accounting Standards Board (ASB) has issued a number of exposure drafts which would bring UK accounting requirements more into line with international rules. International Accounting Standards will therefore affect all UK companies (by the back door) regardless of whether they are caught by the EU Regulation or they opt to use IAS under the DTI proposals.

23 On 12 June 2003, the DTI announced a consultation proposing an amendment to the Companies Act 1985 to allow companies to account for certain financial instruments at fair value, with gains and losses being taken to the P&L account. The proposal to allow companies to fair value account follows on from the 'Fair Value Directive' [2001/65/EC] which is designed to allow EU companies to move to IFRS. Whilst the Fair Value Directive is *part* of the EC's move towards adoption of IFRS, its effect is restricted to the adoption of fair-value accounting for certain financial instruments (in accordance with IAS 39)and does not extend to all the areas covered by existing IFRS. The deadline for comments on the DTI paper is 5 September 2003.

24 The DTI's consultation document makes it clear that the Government's thinking is that the option for fair-value accounting should be extended to all companies, but that small companies will be exempt from certain disclosure requirements (paragraph 1.7). This suggests that the same will apply to the introduction of IFRS generally.

25 We need to establish the current thinking of the DTI on this issue and ensure that all relevant representative bodies are involved in the decision making process.

26 In the meantime the ASB has a convergence programme under which UK Generally Accepted Accounting Practice (GAAP) will eventually, to a large extent, be the same as IFRS. The net effect could be that for accounting periods beginning on or after 1 January 2005 the majority of companies will be preparing their accounts to comply with UK GAAP which will be more closely aligned with IFRS. However, the ASB recently announced that they will be considering in the autumn how best to achieve a convergence of UK standards with those of the IASB.

27 In respect of changes in the future, the ASB published in May 2002 a consultation paper on IASB proposals to amend certain existing IAS. The IAS concerned are:

- IAS 1 'Presentation of Financial Statements'.
- IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.
- IAS 17 'Leases'.
- IAS 27 'Consolidated and Separate Financial Statements'.
- IAS 28 'Accounting for Investments in Associates'.
- IAS 40 'Investment Property'

The ASB has also issued a number of FREDs (Financial Reporting Exposure Drafts) which will impact on existing Accounting Standards. These are:

- FRED 23 "Financial instruments: Hedge accounting" - this was a UK ED because by replacing some of the other standards these issues would have fallen out of account and would then not otherwise be covered in UK GAAP.
- FRED 24 "The effects of changes in foreign exchange rates" and "Financial reporting in hyperinflationary economies" (This exposed improvements to IAS 21 "The effects of changes in foreign exchange rates" and IAS 29 "Financial reporting in hyperinflationary economies")
- FRED 25 "Related party disclosure" (This exposed improvements to IAS 24 "Related party disclosure")
- FRED 26 "Earnings per share" (This exposed improvements to IAS 33 "Earnings per share")
- FRED 27 "Events after the balance sheet date" (This exposed improvements to IAS 10 "Events after the balance sheet date")
- FRED 28 "Inventories" and "Construction and service contracts" (This exposed improvements to IAS 2 "Inventories" and IAS 11 "Construction contracts" and extracts from IAS 18 "Revenue")
- FRED 29 "Property plant and equipment" and "Borrowing costs" (This exposed improvements to IAS 16 "Property plant and equipment" and IAS 23 "Borrowing costs")
- FRED 30 "Financial instruments: Disclosure and presentation and Recognition and measurement" (Exposed improvements to IAS 32 "Financial instruments:

Disclosure and presentation" and IAS 39 "Financial instruments: Recognition and measurement")
- FRED 31 "Share based payment" (ED 2)

28 The ASB is not proposing to implement these IAS in the UK at present on the basis that they are likely to be changed again before 2005 as part of wider ongoing IASB projects. Although these IFRS are not likely to be adopted by the IASB on 1 January 2005, they and what is known of the proposed changes to them should, however, be reviewed for the UK tax implications.

