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Special Issue:
Global Regulatory and Financial Reporting Reform and the Convergence of Accounting and Auditing Standards: The Time Has Come

The Impact of International Financial Reporting Standards

Global Corporate Accounting Frauds and Actions for Reforms

Response to Corporate Fraud in the United States and Europe: Towards a Consistent Approach to Regulation

Convergence of Accounting Standards: A Comparative Analysis of the U.S. Revised Standard on Share-Based Payment and the International Accounting Standards Board’s IFRS 2

Goodwill Impairment: Convergence Not Yet Achieved

The Concept of Control in Consolidated Financial Statements: Convergence of U.S. and International Accounting Rules

Accounting for Research and Development Costs: A Comparison of U.S. and International Standards

Tax Reform in a Global Economy: Shifting the Tax Burden

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Special Issue: Global Regulatory and Financial Reporting Reform and the Convergence of Accounting and Auditing Standards: The Time Has Come

Patrick A. Casabona, The Peter J. Tobin College of Business, St. John’s University

Investors and creditors throughout the world base their decisions on the information published in various financial and economic reports issued by business entities. The most important of these are the annual and quarterly reports that depict an entity’s profitability and financial condition, which investors and creditors review carefully before investing their fortunes. It is, therefore, imperative that these reports convey information that reflects the economic reality of an entity in a meaningful, transparent and comparable fashion.

Recently, however, there have been a host of corporate financial scandals, accompanied by fraudulent financial reporting, both in the U.S. and abroad, which have shaken the very foundation of corporate financial reporting and investor confidence. It is, therefore, imperative that these reports convey information that reflects the economic reality of an entity in a meaningful, transparent and comparable fashion.

In their article, Sylwia Gornik-Tomaszewski and Irene McCarthy explain that in order to restore the public’s confidence in corporate financial reports and the capital markets after the recent corporate scandals, regulatory bodies in the U.S. and in the European Union have undertaken a two-way cooperative approach to develop a compatible set of regulations and oversight.

Next, Benjamin Silliman explains how the FASB and IASB have worked closely during the past several years to develop comparable accounting standards for equity-based compensation transactions (SFAS 123R and IFRS 2, respectively). This is one of the most controversial and complex topics in the accounting profession. This article also examines the similarities and remaining differences between these two standards.

Then, Victoria Shoaf and Ignacio Perez Zaldivar explain that although the IASB and the FASB have had significant success in working toward the convergence of accounting standards, significant differences between U.S. and international standards remain in accounting for impairment of goodwill and other intangible assets, which are not currently scheduled for resolution.

Patrick Casabona and Alex Ardwal explain that although progress has recently been made toward the convergence of a global set of accounting standards, more work needs to be done, especially in the area of consolidation policy, which focuses on the principle of control.

Then, Sylwia Gornik-Tomaszewski and Miguel Millan discuss why the accounting for research and development (R&D) activities is an area of divergence between U.S. Generally Accepted Accounting Standards and International Financial Reporting Standards.

This issue begins with an interview featuring D. J. Gannon, CPA, who discusses the impact that international financial reporting standards are having on global financial reporting and related matters. He currently serves as a consultation partner in Deloitte’s National Office where he specializes in international accounting and financial reporting. He has consulted clients on matters involving International Financial Reporting Standards (IFRS) and worked with SEC registrants that are foreign private issuers. He is Leader of the Americas IFRS Centre of Excellence, which provides technical assistance, including consultation and training, on matters involving IFRS to clients in the region. He currently chairs the AICPA’s International Practices Task Force and the Accounting Standards Executive Committee’s Short-Term International Convergence Task Force.

In his interview, D. J. Gannon clarifies why there has been an increasing trend toward the use of International Financial Reporting Standards—specially in countries that are now requiring companies to use IFRS for local reporting or listing purposes. He also explains why and how IFRS are affecting both U.S. and non-U.S. companies and the increasing efforts being made to develop a global set of high-quality, principles-based accounting standards. The interview ends with Mr. Gannon providing a very informative explanation of the impact the changes in the financial reporting environment are having on accounting professionals and their education requirements.

Following is a summary of articles in this issue that deal with the new global regulatory, accounting and auditing requirements (plus some new tax rules) that are aimed at enhancing the public’s confidence in and understanding of corporate financial reports.

- In the first article, Ibrahim Badawi explains how and why the recent wave of fraudulent corporate financial reporting has prompted global actions for reforms in corporate governance and financial reporting by the governments and accounting and auditing standard setting bodies in the U.S. and abroad, in order to restore investor confidence in financial reporting, the accounting profession and global financial markets.

- Of course, a journal issue concentrating on accounting would not be complete without some articles dealing with taxes. Therefore, the last three articles in this issue do just that. The next article, written by Thomas Boyd, discusses a tax reform proposal that could provide the United States’ global economy an opportunity to correct some of the systemic problems in its existing tax system. The shift of taxes by corporations to individuals has been in part a result of multinational companies exploiting low tax rates in foreign nations. Tax reform that taxes businesses on their economic activity in the U.S. rather than profits could correct this problem.

- Laura Lee Marrino and Richard Lai discuss the IRS recently issued temporary regulations, which target partnerships’ foreign tax credit abuse. The new regulations, which require that foreign taxes be allocated in accordance with the partners’ ownership interests in the partnership, are consistent with the purpose of the foreign tax credit.

- Last, but not least, Mark Aquilio discusses Revenue Ruling 2004-75, which provides that income received by nonresident alien individuals under life insurance or annuity contracts issued by a foreign branch of a U.S. life insurance company is U.S. source income subject to a 30% tax and withholding. Similar income of Puerto Rican residents from contracts issued by a Puerto Rican branch will be considered U.S.-source income subject to graduated U.S. tax rates.
It's clear that IFRS affects companies outside the United States, but could you describe briefly how the movement toward IFRS impacts U.S. companies and professionals?

A: Sure, just because IFRS is not required in the United States does not mean that U.S. companies and professionals are not impacted. In fact, there are a number of situations where a U.S. company may have to report under IFRS. For example, when a U.S. company has a parent or investor located outside the U.S. that is required to report on an IFRS basis, at a minimum, it will have to gather IFRS information. In some cases, it may be required to prepare IFRS-compliant financial statements. This would be the case with EU domiciled parent or investor companies. In addition, U.S. companies that have subsidiaries with local or statutory reporting requirements in another country may have to comply with IFRS for those local or statutory reporting purposes. Further, U.S. companies that have or are looking to establish operations in another country may now be required by local regulators or lenders to prepare IFRS-compliant financial statements. This is the case in certain South and Central American countries.

