

Components and forms of financial statements literature review examples

[Business](#), [Company](#)



U. S. GAAP versus IFRS.

ABSTRACT

There are notable differences between the International Accounting Standard Boards and the Financial Accounting Standard Boards models of accounting for income tax. Efforts to harmonize the two standards through the Exposure Draft were dropped in 2009 and have not been reviewed thereafter. In 2012, SEC staff provided a final IFRS framework that outlined its efforts and findings but did not provide any conclusions or recommendations for any actions. The difference between IFRS and US GAAP remain significantly felt in many areas and are of major interests to users of financial statements. The main areas of comparison include tax basis, initial recognition, intercompany transactions, allocating income tax shared-based compensation accounting for uncertain tax positions and investment in subsidiaries. This literature review paper will put its focus on the similarities and differences between US GAAP and IFRS in respect to how corporations report their income taxes. IFRS is a term used to indicate a body of IASB literature designed for use by profit-oriented entities. An entity claiming to comply with IFRS must comply with all the standards and interpretations including disclosure requirements and indicate an explicit and unreserved statement of compliance with them. IFRS is founded on an overriding requirement to make fair presentation of financial statements.

US GAAP, on the other hand, is a term used to indicate the body of authoritative literature comprising accounting and reporting standard in the US. Authoritative GAAP standards are sourced from federal security laws and interpretive releases of the SEC. Unlike IFRS, US GAAP is intended to be used

by both profit-oriented and non-profit oriented entities. Additional codification topics are used for non-profit entities. An entity claiming compliance to US GAAP should comply with the all the applicable sections of the Codification. A statement of explicit and unreserved compliance is, however, not compulsory for US GAAP. Its main motivation is a fair representation of financial statements.

IFRS considers the following as components of financial statements; a statement of comprehensive income, a statement of changes of equity, a statement of cash flows, notes and accounting policies. A statement of financial position is presented at the beginning of the earliest comprehensive period when an entity restates information in respect to changes in accounting policy. This includes the correction of error or reclassification of financial statements.

The difference occurs in the statements of investments by and distribution to owners when the period for changes in equity presented in the form of notes to the financial statements. Unlike IFRS, GAAP does not require a statement of financial position at the beginning of the earliest comparative period. It also prescribes minimum disclosures of specific formats but not in any particular format as stipulated by IFRS. More specific formats and line item disclosures are used for SEC entrants.

IFRS require comprehensive information for the preceding period only as well as additional periods and information. US GAAP does not require presentation of comparative information. SEC registrants are required to present statements of financial information at the end of reporting periods.

An entity with one or more subsidiaries may present consolidated financial statements in the IFRS framework. However, unlike IFRS, US GAAP has no exceptions other than investment entities for presenting consolidated financial statements in case it has more than one subsidiary.

REVENUE RECOGNITION

IASB framework defines income as encompassing both revenue and gains. It defines revenue as the gross inflow of economic benefits acquired during a period in the course of ordinary activity in an entity when the inflows result in an increase in equity other than increases due to contributions from participants. The standard provides for a comprehensive guidance on the recognition and measurements of revenue. The standard further categorizes revenue as sale of goods, the utilization by others of entity assets in terms of interests, dividends and royalties, rendering of services and construction of assets. IFRS under IAS 18 and IAS 11 recognize revenue through the application of principles-based approaches across all entities. Under IAS 20, it stipulates guidelines for Accounting for Government Grants and Disclosure of Government Assistance.

Under GAAP, revenue is termed as sale of goods or rendering of services based on realization principle where revenue is recognized on a realization basis. The frame work has specific guidance for software transactions and construction contracts but lacks a general comprehensive guideline of revenue. According to an opinion statement for the adjustment between tax law and business accounting principles, the Business Accounting Council of Economic Stabilization Board 1952 defined completion of transfer of goods

and rendering of services and receipts for corresponding proceeds as the only criteria for revenue recognition. According to the Conceptual Framework of Financial Accounting, ASBJ in 2006 termed revenue as items resulting to increase in net income or shares in earnings. It also gives it a representation of the portion of the amount corresponding to increase in assets or reduction in liabilities occurring at the end of a certain period. The main differences between IFRS and GAAP are as follows.

Under IFRS, income tax consequences are realized when the intercompany sale occurs in transactions involving two companies. The profit from recovering the assets of a third party is not recognized at the time of sale and the entity in question might have incurred an economic tax charge or benefit. It thus affects the tax rate at the time of intercompany sale.