3 UK ACCOUNTS AND TAXATION

29 It is laid down in UK legislation, section 42 FA 1998, that accounts must be prepared for tax purposes in accordance with UK GAAP. As noted above, from 2005 onwards, this will mean that accounts may be prepared for tax purposes in accordance with IFRS/IAS.

30 We believe that it is right that the taxation liabilities of companies should continue to be computed by reference to their accounts.

31 It is important to bear in mind that this is an evolutionary rather than a revolutionary change. UK accounting standards have always been subject to change and improvement over time and the UK tax system has absorbed developments in accounting standards without major difficulty. The move to IAS is merely the latest development in the continued evolution of UK accounting standards. It is important to remember, however, that in the past the link between accounts and tax was not as close as it is today and therefore changes in accounting practice were not as relevant for tax purposes as they are today. Therefore, the impact on tax must not be underestimated.

32 Therefore, whilst it is true that accounting standards have always been subject to change over time, this is a step change in approach.

4 PROPOSAL THAT MAY BE IMPLEMENTED BEFORE 1 JANUARY 2005

33 The proposal set out below may be implemented for accounting periods beginning on or after 1 January 2004. The taxation implications of this proposal need to be considered and resolved as a matter of urgency.

Share based payments

34 In November 2002, the ASB issued an exposure draft FRED 31 'Share-based payment' and requested comments by March 2003. FRED 31 in effect will implement the IASB ED 2 'Share-based payment', which was also published at the same time.

35 If FRED 31 is issued as a standard it will apply to all companies, not just listed

companies and to all types of share-based payment transactions, including all employee share option schemes and SAYE-type arrangements. However, the IASB have yet to discuss any potential exemptions which may be included in the final standard.

36 In ED 2, the proposal was that the standard should be effective for periods beginning on or after 1 January 2004. However, the ASB has stated that no decision has as yet been taken on the proposal in FRED 31 that the international standard should be implemented in the UK on the date it is implemented internationally.

37 Under the proposed UK FRS Accounting Standard, on the grant of a share option a fair value needs to be determined. In simple terms this is then expensed through the P&L account over the period up to the exercise of the option. The calculation of the expense takes into account a number of factors such as the number of people who have been granted options and the likelihood that they will still be around and able to exercise them. FRED 31 contains examples of how these calculations are to be undertaken. The net effect will be an expense in the P&L account where previously there may not have been one (assuming that the options were granted at market value).

38 The IASB has been discussing the proposals on share based payment with commentators views in mind. Until the final standard is published the exact requirements are still being debated, and changed. However, the principle that an expense should be recognised and that fair value should be used have been agreed.

39 What is the position for tax purposes? The decision is Lowry v Consolidated African Selection Trust Ltd (1940) 23 TC 259 would suggest that such an expense is not deductible. However, this decision is over 60 years old and given developments in the intervening years and proposed changes in the accounting rules, that decision must be called into question. The position also needs to be considered in the light of the new corporation tax relief for employee share acquisitions set out in Schedule 23 of the Finance Act 2003. Under this new relief, provided certain conditions are met, a company can claim a deduction for the difference between the market value of the shares at the time of the award and any consideration given in respect of the shares.

Conclusion

40 The precise extent to which the tax treatment will follow the accounting treatment is unclear and needs to be resolved. In principle, if a deduction is allowed for accounting purposes for the cost of the shares then tax relief should also be available.

5 PROPOSALS TO BE IMPLEMENTED FROM 1 JANUARY 2005

41 The proposed changes to UK accounting standards set out below will be implemented for accounting periods beginning on or after 1 January 2005. The taxation implications need to be considered and resolved before the new rules come into force. If legislative changes are required, these should ideally be made in the Finance Act 2004 so that companies have certainty as regards their tax position before the new accounting rules commence. The timescale is therefore very short and the following issues need to be addressed as a matter of priority.

Pensions

42 IAS 19 deals with pensions and is currently under review. The current UK standard is FRS 17 'Retirement benefits'. We understand that a fundamental revision of IAS 19 is under way, in addition to a minor review under the IASB/US FASB convergence programme.