Q: You mentioned earlier that the standard-setting process is evolving. Can you explain this and address the efforts to converge IFRS and U.S. GAAP (Generally Accepted Accounting Principles)?

A: Well, unlike the old IASC, the primary focus of the IASB is convergence of accounting standards worldwide. In order to facilitate convergence of accounting standards, the IASB has seven members that serve as official liaisons to national standard-setters. These “liaison” Board members will maintain close contact with their respective national standard-setters and will be responsible for coordinating agendas and ensuring that the IASB and national bodies are working towards convergence. Countries with formal liaisons are Australia (including New Zealand), Canada, France, Germany, Japan, the United Kingdom and the United States.

The liaison function is significant because the IASB, unlike its predecessor, is now formally linked to national standard-setters around the globe. As a result, projects that are addressed by the IASB are likely to be addressed concurrently by these national standard-setters, including the FASB, who also will now be more likely to adopt the same conclusions.

With its restructuring, the IASC evolved from a part-time, profession-dominated body to a full-time, independent body. Also noteworthy is that the influences on the IASB have changed, with the U.S. constituency having greater influence on the activities of the IASB than in the past. In turn, the output of the IASB will have a greater influence on U.S. financial reporting. We're seeing that now with certain issues that are being addressed by the FASB, such as the short-term convergence initiative and the accounting for share-based payments.
Q: D. J., I’ve been reading a lot about “principles-based” approach versus a “rules-based” approach to accounting. How are these approaches different?
A: We’ve certainly seen a lot written about “principles-based” versus “rules-based” standards over the last couple of years. Let me try to put some context around this. U.S. standards often are characterized as “rules-based” standards, while international standards are considered more “principles-based.” If you think about U.S. GAAP, what makes it so complicated is not the fact that principles don’t exist (remember the “P” in GAAP still stands for “principle”), but that there are many exceptions to those principles. Such exceptions and so-called “bright-line” tests that exist within U.S. GAAP also encourage companies to concentrate on “letter of the law” compliance. Often, that can result in financial statements that do not capture the economic substance of a company’s activities.

To me, “principles-based” standards are ultimately about simplifying accounting standards. The focus is on understanding the economics underlying a transaction or event and applying qualitative factors, rather than adherence to strict criteria, when accounting for that transaction. They adapt more readily to differing environments—a real plus in an era of increasingly multinational business activity. While they require a higher degree of professional judgment, which can make effective enforcement more of a challenge, they are easier to comprehend. Standards that focus on general principles with few exceptions also tend to result in greater transparency.

I believe that when you look at what a “principles-based” approach is trying to accomplish, it means standards that:

- Are based on and consistent with an underlying conceptual accounting framework;
- Clearly state the accounting objective;
- Provide sufficient detail and structure so that the standard can be operationalized and applied on a consistent basis;
- Limit exceptions and alternative treatments; and
- Avoid the use of percentage tests (i.e., “bright-lines”).

Q: So what are some of the challenges in implementing a “principles-based” approach?
A: The challenge with principles is having a consistent application and transparency in the judgments being made in applying the standards. In the absence of specific rules in the preparation of financial statements, it’s critical that all participants concur that accounting done under international standards also conforms to the “spirit of the standard.” Clearly, this can create tensions over interpretation and threaten consistent application. The challenge for the regulators, companies and auditors is making sure that consistency exists within the conceptual parameters of the IFRS.

If you look at some of the discussion following the Enron fallout here in the U.S., many people, including those at the SEC, are talking about the need for more “principles.” With the movement to a “principles-based” set of standards, there must be a greater acceptance of judgment, and that is something that is difficult for most people, particularly for us in the U.S. We’re really talking about a fundamental shift in how we approach accounting.

Q: It sounds like this is more than just accounting standards.
A: It is. In order for “principles-based” standards to work, it is necessary for all the elements of a financial reporting scheme to be operating efficiently, including all of the objectives and reforms contemplated in the Sarbanes-Oxley Act. In its Concept Release, International Accounting Standards, the SEC emphasized the importance of supporting high-quality accounting standards with an infrastructure that ensures that those standards are rigorously interpreted and effectively applied. The SEC noted that the primary elements for this infrastructure would include:

- Effective, independent and high quality accounting and auditing standard-setters;
- High quality auditing standards;
- Audit firms with effective quality controls worldwide;
- Profession-wide quality assurance; and
- Active regulatory oversight.

Many of the items noted above have been or are being addressed. In addition, the Sarbanes-Oxley Act requires changes in many facets of the financial reporting by and analysis of companies. Some of the important changes implemented under the Act are:

- Required certification of financial and other information by company CEOs and CFOs;
- Empowerment of audit committees to engage and approve the services provided by independent auditors;
- More stringent auditor independence standards;
- Greater independence for the accounting standard setter; and
- Greater oversight of auditors through the establishment of the Public Company Accounting Oversight Board or PCAOB.

Q: In your opinion, what impact will changes in the financial reporting environment have on accounting education?
A: I believe it will have a significant impact on accounting education. As I mentioned earlier, we are really talking about a fundamental shift in how we approach accounting. Accountants must understand the base concepts, how judgments are made under IFRS and how they are applied in relation to the base concepts. The test is does the financial reporting make sense? Does it follow the underlying economics? How does it compare to other companies that assemble financial reports under similar circumstances? Accountants must impose a kind of “reasonableness” test.

Such an approach to accounting requires changes in behavior. Since accountants will be required to use more professional judgment in this environment, training in areas such as problem solving and logic should be emphasized. Accountants now will have to rely on their ability to understand the economics and substance underlying a transaction or event. I also see a need to educate accountants in finance and valuation techniques, as many new standards now focus on fair value.
Global Corporate Accounting Frauds and Action for Reforms

Ibrahim M. Badawi, The Peter J. Tobin College of Business, St. John’s University

Abstract
The recent wave of corporate fraudulent financial reporting has prompted global actions for reforms in corporate governance and financial reporting, by governments and the accounting profession. The Sarbanes-Oxley Act of 2002, reforms of corporate America, resulting from the Sarbanes-Oxley Act of 2002, reforms were also initiated worldwide. The recent wave of corporate fraudulent financial reporting was disclosed in several other countries. Almost all cases of foreign corporate accounting frauds were committed by fraudsters that used the financial reporting system to conceal true business performance, to preserve personal status and control and to maintain personal income and wealth. Mid- and lower-level employees falsify financial statements related to their area of responsibility (subsidiary, division or other unit) to conceal poor performance and/or to earn performance-based bonuses. Organizational criminals falsify financial statements to obtain loans or to inflate the stock price of a company to sell in a “pump-and-dump” scheme.