US GAAP uses a different approach. The parent company defers the income tax consequences of the intercompany sale until the asset is disposed outside the group. The standard also matches the income tax consequence. In the event of an amortizable asset including intellectual property, a parent company using the US GAAP framework matches the income tax consequence of the sale to the asset's recovery through use during the amortization. The effect of the income tax is felt at the time of the third party sale or when the company is amortized. A practical example is represented as follows. Bluecorp is an international company having many subsidiaries. One subsidiary sells services to a sister subsidiary and makes a profit of 100. The seller's tax rate is 40% while the buyer's tax rate is 30%. A consolidated financial statement eliminates the profit of 100 on the intercompany sale. The tax burden of the selling subsidiary is the amount in the period of sale to

the buying subsidiary. The buying subsidiary tax basis is the cost of the sale or the amount it paid to the selling subsidiary.

The services are then sold to a third party at an additional profit of 20. The following entries show the accounting details reflected in the consolidated financial statements when the service was sold between the subsidiaries.

When the service is sold outside to a third party outside the consolidated group, the following entry is shown in the financial statements under IAS 12 accounting guidelines.

In a transaction involving IFRS and US GAAP compliant companies, income tax consequences as a result of intercompany transfer of assets occur. The company would write off the equivalent amount when it adjusts the opening IFRS balance sheet during the transition date. IFRS companies would record deferred taxes that are not recorded by US GAAP system.

TAX BASIS

Tax basis refers to the amount of the asset or liability used for tax purposes. For instance, the tax basis of a depreciable asset is the amount that is depreciable upon its sale or liquidation. A company acquiring a commercial building for generating rental income will treat tax basis differently according to the standard used. If the company intends to sell the property after a period of 8 years although the building has a useful life of 10 years will be bound by the tax law for capital deductions on the fair value of the building. Under IAS 12, the managers need to determine the portion of the asset that will be recovered through the use of the building and the portion recovered through the sale. It also needs to determine the tax consequences and the

differences that might arise if the recovery is via by of the stated means.

Under US GAAP, depreciation is not deductible for tax purposes and cost of the asset will be deductible when the asset is sold. If the cost of the asset at acquisition is 100 both book basis and tax basis will record 100 and there is no difference. However, when the building is depreciating, the book difference decreases creating a temporary deductible difference. The deduction is only available at the time of sale of the asset, and the relevant tax rate is used at the time of sale. Initially, the company expects a residual value of the commercial building at 20 and the management expects to recover 80 through its use. Under IAS 12, the tax base of the portion of the asset to be gained through use is zero due to the fact that no tax deductions are available for depreciation. The carrying value of the commercial building recovered through use will result in tax payments that are more than those recovered if there were tax deductions in use. The zero tax bases, therefore, results in a temporary difference of 80 and a deferred tax assets of 16 which is a capital loss upon sale.

Given that the tax rate is 40% and the tax basis of the building is the same as the previous owners tax basis, applying US GAAP guidelines will result in higher depreciation charges than when IFRS is used. US GAAP guidelines normalize the impacts on the applicable tax rates while the guidance under IAS 12 leads to disproportionate tax rates over time. Accounting in the books would be as follows. NEXT INC utilizes a US GAAP system.

The company only records the value of the building at the time of consideration while deferred taxes would not be recorded.

EMPLOYEE BENEFITS

Employee benefits can be classified as post-employment, short term and long term benefits. The two accounting standards treat differently employee benefits. Short term benefits are benefits that are due to be settled within a period of one year of the period the services were offered and are accounted using the normal accrual accounting systems. IFRS considers other long-term benefits as those that are not settled within 12 months of the end of the duration in which the services were offered. It also distinguishes post-employment benefits as benefits paid after the completion of employment period.

Unlike IFRS, US GAAP divides employee benefits into post retirement and other post-employment benefits. The accounting of post-employment benefits is based on the type of benefit under the US GAAP system. US GAAP system does not contain specific guidelines on short-term employee benefits apart from the compensated absences. It also does not distinguish between long term and short term employee benefits.

Under IFRS, Insurance policies issued to the sponsor fulfill the requirements of a plan asset if they are issued by a third party unrelated to the entity. They are also considered to meet the plan assets if they are transferable among other criteria. Unlike IFRS, US GAAP issued to the sponsor do not meet the definition of plan assets. Both systems consider policies issued to a [plan by a related party to meet the requirements of plan assets. Assets that fulfill the definition of plan assets such as qualifying insurance policies and related liabilities are given on a net basis in the statement of financial position. The same criteria is applicable under US GAAP as assets that meet

the definition of plan assets as well as the related liabilities are presented on a net basis in the financial statement.