43 We need to clarify the IASB's thinking in this area. However, our analysis of FRS 17/IAS 19 is as follows.

44 Although IAS 19 uses a similar approach to FRS 17 to measure the pension surplus or deficit, under IAS 19 there are differences concerning the amount of the surplus or deficit that needs to be recognised in the balance sheet and how actuarial gains and losses are reported.

45 Under FRS 17 the full pension surplus or deficit must be recognised in the balance sheet. Movements in the surplus or deficit are split between:

- the profit and loss account; and
- the statement of total recognised gains and losses (STRGL).
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46 Certain elements of the profit and loss account charge are taken to operating profit, whereas others (the unwinding of the discount on scheme liabilities and the expected return on scheme assets) are taken as an "other finance charge". Only actuarial gains and losses (the difference between the actual and expected return on scheme assets, experienced gains and losses on scheme liabilities and the effects of changing the assumptions underlying the scheme liabilities) are reported in the STRGL.

47 IAS 19 provides that actuarial gains and losses in excess of the greater of 10% of the scheme's gross assets or 10% of the scheme's gross liabilities may be deferred. Furthermore, unrecognised gains and losses in excess of that 10% may be recognised in the income statement over the average remaining service lives of the employees in the scheme (i.e. spread). This is often referred to as the "corridor" approach. Alternatively the company may:

- recognise in full the actuarial gains and losses immediately in the income statement; or
- adopt an approach that falls between these two extremes (concerning both the amount of actuarial gains and losses to be deferred indefinitely and the period over which any excess actuarial gains and losses are recognised in the profit and loss account) as long as the company policy is consistent from one year to the next.

48 In effect, the balance sheet under IAS 19 equals the surplus / deficit in the scheme (similarly calculated to FRS 17) less unrecognised actuarial gains / losses. Note that although IAS 19 allows for deferral of actuarial gains and losses, when they are recognised they are reported in the income statement, whereas under FRS 17 actuarial gains and losses are taken to reserves and reported in the STRGL.

49 If companies were required to adopt the UK approach but only had one all encompassing performance statement then the "volatile" element from the fair value exercise would be recognised each period directly in that statement. If the IAS 19 "corridor" approach is retained, a more steady amount would be recognised each period.

50 For tax purposes relief is only given for actual payments into a pension scheme so any provisions under the proposed new rules would not be allowed for tax purposes.

Conclusion re Pensions

51 The move to a new standard will not make a difference if the UK continues to have specific rules for tax relief for pensions. However, given the closer alignment between tax and accounting it may be appropriate for the tax treatment to move away from the cash basis.

52 It is likely that there will be changes to the current proposals in IAS 19 but these will not be introduced until after 2005.

Service contracts

53 There is currently a UK exposure draft FRED 28 (comments were required by September 2002) which if published as a standard will move UK Accounting Standards towards IAS.

54 FRED 28 proposes to replace SSAP 9 'Stocks and long-term contracts' with two international standards: one based on the revised IAS 2 'Inventories'; and another based on IAS 11 'Construction Contracts', with some text from IAS 18 'Revenue'.

55 The ASB states that 'there are no major differences between the accounting required by the proposals in FRED 28 and the existing requirements of SSAP 9.'

56 There are two main differences between SSAP 9 'Stocks and long-term contracts' and IAS 11 'Construction contracts' as far as long-term contracts go:

- SSAP 9 requires profits to be assessed on a prudent basis, whereas IAS 11 talks about being able to "estimate reliably" revenue and costs associated with the contract.
- IAS 11 only considers contracts for the construction of an asset, and hence excludes contracts for services. SSAP 9, however, considers all long-term contracts, thereby including long term contracts for services.

57 The importance of prudence has been watered down in UK GAAP following the introduction of the ASB's Statement of Principles and FRS 18 'Accounting Policies'. Although prudence was a fundamental concept under UK GAAP, FRS 18 (which replaced SSAP 2) now considers neutrality to be more important than prudence.

58 As a result of the move to IAS 11, it is likely that for some entities, profits on long-term contracts will be recognised slightly earlier than they were under SSAP 9, but it is a moot point as to how significant or fundamental the change will be.