Methods of financial statement schemes range from fictitious or fabricated revenues; altering the times at which revenues are recognized; improper asset valuations and reporting; concealing liabilities and expenses; and improper financial statement disclosures. The primary purpose of this paper is twofold: (1) to identify the prominent American and foreign companies involved in fraudulent financial reporting and the nature of accounting irregularities they committed; and (2) to highlight the global reaction for corporate reforms which are aimed at restoring investor confidence in financial reporting, the accounting profession and global financial markets.

Introduction
During the recent series of corporate fraudulent financial reporting incidents in the U.S., similar corporate scandals were disclosed in several other countries. Almost all cases of foreign corporate accounting frauds were committed by entities that conduct their businesses in more than one country, and most of these entities are also listed on U.S. stock exchanges. Following the legislative and regulatory reforms of corporate America, resulting from the Sarbanes-Oxley Act of 2002, reforms were also initiated worldwide.

Cases of Global Corporate Accounting Frauds
The list of corporate financial accounting scandals in the U.S. is extensive, and each one was the result of one or more creative accounting irregularities. Exhibit 1 identifies a sample of U.S. companies that committed such fraud and the nature of their fraudulent financial reporting activities [2, 3, 7]. Overseas, nine major international companies, based in eight different countries have also committed financial accounting frauds. Exhibit 2 identifies these nine international companies and the nature of the accounting irregularities they committed [10, 13].

Who Commits Financial Fraud and How
There are three groups of business people who commit financial statement frauds. They range from senior management (CEO and CFO); mid- and lower-level management; and organizational criminals [6, 16]. CEOs and CFOs commit accounting frauds to conceal true business performance, to preserve personal status and control and to maintain personal income and wealth. Mid- and lower-level employees falsify financial statements related to their area of responsibility (subsidiary, division or other unit) to conceal poor performance and/or to earn performance-based bonuses. Organizational criminals falsify financial statements to obtain loans or to inflate the stock price of a company to sell in a “pump-and-dump” scheme.

Methods of financial statement schemes range from fictitious or fabricated revenues; altering the times at which revenues are recognized; improper asset valuations and reporting; concealing liabilities and expenses; and improper financial statement disclosures [6, 16].

Global Regulatory Action for Corporate and Accounting Reforms
In response to corporate and accounting scandals, the effects of which are still being felt throughout the U.S. economy, and in order to protect public interest and to restore investor confidence in the capital market, U.S. lawmakers, in a compromise by the House and Senate, passed the Sarbanes-Oxley Act of 2002. President Bush signed this Act into law (Public Law 107-204) on July 30, 2002. The Act resulted in major changes to compliance practices of large U.S. and non-U.S. companies whose securities are listed or traded on U.S. stock exchanges, requiring executives, boards of directors and external auditors to undertake measures to implement greater accountability, responsibility and transparency of financial reporting. The statutes of the Act, and the new SEC initiatives that followed [1, 4, 8, 12, 15], are considered the most significant legislation and regulations affecting the corporate community and the accounting profession since 1933. Other U.S. regulatory bodies such as NYSE, NASDAQ

EXHIBIT 1. A SAMPLE OF CASES OF CORPORATE ACCOUNTING FRAUDS IN THE U.S.A.

<table>
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<tr>
<th>Company</th>
<th>Description</th>
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<tr>
<td>Adelphia Communications</td>
<td>Founding family collected $3.1 billion in off-balance-sheet loans backed by company. Earnings were overstated by capitalization of expenses and hiding debt.</td>
</tr>
<tr>
<td>AOL Time Warner</td>
<td>Barter deals and advertisements sold on behalf of others were recorded as revenue to keep its growth rate high. Sales were also boosted via “round-trip” deals with advertisers and suppliers.</td>
</tr>
<tr>
<td>Bristol-Myers Squibb</td>
<td>Inflated 2001 revenues by $1.5 billion by “channel stuffing,” forcing or giving inappropriate incentives to wholesalers to accept more inventory than they needed, to enable company to meet its 2001 sales targets.</td>
</tr>
<tr>
<td>CMS Energy</td>
<td>Executed “round-trip (buy and sell)” trades to artificially boost energy trading volume and revenues.</td>
</tr>
<tr>
<td>Duke Energy</td>
<td>Engaged in 23 “round-trip” trades to boost trading volumes and revenues.</td>
</tr>
<tr>
<td>Dynegy</td>
<td>Executed “round-trip” trades to artificially boost energy trading volume, revenues and cash flows.</td>
</tr>
<tr>
<td>Enron</td>
<td>Tops the list of biggest U.S. corporate collapses. Company boosted profits and hid debts totaling over $1 billion over several years by improperly using partnerships. It also manipulated the Texas power and California energy markets and bribed foreign governments to win contracts abroad.</td>
</tr>
<tr>
<td>Halliburton</td>
<td>Improperly booked $100 million in annual construction cost overruns (revenues) before customers agreed to pay for them.</td>
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<td>Merck</td>
<td>Recorded $14 billion over three years in consumer-to-pharmacy co-payments that the company never collected.</td>
</tr>
<tr>
<td>Qwest Communications</td>
<td>Inflated revenues using network capacity “swaps” and improper accounting for long-term deals. Former CEO L. Dennis Kozlowski was indicted for tax evasion ($1 million of New York sales tax on art purchases). The SEC is investigating whether the company was aware of his actions, and possible improper use of company funds and related-party transactions, as well as improper merger accounting practices.</td>
</tr>
<tr>
<td>WorldCom</td>
<td>To cover losses, top executives overstated earnings by capitalizing $9 billion of telecom operating expenses, and thus overstating profits and assets over five quarters, beginning 2001. Founder Bernard Ebbers received $400 million in off-the-books loans.</td>
</tr>
<tr>
<td>Xerox</td>
<td>Overstated earnings for five years, boosting income by $1.5 billion, by misapplication of various accounting rules.</td>
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The list of corporate financial accounting scandals... is extensive, and each one was the result of one or more creative accounting irregularities.