In terms of actuarial gains or losses pertaining defined benefit plans, IFRS recognizes immediately in other comprehensive income. Under US GAAP, only actuarial gains and losses that are excluded in profit or loss are recognized in other comprehensive income. If the actuarial gains and losses exceed a certain corridor, they are mandated to be recognized in profit or loss over the remaining working lives of active employees in the plan.

Amounts that are recognized in accumulated OCI are reclassified to profit or loss.

Under the US GAAP, both vested and unvested service costs are initially recognized in OCI and are subsequently amortised into profit or loss over the average remaining service period. This is in contrast with IFRS where all past service costs relating to a defined benefit plan including unvested amounts are immediately recognized in the profit or loss.

The US GAAP recognizes the curtailment losses when they are probable while curtailment gains are recognized when they happen. The contrast is witnessed in IFRS system where curtailments among other plan amendments are recognized at the same instance as a related restructuring/termination benefits occurring before the curtailments of other plan amendments.

Entities recognize the liabilities and termination benefits under IFRS reporting systems when it recognizes a cost for restructuring within the framework of the provision standards that encompasses the payment of the termination benefits. It also recognizes when it can no longer withdraw the offer of the related benefit. US GAAP uses different and more explicit criteria

to determine the obligation for a one time termination benefits.

In general, US GAAP does not have a single mode that regulates the recognition of termination benefits for employees. The time of recognition is based on whether the costs will be offered in respect to an ongoing plan, a contract or one time arrangement. However, in IFRS reporting system, redundancy cost is not recognized until a time when the redundancy has been conveyed to the affected employees.

ACCOUNTING FOR UNCERTAIN TAX POSITIONS

IAS 12 does not conclusively address accounting for uncertain tax positions. Most companies using the IAS 12 record liabilities for uncertain tax positions that are not factored in while using probability weighted average and single best estimate approach.

If a company gets a deduction for an uncertain tax position that is as a result of a tax benefit and the management is certain that the company will sustain the position. Using a single best estimate approach, the company will certainly recognize the full benefit of tax deduction. However under the probability-weighted-average approach, the company will recognize less than 100% benefit and the remaining a liability. If the converse was to happen and the company is 80% sure that the tax position would not be sustained, it would recognize zero tax benefit and a 100 liability under the single-best-estimate approach. If it uses the probability-weighted-average approach, the company would recognize a 20% tax benefit and an 80% liability.

The two accounting reporting standards provide a diverse way of solving this

situation. US GAAP gives clear guidance on uncertain tax positions. FASB requires in ASC 740 that a company evaluates its tax positions by determining if there is a likelihood that the tax position will be sustained basing on recognition threshold. It would also require that the entity measures the amount of tax that is subject to recognition in the financial statements. By using the cumulative-probability approach it endeavors that a tax position meeting the recognition threshold be measured basing on the largest amount of benefit that is in excess of 50% likelihood of realization upon settlement. All the other tax positions that do not meet the criteria are not recorded. Car Net uses the probability-weighted calculation and the chart below compares different approaches.

The two accounting standards differ in respect to accounting for certain securities in that under ASC 740 an entity would recognize the largest tax benefit that contain a 50% plus likelihood with a corresponding liability of less than 50%. IAS 12 does not give clear guidance on accounting for uncertain tax positions and leave entities with an option of using a probability-weighted-average outcome among other methods.

ALLOCATING INCOME TAXES

As much as it is complex to allocate income tax benefit of expense to the various components of income and equity, IAS 12 and ASC 740 do not provide a comprehensive and universal methodology to handle the case. The difference is pronounced in allocating income tax expense recorded in one year but is related to a prior year. IAS 12 follows a pre-tax technique in allocating income tax expenses in spite of the period it was recorded. The

technique is easy to comprehend but difficult to apply and can be more complicated when a rate change is enacted. It is different when compared to what ASC 740 uses. ASC 740 first computes the total tax expense or benefit after which it allocates the other financial statement components the difference between the total taxes and the computed amount allocated to continuing operations. This procedure requires entities to record some tax effects such as variations in tax laws and rates in continuing operations. Barclays Bank ASC 740 method is as shown below.

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