59 The accounting for items of stock is considered by IAS 2 'Inventory'. Proposed revisions to IAS 2 will result in a standard that is fundamentally the same as the accounting required by SSAP 9. FRED 28 sets out proposals in one standard accounting for construction contracts and service contracts, as mentioned above this combines material from IAS 11 and IAS 18. As a result service contracts come within the proposed standard. The proposals set out that all such contracts should be accounted for on a percentage completion basis. Businesses which provide services will therefore have to credit to their P&L accounts profits in respect of service contracts which are partially completed at the Balance Sheet date. This will generally result in profits being reported in an earlier period than at present and hence the tax liabilities will arise in an earlier period.

Conclusion re Service contracts

60 Adoption of FRED 28 may to a limited extent result in service income being reported earlier than under existing rules. To that extent, this will bring forward tax liabilities for anticipated profits.

Business combinations

61 On 5 December 2002, the IAS published an exposure draft ED 3 ‘Business combinations’. The consultation period ended on 4 April 2003. Under ED3, merger accounting will no longer be available when two companies combine and meet specified criteria. Instead business combinations will be accounted for using purchase accounting with an acquirer always being identified

62 Where the acquiring company acquires the shares in another company, the acquirer will have to record goodwill in its consolidated accounts to the extent the ‘purchase’ consideration exceeds the fair value of the assets and liabilities of the acquired company. The individual accounts of the acquiring company will show the cost of the investment.

63 Where the acquiring company acquires the business and assets of another company, goodwill arises in the accounts of the acquirer company (individual accounts) to the extent that the consideration exceeds the fair value of the assets and liabilities acquired.

64 All goodwill recognised as an asset in the accounts of a UK company is currently accounted for under FRS 10. FRS 10 requires goodwill to be amortised annually over its estimated useful economic life although, there is a rebuttable presumption that the useful economic life does not exceed 20 years. ED 3 does not permit amortisation of goodwill. At the end of each accounting period the acquirer should instead carry out an impairment review and write down any diminution in the value of the goodwill.

65 The tax regime for intangible assets, including goodwill, changed in FA 2002. As a result business goodwill is now considered to be an asset which can be written off for tax. The tax regime (i.e. the providing of relief) will normally follow the accounting treatment and therefore tax relief will be obtained as the intangible asset or business goodwill is written off. This treatment applies only to “business” goodwill recorded in

the individual balance sheet of a company and not to "consolidation" goodwill.

66 ED 3 requires stringent valuation testing of the assets and liabilities acquired to eliminate as much negative goodwill as possible. However, any negative goodwill still remaining should be immediately recognised in the P&L account. This approach was rejected in FRS 10 – instead it is recognised in the balance sheet as a negative asset and released to the P&L account only as and when the non-monetary assets that it represents are recovered, whether through depreciation or sale. If ED 3 is adopted, there will be a mismatch between the immediate taxable credit in the P&L account (from the recognition of the negative goodwill) and the gradual amortisation of the acquired non-monetary assets.

Conclusion re Business combinations

67 The adoption of the IAS exposure draft would not appear likely to have a major impact for most acquiring companies since tax relief is not available on consolidation goodwill However, we need to clarify the tax position in respect of negative goodwill.

Financial Instruments and Hedging

68 IAS 39, Financial Instruments: Recognition and Measurement, became effective for annual financial statements covering financial years beginning on or after 1 January 2001. An exposure draft was published by the IASB for comment in 2002 making various amendments to IAS 39. The ASB has proposed (in FRED 30 and FRED 23) to implement most but not all of this standard in the UK – see further comments below.

69 IAS 39 is one of the more controversial areas of moving to IFRS. In broad terms, under IAS 39, financial instruments will have to be recorded in the accounts at their fair value, with changes in fair value being reported directly in the performance statement. The consequence of this being a potential increase in the volatility of reported earnings. Current accounting rules in the UK are not prescriptive in the area of accounting for financial instruments and there is also considerable flexibility in using hedge accounting techniques. The proposals in the amendment to IAS 39 on hedge accounting are prescriptive. Current hedging arrangements may not qualify under the proposals and therefore the resultant volatility in the profit and loss account might be fully subject to tax, depending upon the view taken by the Inland Revenue.