1. All public interest entities should have an independent audit committee or similar body.
2. The audit committee should regularly report to the board and address concerns about financial information, internal controls or the audit.
3. The audit committee must meet regularly and have sufficient time to perform its role effectively.
4. Audit committees should have core responsibilities, including monitoring and reviewing the integrity of financial reporting, financial controls, the internal audit function, as well as for recommending, working with and monitoring the external auditor.
5. Audit committee members should be financially literate and a majority should have "substantial financial experience." They should receive further training as necessary on their responsibilities and on the company.
6. Audit committees should have regular private "executive sessions" with the outside auditors and the head of the internal audit department. These executive sessions should not include members of management. There should be similar meetings with the chief financial officer and other key financial executives, but without other members of management.
7. Audit committee members should be independent of management.
8. There should be a principles-based approach to defining independence on an international level. Companies should disclose committee members' credentials, remuneration and shareholdings.
9. Reinforcing the role of the audit committee should improve the relationship between the auditor and the company. The audit committee should recommend the hiring and firing of auditors and approve their fees, as well as review the audit plan.
10. The IFAC Code of Ethics should be the foundation for individual national independence rules. It should be relied on in making decisions on whether auditors should provide non-audit services. Non-audit services performed by the auditor should be approved by the audit committee.
11. All fees, for audit and non-audit services, should be disclosed to shareholders.
12. Key audit team members, including the engagement and independent review partners, should serve no longer than seven years on the audit.
13. Two years should pass before a key audit team member can take a position at the company as a director or any other important management position.

Organization for Economic Cooperation and Development (OECD)

The Organization for Economic Cooperation and Development (OECD) is a quasithink tank made up of 30 member countries, including the United States and United Kingdom, and it has working relationships with more than 70 other countries. In 2004, the OECD unveiled the updated revision of its "Principles of Corporate Governance" that had originally been adopted by its member governments (including the U.S. and UK) in 1999. Although they are non-binding, the principles provide a reference for national legislation and regulation, as well as guidance for stock exchanges, investors, corporations and other parties [11,13].

The principles have long become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide. They have advanced the corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both the OECD and non-OECD countries. The 2004 updated version of "Principles of Corporate Governance" includes recommendations on accounting and auditing standards, the independence of board members and the need for boards to act in the interest of the company and the shareholders. The updated version also sets more demanding standards in a number of areas that impact corporate executive compensation and finance, such as [11,13]:

1. Granting investors the right to nominate company directors, as well as a more forceful role in electing them.
2. Providing shareholders with a voice in the compensation policy for board members and executives, and giving these stakeholders the ability to submit questions to auditors.
3. Mandating that institutional investors disclose their overall voting policies and how they manage material conflicts of interest that may affect the way the investors exercise key ownership functions, such as voting.

5. Directing rating agencies, brokers and other providers of information that could influence investor decisions to disclose conflicts of interest, and how those conflicts are being managed.
6. Mandating board members to be more rigorous in disclosing related party transactions, and protecting so-called "whistle blowers" by providing the employees with confidential access to a board-level contact.

U.S.-EU Cooperation for Corporate Reforms

Initially, the European Union resisted applicability of U.S. Sarbanes-Oxley Act reforms to European companies and accounting firms operating in the U.S. However, after a series of negotiations, the U.S. and EU authorities have agreed to cooperate and decided to develop a compatible set of regulations. The regulatory bodies on both continents have undertaken a two-way cooperative approach based on effective equivalence of regulation and oversight authorities [8]. Furthermore, member states of the European Union have proposed a code of conduct on the independent auditors which includes a five-year auditor rotation requirement [5].

Furthermore, the national governments of the individual European countries have proposed reforms of their corporate laws. For example, in July 2002, the British government released a white paper proposing changes to the Company Law, which included mandatory penalties for misleading auditors; redefining the roles of the directors; and creating standards for boards in accounting supervision and other disclosure issues. The British government is also reviewing the roles of non-executive directors and is considering the regulation of audit committees [5].

International Perspective, includes recommendations for strengthening corporate governance, and raising the regulating standards of issuers. Among its conclusions and recommendations related to audit committees are [9]:

1. The audit committee should have regular private "executive sessions" with the outside auditors and the head of the internal audit department. These executive sessions should not include members of management. There should be similar meetings with the chief financial officer and other key financial executives, but without other members of management.
2. The audit committee should review the financial information, internal controls or the audit.
3. The audit committee must meet regularly and have sufficient time to perform its role effectively.
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10. The IFAC Code of Ethics should be the foundation for individual national independence rules. It should be relied on in making decisions on whether auditors should provide non-audit services. Non-audit services performed by the auditor should be approved by the audit committee.

International Federation of Accountants (IFAC)

The IFAC is a private governance organization whose members are the national professional associations of accountants. It formally describes itself as the global representative of the accounting profession, with the objective of serving the public interest, strengthening the worldwide accounting profession and contributing to the development of strong international economies by establishing and promoting adherence to high quality standards [9]. The Federation represents accounting groups worldwide and has served as a reminder that restoring public confidence in financial reporting and the accounting profession should be considered a global mission. It is also considered a key player in the global auditing arena which, among other things, constructs international standards on auditing and has laid down an international ethical code for professional accountants [14]. The IFAC has recently secured a degree of support for its endeavors from some of the world's most influential international organizations in economic and financial spheres, including global financial stability framework (FSF), the International Organization of Securities Commissions (IOSCO), the World Bank and, most significantly, the EC.

In October 2002, IFAC commissioned a Task Force on Rebuilding Public Confidence in Financial Reporting to use a global perspective to consider how to restore the credibility of financial reporting and corporate disclosure. Its report, "Rebuilding Public Confidence in Financial Reporting: An International Perspective, includes recommendations for strengthening corporate governance, and raising the regulating standards of issuers. Among its conclusions and recommendations related to audit committees are [9]:
The Swedish-Swiss firm Asea Brown Boveri was seen as “a paradigm of European capitalism at its best.” In 2002, it suddenly turned into a “Swedish version of Enron.” In 2004, the company confirmed existence of weakness in internal control systems and accounting of Adeque staffing operations in certain countries, especially in the U.S. Manipulation involved IT system security, reconciliation of payroll bank accounts, accounts receivable and documentation in revenue recognition. These irregularities forced an indefinite delay in the company’s profit figures, which eventually caused a significant decline in the company’s stock prices in Switzerland and the U.S.; and intervention of the SEC.

The Canadian company, headquartered in Ontario, is the largest telecom equipment maker and provider in North America. Company remained tied up in a long SEC review of its financial results for 2001-2003, and the first half of 2004, due to material weaknesses in internal controls. Several top executives were fired as securities regulators performed investigations. In 2004, the company delayed restating its financial results for the third time, as it underwent investigations. Former top executives are suspected of committing accounting irregularities, aimed at inflating earnings, which helped make the company the largest telecom equipment supplier. Under investigation is the appropriateness of the company’s reserve accounts, whether there was an intentional inflation of reserves, which would be released to earnings in later years and the company’s questionable bonus program.

Parmalat, a global food and dairy conglomerate, is Italy’s eighth-largest company and the No. 3 provider of dairy (and cookemaker) in the U.S. In December 2003, a bank account with Bank of America holding $9 billion was revealed not to exist. More than 50 individuals, including the founder and former chairman, the chief financial officer, two of Parmalat’s external auditors at Grant Thornton and Deloitte Touche, and seven bank officials associated with the company were investigated. They were suspected of committing fraud and false financial accounting, which contributed to the company’s bankruptcy. The company acknowledged a multi-billion-dollar gap in its balance sheet accounts and subsequently filed for protection from its creditors. Parmalat’s jailed founder estimated the size of the deficiency in its finances at $10 billion, and admitted that he shifted $620 million from the company’s coffers to unprofitable travel businesses that were controlled by his family.

Royal Dutch/Shell Group

Shell, the third largest oil company, is a global group of (The Netherlands) energy and petrochemical companies, operating in more than 145 countries. In July 2004, the company reported paying a total of $150 million in fines to the SEC and its British counterpart, the Financial Services Authority (FSA), following investigations into the company’s overstatement of its oil and gas reserves. Since January 2004, the company was subject to intense criticism and scrutiny when executives made the first of four restatements related to its oil and gas reserves. Ultimately, Shell revised its claim, stating that its reserves were only 4.47 billion barrels, a 22% reduction from its original claim. Shell agreed with Britain’s FSA’s findings that it abused the provisions of the Financial Services and Markets Act. It paid £17 million in fines, the largest the regulator has ever levied. Shell also agreed to an SEC order that finds that the company violated antifraud, reporting, recordkeeping and internal control provisions of U.S. federal securities laws. The company also was investigated by the U.S. Department of Justice and by Netherlands regulators. The fines it has paid to the SEC and FSA do not rule out the possibility that individual executives could be fined separately by regulators.

Vivendi Universal (France)

The SEC accused this Paris-based company of misleading investors in its news releases and financial statements. Management was engaged in misconduct trying to meet earnings goals and intentionally violated certain accounting principles to inflate profits. For 18 months, senior executives refused to acknowledge the company’s liquidity problems and earnings shortfalls. Its former CEO transformed the company from a water utility into a film and media empire but saddled it with huge debts (33 billion) which were difficult to pay. On December 23, 2003, the company agreed to pay $50 million to settle accusations by the SEC and it did not have to revise any financial statements.
“...[B]usiness people who commit financial statement frauds...range from senior management...mid- and lower-level management and organizational criminals.”

Response to Corporate Fraud in the United States and Europe: Towards a Consistent Approach to Regulation

Sylvia Gornik-Tomaszewski, The Peter J. Tobin College of Business, St. John’s University
Irene N. McCarthy, The Peter J. Tobin College of Business, St. John’s University

Abstract

The recent spate of accounting scandals in the United States and in the European Union have shaken the faith in capital markets. Comprehensive measures have been undertaken on both sides of the Atlantic to restore the confidence of investors. In the United States, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB), effectively ending over a century of self-regulation of the accounting profession. The Act also mandates that company management provide accurate and timely financial information to investors. Initially, the U.S. approach was strongly resented in Europe because of its impact on European companies and auditors. After a series of negotiations, the U.S. and EU authorities increased cooperation and decided to develop a compatible set of regulations.

Introduction

In 2002, a series of sensational accounting scandals occurred in the United States. A number of leading companies admitted giving misleading impressions of their financial status by engaging in manipulation of their financial statements, and in outright fraud. In 2003, it was Europe’s turn. Scandals at Parmalat and Royal Ahold have shaken the faith in capital markets to the core. As it turns out, neither the U.S. nor Europe has any shortage of accounting loopholes, or examples of managers taking advantage of these loopholes and auditors willing to assist them. Exhibit 1 summarizes the most prominent corporate scandals of recent years.

Response to the wave of fraudulent corporate financial reporting experienced during the 1990s and early 2000s is not unique to the United States. The European Union has proposed a code of conduct for independent auditors, which include a five-year auditor rotation requirement. European countries are also individually involved in improving their corporate laws through governance codes of practice.

References


The Sarbanes-Oxley Act has wide sweeping implications for businesses and the accounting profession in the United States and abroad. The Act applies globally to supervisory boards, executives and auditors involved in both U.S. domestic and foreign public companies listed on U.S. stock exchanges. For these very reasons the Act was strongly criticized in Europe, especially because of the high cost of compliance. European companies seeking funds from the U.S. capital markets felt that PCAOB’s new standard that requires an audit of internal control over financial reporting placed the full weight of the regulatory response to U.S. accounting scandals on them and their auditors. Many of the European companies listed on U.S. stock exchanges have considered delisting. At the heart of the controversy over the Sarbanes-Oxley Act, however, was the fact that the PCAOB was given a right to regulate European auditors, if they audited U.S. companies.

During 2003, EU finance ministers were threatening an uncompromising rejection of the U.S. legislation and called for a full exemption for EU audit firms from registration with the PCAOB. Today, the heated dispute is replaced by increased cooperation between the two sides and an agreement from the European Commission (the Commission) to replicate a large part of the Sarbanes-Oxley Act. Proposals set out in the new Directive on statutory audits in March 2004, if approved, would mirror many of the provisions of this Act and establish U.S.-style oversight boards in each of the EU member states, as well as an EU-wide committee in charge of the details of the new legislation [3].