70 IAS 39 covers the recognition and measurement issues associated with financial instruments. The definition of a financial instrument is broad and specifies the accounting required by:

- most monetary assets and liabilities not covered by other accounting standards;
- derivatives; and
- equity instruments held of another enterprise (i.e. equity investments).

71 The implementation of IAS 39 will present a big challenge to UK companies. Under the proposals companies will have to categorise their financial assets into the following four categories:

- assets held for trading;

- loans and receivables originated by the enterprise;
- assets held to maturity; and
- available-for-sale financial assets.

72 Financial liabilities would have to be categorised as:
- liabilities held for trading (generally only relevant to banks and similar financial institutions); or
- "other".

73 Ignoring hedge accounting for the moment, the following accounting would be required:

- assets held for trading should be measured at fair value with gains and losses recognised in the profit and loss account;
- loans and receivables should be measured at amortised cost;
- assets held to maturity should be measured at amortised cost;
- available for sale financial assets should be measured at fair value with the gains and losses being recognised directly in equity. On derecognition of the financial asset those gains and losses would be "recycled" through the profit and loss account;
- liabilities held for trading should be measured at fair value with gains and losses taken to the profit and loss account;
- "other" liabilities would be held at amortised cost; and
- all derivatives should be measured at fair value with gains and losses taken to the profit and loss account. Note that although derivatives may be held as part of an entity's hedging strategy, a company may choose not to hedge account.

74 If a company chooses to hedge account, then there are various conditions that must be met (including documentation detailing the hedge relationship and a requirement for management to measure the effectiveness of the hedge on an ongoing basis). Where the conditions for hedge accounting have been met then the principle of hedge accounting is followed with offsetting the effects of changes in the fair value of the hedging instrument and the hedged item. The accounting will however depend on whether the hedge is classified as a cashflow hedge or a fair-value hedge.

75 For cash-flow hedges, the accounting for the hedged item remains unchanged. However, the accounting for the hedging instrument (the derivative) is different. Although the hedging instrument is still measured at fair value, rather than recognising gains and losses in the profit and loss account, they are taken directly to equity. Those gains and losses are then recycled through the profit and loss as the hedged item is recognised in the profit and loss account. Any ineffective portion of the gain or loss on the hedging instrument will generally be recognised in the profit and loss account immediately if the hedging instrument is a derivative.

76 For fair-value hedges, it is the accounting for the hedged item that is altered, not that for the hedging instrument. Irrespective of what the rules stated above are, the hedged item is shown at fair value with gains and losses going through the profit and loss account (i.e. even if it is one that would be shown at amortised cost if hedge accounting had not applied). This gain or loss would then be offset against the gain or loss arising on the hedging instrument (the derivative).

77 Note that the UK's ASB dislikes the concept of recycling gains and losses through the profit and loss account and so FRED 23 and FRED 30 (the draft standards intended to converge the UK accounting with IFRS) differ from IAS 39. For cashflow hedges they require that gains and losses on derivatives be deferred in the balance sheet rather than taken to equity.

78 Under the proposals preference shares will generally be treated as debt and preference share dividends will hence be treated as interest. Currently, preference share dividends are treated as a distribution and are not deductible for tax purposes. If the accounting rules are changed, the questions that follow are:

- will the 'dividend' still be a distribution for tax purposes; and
- if it is not, will the Revenue change the rules so as to prevent a deduction?

79 On the face of it, a preference share dividend will presumably still be legally a dividend and so it would appear to still rank as a distribution under section 209(2)(a), ICTA 1988 regardless of the accounting treatment adopted.

Conclusions re Financial Instruments and Hedging

80 Marking financial instruments to market will cause more volatility in reported earnings and presumably therefore also in the associated tax charge.

81 A decision will need to be taken as to whether the use of mark to market for financial instruments for non-banks is an appropriate starting point for calculating the tax charge. There is a precedent for this: it is already an option under loan relationships rules in accordance with UK GAAP (now set out in paragraph 6 of Schedule 25, FA 2002). However, if the basis is made mandatory, it may give rise to the fluctuations referred to above.

82 In the event that mark-to-market is accepted as a suitable starting point, there needs to be an examination as to whether the tax system needs to provide a 'safety net' in cases where a large proportion of the taxable profits are unrealised.

83 The reclassification of a preference share dividend as interest for accounting purposes would not appear to change its fundamental characteristic as a dividend rather than tax deductible interest. However, if preference share dividends will be treated as interest for accounting, the question arises as to whether it would make sense to bring the tax treatment into line with the accounting treatment. This would then give tax relief for interest but it would also make preference dividends subject to thin capitalisation, deduction of tax etc.

Investment properties – IAS 40

84 As noted above, the ASB has published a consultation paper by the IASB suggesting revisions to a number of existing IAS. It is not proposed at present that the international standard on investment properties, IAS 40, will be adopted by the ASB.

85 The existing UK standard is SSAP 19 'Accounting for Investment Properties' and was published in 1981. SSAP 19 requires investment properties to be included in the

balance sheet at their open market value with any revaluation adjustments reflected in reserves, except that where a write-down or its reversal is expected to be permanent, it should immediately be taken to the profit and loss account. For tax purposes, the revaluation adjustments etc are ignored.

86 Under IAS 40, there is an option either to record properties at cost with depreciation or to apply fair value. Changes in fair value each period should be reported directly in the income statement. Any diminution in value as a result of the fair value review will reduce the reported profit and any increase will increase reported profit.

Conclusion re Investment properties

87 If IAS 40 is adopted, then the tax treatment of fair value adjustments will need to be resolved. Should tax relief be given for fair value adjustments or should the tax rules follow the existing UK tax rules? Given that most investment properties are likely to increase in value, the result will be that companies will be taxed on valuation increases under the income rather than the capital gains rules. If relief is given for fair value adjustments, then presumably downward adjustments will be relieved and upward revaluations will be taxable. If such adjustments were taxable, then if companies decided to record assets at cost and charge depreciation then it would appear logical to allow any depreciation for tax purposes.

88 It is also important to remember the continuing consultation on the possible reforms to corporation tax. One proposal is to assimilate gains to income. It is important that the consultation takes full account of the move to IFRS and the consequences of that.

Biological assets – IAS 41

89 IAS 41 'Agriculture' is effective for annual financial statements covering periods beginning on or after 1 January 2003. This standard prescribes the accounting treatment, financial statement presentation and disclosures related to agricultural activity. These will affect mainly farmers/farming companies whose assets will have to be valued based on fair value.

90 The implications are that growing crops will have a fair value in excess of original cost. Would this unrealised profit need to be recognised for tax purposes?

Conclusion re Biological assets

91 Adoption of IAS 41 is likely to accelerate recognition of profits. The Farming and Rural Business Group of the ICAEW have raised this issue with the Revenue who are considering the implications and whether any additional charge might be spread over 10 years under Schedule 6 FA 1998 or some equivalent relief be made available.

6 PROPOSED CHANGES TO ACCOUNTING STANDARDS POST 2005

92 In addition to the changes which will be implemented on 1 January 2005, the accounting standard setters are also working on a number of other proposals for new and revised standards which will also have tax implications. These include the project on Reporting Financial Performance. This project sets out the format for one all encompassing performance statement. It is likely that the presentation of the performance statement will have implications for how the tax charge is computed.

Although the precise date when these changes may be introduced is not yet known, it is important that consideration is given now to the issues raised by these proposals.

Reporting financial performance

93 In December 2002, the ASB issued FRED 22 which proposed to revise FRS 3 Reporting Financial Performance. FRED 22 proposed that entities should present a single performance statement, replacing the current system whereby unrealised gains and losses are reported in the Statement of Total Recognised Gains and Losses. Such an approach would require a change in UK company law, which provides that only realised profits and losses may be reported in the profit and loss account. However, this is a problem that must be tackled for the purposes of the transition to IFRS as several international standards (including IAS 39 and IAS 40 discussed earlier) require unrealised gains and losses to be reported in the profit and loss account (as highlighted earlier the DTI has issued a Consultation Document on "Fair value accounting").