The proposed new EU rules on statutory audits are part of an integrated approach to modernize company law and corporate governance in the European Union. The Commission concluded that a self-regulatory market approach is no longer sufficient to guarantee sound corporate governance. Instead, a common approach covering a few essential rules should be adopted and adequate coordination of national corporate governance codes should be ensured. Regulators of securities markets in the United States and the European Union were also encouraged to cooperate more closely. The objective of the enhanced dialogue between the U.S. and EU regulatory bodies is to more quickly address potential problems and converge the respective regulations.
EXHIBIT 1. RECENT MAJOR CORPORATE SCANDALS IN NORTH AMERICA AND EUROPE

<table>
<thead>
<tr>
<th>Country of Incorporation</th>
<th>Company</th>
<th>Industry</th>
<th>Auditor of Consolidated Accounts</th>
<th>Questionable Accounting Practices</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>Enron</td>
<td>Energy &amp; utilities</td>
<td>Arthur Andersen</td>
<td>Widespread use of off-balance sheet financing in the reporting of partnership transactions. Enron was forced to restate its profits from 1997 through 2000 - lowering its book value by $1.25 billion.</td>
</tr>
<tr>
<td>USA</td>
<td>WorldCom</td>
<td>Telecommunications Services</td>
<td>Arthur Andersen</td>
<td>Reduction of operating expenses by: (1) improperly releasing certain reserves held as assets, (2) recharacterizing certain expenses as capital assets, and (3) overstating the reported income by approximately $9 billion.</td>
</tr>
<tr>
<td>Bermuda</td>
<td>Global Crossing, Ltd.</td>
<td>Telecommunications Services</td>
<td>Arthur Andersen</td>
<td>Inflation of pro forma values for cash revenue and adjusted EBITDA by including amounts for which cash was not received or where there had been non-monetary exchanges of capital capacity.</td>
</tr>
<tr>
<td>Italy</td>
<td>Pannalat Finanziara, SpA</td>
<td>Dairy</td>
<td>Deloitte &amp; Touche (Grant Thornton - individual accounts)</td>
<td>3.95 billion in cash and securities supposedly contained in a Cayman-based bank account did not exist.</td>
</tr>
<tr>
<td>The Netherlands</td>
<td>Royal Ahold N.V.</td>
<td>Retail Trade/Food Service</td>
<td>Deloitte &amp; Touche</td>
<td>Fraudulent inflation of promotional allowances at U.S. Foodservice, Ahold's wholly owned subsidiary, the improper consolidation of joint ventures through fraudulent sideletters and other accounting errors and irregularities which amounted to $880 million.</td>
</tr>
</tbody>
</table>

All these developments are of great importance in order to restore investors' confidence in capital markets, integrate the capital markets, lower the cost of capital, as well as to create an infrastructure for the development and application of principles-based accounting standards in the United States and in Europe.

The objective of this paper is to discuss parallel developments in the United States and in Europe.

EXHIBIT 2. IMPLICATIONS OF THE SARBANES-OXLEY ACT FOR THE ACCOUNTING PROFESSION

Section 101. Establishment and Duties of the Board
- Public Company Accounting Oversight Board. The Public Company Accounting Oversight Board (the Board) has been established and oversees by the SEC. The Board, made up of five full-time members, oversees and investigates the audits and auditors of public companies, and sanctions both firms and individuals for violations of laws, regulations and rules.
- Board Composition. Two of the five Board members must be or have been CPAs. The remaining three must not be and cannot have been CPAs. The Chair may be held by one of the CPA members, but he or she must not have practiced accounting during the five years preceding his/her appointment.

Section 109. Funding
- The Board is funded by public companies through mandatory fees. Accounting firms that audit public companies must register with the Board (“registered firm”), and pay registration and annual fees.

Section 108. Accounting Standards
- The Board issues standards or adopts standards set by other groups or organizations, for audit firm quality controls for the audits of public companies. These standards include auditing and related attestations, quality control, ethics, independence and “other standards necessary to protect the public interest.” The Board has the authority to set and enforce audit and quality control standards for public company audits.

Section 105. Investigations and Disciplinary Proceedings
- The Board is empowered to regularly inspect registered accounting firms’ operations and investigates potential violations of securities laws, standards, competence and conduct. Sanctions may be imposed for non-cooperation, violations, or failure to supervise a partner or employee in a registered accounting firm. These include revocation or suspension of an accounting firm’s registration, prohibition from auditing public companies and imposition of civil penalties. During investigations, the Board can require testimony or document production from the registered accounting firm or request information from relevant persons outside the firm. Investigations can be referred to the SEC, or with the SEC's approval, to the Department of Justice, state attorneys general or state boards of accountancy under certain circumstances.

Section 3. Commission Rules and Enforcement
- A violation of Rules of the Board is treated as a violation of the Securities Exchange Act of 1934, giving rise to the same penalties that may be imposed for violations of that Act.

Section 103. Auditing, Quality Control and Independence Standards and Rules
- Registered public accounting firms are required to prepare and maintain, for at least seven years, audit documentation in sufficient detail to support the conclusions reached in the auditor’s report.
- The relationship between accounting firms and their public audit clients is outlined below:
  - Auditors Report to Audit Committee. Auditors must now report to and be overseen by a company’s audit committee, not management.
  - Audit Committees Must Approve All Services. An audit committee must preapprove all services (both audit and non-audit services not specifically prohibited) provided by its auditor.
  - Auditor Must Report Additional Information to Audit Committee. This information includes critical accounting policies and practices to be used, alternative treatments of financial information within GAAP that have been discussed with management, accounting disagreements between the auditor and management, and other relevant communications between the auditor and management.
  - Offering Specified Non-Audit Services Prohibited. The Act authorizes the SEC to prohibit auditors from offering certain non-audit services to audit clients. These services include: bookkeeping, information systems design and implementation, appraisals or valuation services, actuarial services, internal audits, management and human resources services, legal or expert services related to audit services and other services the board determines by rule to be impermissible. Other non-audit services not banned are allowed if preapproved by the audit committee.
  - Audit Partner Rotation. The lead audit partner and audit review partner must be rotated every five years on public company engagements.
- Employment Implications. An accounting firm cannot provide audit services to a public company if one of that company’s top officials (CEO, controller, CFO, Chief Accounting Officer, etc.) was employed by the firm and worked on the company’s audit during the previous year.

Major Provisions of the Sarbanes-Oxley Act

Establishment of the Public Company Accounting Oversight Board (PCAOB). The Sarbanes-Oxley Act of 2002 created the PCAOB, an independent and non-partisan entity to set standards for the audits of public companies. The PCAOB is subject in all instances to the SEC’s approval. The Act, which applies in general to publicly held companies and their audit firms, dramatically affects the accounting profession and impacts not just the largest accounting firms, but any CPA actively working as an auditor of, or for, a publicly traded company. The basic implications of the Act for accountants are summarized in Exhibit 2.
To date, the PCAOB has finalized three auditing standards. All three standards have been approved by the SEC.

PCAOB Auditing Standard 1, References in Auditor’s Reports to the Standards of the Public Company Accounting Oversight Board, directs auditors of publicly held companies to state that the audit was conducted in accordance with “the standards of the Public Company Accounting Oversight Board (United States).” This requirement went into effect for audit reports issued on or after May 24, 2004.