94 Under FRED 22, the single performance statement would have comprised three sections:

- operating section;
- financing and treasury section; and
- "other" section

95 FRED 22 has been superseded by a joint project between the ASB and the International Accounting Standards Board (IASB) in the area of reporting financial performance. It is proposed that an exposure draft will be published in the fourth quarter of 2003. It is not yet known whether these proposals will be turned into an accounting standard. However, if they are, the proposals will make radical changes to the way that financial performance is currently reported.

96 The accounting boards have 'tentatively' agreed to replace the existing profit and loss account with a new '3 column' financial reporting statement. The three columns are, profits before remeasurement, remeasurements and a total column.

97 All items of income and expense would be reported in the one performance statement (other than transactions with shareholders).

98 Remeasurements are defined as revisions of prices or estimates that change the carrying value of assets and liabilities. They would include items such as fixed asset revaluations and actuarial gains and losses on a pension scheme. However, remeasurements also extend to items such as bad debts or revisions in the estimate of provisions generally.

99 If these proposals are enacted, they would be a major departure from the existing profit and loss account. The adoption of this approach raises a number of questions.

100 The first key question is: should the tax computation start with the figures before or after they are remeasured? The decision will have major implications on the business profits subject to tax. For example, many existing 'remeasurements' which are

currently allowed for tax purposes will be moved to the remeasurement column; relief would be denied if the taxable profits are based on the figures before remeasurement. Conversely, if the tax charge starts with the remeasured figure, unrealised gains will be taxed.

101 A second question is: assuming that a decision is made to base the tax charge on one of these two figures, what if any further adjustments should be made?

102 Further consideration needs to be given to what types of adjustment would be expected and how they are currently treated for tax purposes.

Conclusions re Reporting financial performance

103 There is a need to clarify what figure will form the basis for calculating the tax charge, i.e. before or after remeasurements.

104 There is a need to identify likely remeasurement adjustments and how these would be treated under existing rules. This is likely to involve establishing lines of communication with the ASB/IASB in order that we can understand and keep abreast of developments.

105 There is then a need to identify where problems might occur with remeasurements from a tax perspective and if necessary seek changes.

Revenue recognition

106 On 5 July 2001 the ASB published a Discussion Paper entitled 'Revenue Recognition'. The Paper suggested that inconsistent revenue recognition practices were not merely a practical problem: they also reflected different views of what revenue should represent, and of how financial statements should portray a business's operating activities. On 27 February 2003 the ASB published an exposure draft *Amendment to FRS 5 'Reporting the substance of transactions': Revenue Recognition"* as an interim step pending the development of a replacement for the international standard on revenue, IAS 18. Comments were requested by 30 May 2003. The intention is to ensure that entities report turnover in accordance with the substance of their contractual arrangements with customers, and at the point at which their performance entitles them to recognise either an increase in assets or a decrease in liabilities. This is likely to result in turnover being recognised at a different time than under current rules.

107 The current applicable international standard, IAS 18 'Revenue' was issued in 1993. It is currently under review by the IASB in a joint project with the US Financial Accounting Standards Board.

Conclusions re Revenue recognition

108 It is likely that changes will be made to the existing UK rules and this is likely to result in changes to the time when profits are recognised. There is a need to decide whether the tax implications of this proposal should follow the accounting treatment or whether changes should be made.

Leases

109 The ASB is developing proposals for a new accounting standard that would require a single method of accounting for all leases, both finance and operating leases. A possible approach was set out in a G4+1 Discussion Paper 'Leases: Implementation of a New Approach', which was published by the ASB (and others) in December 1999. The current position is that the ASB is considering the issues raised by respondents to the earlier Paper, and is continuing to exchange views and information with other members of the G4+1 (the International Group of Standard setters – UK, US, Australia, Canada, New Zealand and the IASC). Due to the complexity of the issues involved, it is unlikely that a Financial Reporting Exposure Draft will be published in the near future. The issue is also listed as an 'active research topic' by the IASB but it appears that on the basis of their current agenda is not likely to come to fruition until 2007 at the earliest.

110 Assuming that any proposals follow broadly the position already published by the G4+1, the distinction between operating and finance leases would be removed. The proposals aimed to capitalise property rights inherent in all leases. For short leases this would be achieved by capitalising a percentage of the property to represent the lessee's usage period. An asset and liability would therefore be set up on the balance sheet and the lease payments will be recorded as payments of capital and interest. This approach would cause difficulties in respect of the UK taxation treatment given that many of the provisions in recent years have been aimed at leases which are accounted for as finance leases under SSAP 21. This suggests that the existing UK tax rules in respect of leases would require extensive redrafting. Statement of Practice SP3/91 would also need to be revised and updated.

Conclusions re Leases

111 Given the key importance in recent years of the accounting treatment in respect of changes to the taxation of leases, any changes to the accounting treatment of leases will have major implications for the tax position. There is a need to examine what tax changes would result from an amendment to the existing accounting standard along the lines of the G4+1 paper and consider whether the existing tax rules will need to be changed to take account of such developments.

112 In respect of timing, given that any changes to the rules are unlikely to happen in the short term, this is an issue that needs to be monitored closely and taken up with the Revenue when the likely shape of the rules is clarified. However, it would make some sense to identify the key issues and parameters at an earlier stage so that we are not just reacting to changes.

7 OTHER ISSUES

The transition to IFRS

113 On 16 June 2003, the IASB published IFRS 1 'First-time Adoption of International Financial Reporting Standards'. It will require comparatives appearing in the first set of financial statements to be drawn up under IFRS to be computed on the same basis. This will involve a restatement of the previous period's closing figures. Further

consideration needs to be given to the effect of IFRS 1 and its implications for tax purposes.

114 For tax purposes the transition to a new accounting standard will be subject to the rules set out in Schedule 22, FA 2002. The broad effect of this section is to ensure that all profits are subject to tax once only. Any extra profit is taxed under Schedule D Case VI.

115 Where a change is made from a realisation basis to a mark to market basis, then an election may be made to spread any charge arising over the next six accounting periods under paragraph 9 of Schedule 22, FA 2002. Is this relief sufficient to cope with major changes in valuations which might arise on a mark to market basis? The relief only applies on a move to a mark to market basis. Should we request a relief to avoid large changes in the tax charges as a result of unrealised gains and losses? In principle, it is unlikely that the Treasury will wish to see large swings in the taxation yield as a result of a move to a mark to market basis.

116 The above provision could be amended easily to apply to any fundamental change in accounting policies or specifically to the adoption of IFRS.

Financial Reporting Standard for Smaller Entities (FRSSE)

117 Smaller reporting entities need not be subject to the full range of accounting standards if they opt to comply with the FRSSE. The basic measurement requirements in the FRSSE are the same as those in other accounting standards (although with some slight simplifications), but many of the disclosure and presentation requirements of other standards have not been included in the FRSSE.

118 There is a need to clarify, for example, whether the proposed new reporting financial performance project will apply to reporting entities covered by the FRSSE. In principle we should aim to ensure that all reporting entities are subject to the same basis of taxation which should, we believe, be based on their accounts. There should be no reason for smaller entities to opt into or out of the FRSSE other than for commercial reasons.

Current and future developments in IFRS

119 Each current IFRS/IAS and any proposed revisions need to be examined specifically to identify their tax implications. Such a study should include those IFRS/IAS that it is currently proposed not to adopt immediately.

Reform of corporation tax

120 Consultations on the tax consequences of IFRS should not be divorced from continuing consultations on the reform of corporation tax generally. There must be joined-up thinking in this area. It is important that they should inform each other. It is interesting that the introduction of the new regime for intellectual property, which is aligned closely with accounting practice, took place with no reference to the possible changes in accounting practice that adoption of international accounting standards would entail.

FJH/IY/ZK
1 August 2003