PCAOB Auditing Standard 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, addresses how to audit management’s assessment of the effectiveness of internal control and requires that the audit of internal control be integrated with the financial statement audit.

PCAOB Auditing Standard 3, Audit Documentation, to address what documentation auditors need to generate and retain in an audit and review engagement. Standard 3 becomes effective for audits for fiscal years ending on or after the later of November 15, 2004. For quarterly reviews, the standard is effective beginning with the first quarter after the first year-end audit.

Section 10(a) of the Sarbanes-Oxley Act provides that any non-U.S. public accounting firm that prepares or furnishes an audit report with respect to any U.S. public company is subject to the Act and rules of the Board and the SEC, in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of any state in the United States. Also, foreign private issuers registered with the SEC are included within the scope of the SEC’s final rules implementing various sections of the Act.

The European Commission’s Initiatives in Wake of Corporate Scandals

In the aftermath of the multi-billion-euro scandals involving European companies, the European Commission outlined several areas of EU policy that had to be examined. The Commission has been focusing on statutory audit and other corporate governance measures. It also undertook steps to curtail insider dealing and improve financial reporting by publicly traded companies. Recently, the Commission has announced a broad strategy to fight fraud.

1. Proposed Directive on Statutory Audit

Corporate accounting regulation within the European Union requires that the annual statutory audit of listed accounts of companies, banks and other financial institutions, as well as insurance undertakings, are audited by one or more persons entitled to carry out such audits. The Eighth Council Directive (78/660/EEC) regulated audit approval of persons responsible for carrying out the statutory audits in the Member States. It does not, however, indicate how a statutory audit should be conducted and does not specify the required degree of public oversight or external quality assurance, which is needed to ensure a high audit quality. Worldview fears refer to the discretion of the appropriate authorities in the Member States.

The reorganization of the EU policy on statutory audit started in 1996 with a Green Paper on “The Role, Position and Liability of the Statutory Auditor in the EU.” Respondents to the Green Paper expressed dissatisfaction with the lack of a harmonized approach to statutory auditing within the EU and suggested a need for action at EU level beyond that authorized by the Eighth Council Directive. The policy conclusions which the Commission drew from these responses were included in the 1998 Communication, “The Statutory Audit in the European Union: The Way Forward.” It proposed the creation of an EU Committee on Auditing which would develop further action in close cooperation between the accounting profession and Member States.

Based on the Committee’s work, the Commission issued two Recommendations:

- “Quality Assurance for the Statutory Auditor in the EU” in November 2000; and
- “Statutory Auditors’ Independence in the EU” in May 2002.

President Dürkjan’s work on the use of International Standards on Auditing (ISA) has also been carried out.

Recent accounting scandals only underlined the urgency of the new policy. The European Commission, while appreciating the work of the U.S. legislators in the form of the Sarbanes-Oxley Act of 2002, criticized the Act for creating a series of problems due to its outreach effects on European companies and auditors. At the heart of the controversy were claims that Sarbanes-Oxley Act sought to influence matters well beyond U.S. jurisdiction by giving the PCAOB the right to inspect European auditors if, for example, they audit a U.S. subsidiary. The Commission and European auditing groups have repeatedly applied for exemption for EU audit firms from this aspect of the Sarbanes-Oxley Act under Article 106, because of the high standards of national oversight and regulation in the EU.

The Commission engaged in an intense regulatory dialogue with a view to negotiate acceptable solutions with the U.S. authorities. In response, the PCAOB hosted a series of roundtable meetings to solicit views on whether the registration requirements should be modified for foreign public accounting firms, and how the Board should discharge its oversight responsibilities with respect to registered foreign public accounting firms.

On April 14, 2003, the European Commissioner for the Internal Market and Financial Services, Frits Bolkestein, wrote to U.S. authorities to set out the case for exemption of EU audit firms from registering in the United States. He asked for a moratorium of the registration of EU audit firms so that effective transatlantic and international solutions can be found, and to avoid further problems in financial markets without imposing disproportionate burdens on EU businesses and audit firms. Despite these efforts, the PCAOB decided on April 21, 2003, that it would not waive EU audit firms working in the United States to register and submit to its oversight procedures.

In May 2003, the Commission published its own response to accounting scandals and market failures in the form of a Communication on statutory audit entitled “Reinforcing the Statutory Audit in the EU,” where it set priorities to improve audit quality within the EU. The Communication, calling for similar regulation of the accounting profession as being imposed in the United States under the Sarbanes-Oxley Act, contained a 10-point plan divided into short- and medium-term priorities. The short-term priorities, set for the 2003-2004 period, include modernization of the Eighth Council Directive; creation of an Audit Regulatory Committee of Member State representatives equipped with the power to adopt detailed binding audit regulations; strengthening of the rights of public oversight of auditors at the Member State and EU levels; and a requirement to implement ISA for all statutory audits of listed companies. Medium-term priorities, set within the 2004-2006 time frame, include, among others, improvement of the system of disciplinary sanctions; audit firm networks; and the improvement of audit committees and internal control; and the reinforcement of auditor independence and codes of ethics.

In October 2003, significant consultations and negotiations between the PCAOB and the Commission were launched. The two regulatory bodies undertook a two-way co-operative approach based on effective equivalence of regulation and oversight, to avoid duplication of oversight and minimize any conflict of law. Following the consultations, on March 16, 2004, the Commission put forward a proposal of a Union-wide law on corporate auditing in the form of a new “Directive on Statutory Audit of Annual Accounts and Consolidated Accounts.”
The proposed Directive, based on the May 2003 Communication on statutory audit, introduces a requirement for external quality assurance by ensuring robust public oversight over the accounting profession. The proposal aims at improving cooperation between oversight bodies within the EU, and with oversight bodies of non-EU countries. It also clarifies the duties of statutory auditors, their independence, and sets up independent supervisory bodies for Member States to regulate accountants and reinforce regulatory oversight over the accounting profession in the European Union. It will require Member States to set up independent supervisory bodies in each of the EU member states.

The PCAOB did in the United States, the proposed Directive, if adopted, effectively ends self-regulation of the accounting profession in the European Union. It will require the Member States to set up independent supervisory bodies to regulate accountants and reinforce regulatory cooperation within the EU. It introduces common criteria for public oversight systems at the Member State level where non-practitioners would have to predominate. A model of cooperation among regulatory authorities of Member States has been created. The model includes mutual recognition by Member States of each other’s regulatory requirements in the case of audits covering more than one jurisdiction.

**EXHIBIT 3. MEASURES BEING PROPOSED IN THE DIRECTIVE ON STATUTORY AUDIT**

**Measures to apply to statutory auditors and audit firms:**

- Requirement to use International Standards on Auditing (ISA) for all EU statutory audits – once those standards have been endorsed under an EU procedure; Member States can only impose additional requirements in certain defined circumstances;
- Possible adoption of a common audit report throughout the EU for financial statements that have been prepared on the basis of International Financial Reporting Standards (IFRS);
- Update of the educational curriculum for auditors, which must now also include knowledge of IFRS and ISA;
- Liberalization of the ownership and the management of audit firms by opening up the ownership and the management to statutory auditors of all Member States;
- Introduction of an electronic registration system for auditors and audit firms in all Member States, with a catalogue of registration information that has to be permanently updated;
- Requirement that statutory auditors and audit firms be subject to a code of professional ethics at least as rigorous as the code adopted by the Ethics Committee of IFAC;
- Establishment of legal underpinning of principles of auditor independence, including the duty of the statutory auditor or audit firm to document factors which may affect auditors’ independence and safeguards against these sorts of risks;
- Obligation for Member States to set rules for audit fees that ensure audit quality and prevent “low-balling;”
- Disclosure by companies, in the notes to their financial statements, of the audit fee and other fees for non-audit services delivered by the auditor;
- Introduction of a requirement for Member States to organize an audit quality review system that has to comply with clearly defined principles;
- Obligation for Member States to introduce effective investigative and disciplinary systems;
- Adoption of common rules concerning the appointment and the resignation of statutory auditors and audit firms, and introduction of a requirement for companies to document their communication with the statutory auditor or audit firm.

**Measures to apply to statutory auditors and audit firms of publicly held companies:**

- Introduction of an annual transparency report for audit firms that includes information on the governance of the audit firm, its international network, its quality assurance systems and the fees collected for audit and non-audit services; these reports would be publicly available;
- Auditor rotation with the following options left to the Member States: rotation of the lead audit partner on an engagement every five years; or rotation of the entire audit firm every seven years;
- Shortening of the period when an audit quality review must be carried out from five to three years;
- Appointment of the statutory auditor or audit firm on the basis of a selection by the audit committee which must be set up in all publicly held companies;
- Obligation for the statutory auditor or audit firm to report to the audit committee on key matters arising from the statutory audit, particularly on material weaknesses of the internal control system;
- Disclosure to and discussion with the audit committee of any threats to the auditor’s independence and confirmation in writing to the audit committee of higher independence.

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related to the oversight of non-U.S. registered public accounting firms. These firms had to register with the PCAOB by July 19, 2004. The SEC approved the rules on August 30, 2004.

In the spirit of mutual recognition, invoked during the long EC-PCAOB negotiations, the rules allow the PCAOB to implement the provisions of the Act, with respect to non-U.S. firms, by relying on a non-U.S. oversight system [4]. The process for examining foreign firms, however, would vary from country to country. The Board would use a “sliding scale” approach that would weight the rigor and sophistication of national oversight systems [5]. Specifically, under the Board’s rules, a firm would first provide the Board with a one-time statement asking the Board to rely on a non-U.S. inspection. At an appropriate time before each inspection of a non-U.S. firm that has submitted such a statement, the Board would determine the appropriate degree of reliance based on information about the non-U.S. system obtained primarily from the non-U.S. regulator. The Board would also take into consideration its discussions with the appropriate entity or entities within the oversight system concerning the specific inspection program of a non-U.S. firm at hand. The more independent and rigorous a national system of oversight is found to be, the higher the Board’s reliance on that system.

2. Other Corporate Governance and Anti-fraud Initiatives

The proposed EU rules on statutory audit, discussed above, should be seen in a wider context of an integrated approach to modernization of company law and enhancement of corporate governance in the European Union. The main objectives of the modernization are to strengthen shareholders’ rights, protect shareholders and third parties; and promote the efficiency and competitiveness of businesses. The Commission’s proposals cover corporate governance; capital maintenance and alteration; and corporate malpractice was unveiled by Frits Bolkenstein, the EU Commissioner for Internal Market. The new strategy is based on four defenses against corporate misconduct: (1) internal control in the company; (2) independent auditing; (3) supervision and oversight and (4) law enforcement. It calls for more transparency and information exchanges in the company tax area; more coherent EU policies concerning offshore financial centers; new policies to tackle obstruction of justice, corporate liability and asset-sharing; and more coherent EU policies concerning the company tax area; more coherent EU policies concerning offshore financial centers; new policies to tackle obstruction of justice, corporate liability and asset-sharing; and more coherent EU policies concerning offshore financial centers; new policies to tackle obstruction of justice, corporate liability and asset-sharing; and more coherent EU policies concerning offshore financial centers; new policies to tackle obstruction of justice, corporate liability and asset-sharing; and more coherent EU policies concerning offshore financial centers; new policies to tackle obstruction of justice, corporate liability and asset-sharing; and

The Commission also introduced, in 2003, a new Directive on insider dealing and market manipulation. The Directive involves several important changes, including forcing companies and their advisers, such as law firms and accountants, to keep detailed lists of people with access to price sensitive information relative to stock exchange announcements or mergers. Relationships between analysts and investment banking and individual trading accounts would also come under scrutiny.

The current level and frequency of the mandatory financial information that publicly traded companies must provide to the markets throughout the financial year was also upgraded. Under the new Transparency Directive, all issuers of securities must publish an annual financial report, based on IFRS, and a management report, within four months of the end of each financial year. They also are required to publish a half-year condensed financial report based on an update of the last annual management report.

On September 30, 2004, a new broad-based strategy to fight corporate malpractice was unveiled by Frits Bolkenstein, the EU Commissioner for Internal Market. The new strategy is based on four defenses against corporate misconduct: (1) internal control in the company; (2) independent auditing; (3) supervision and oversight and (4) law enforcement. It calls for more transparency and information exchanges in the company tax area; more coherent EU policies concerning offshore financial centers; new policies to tackle obstruction of justice, corporate liability and asset-sharing; and restoration of confiscated proceeds.

The U.S.-EU Collaboration in Regulating Securities Markets

The regulators of securities markets in the United States and the European Union are also trying to develop closer working relationships. Under the current regulatory framework, global securities markets are regulated by national securities regulators. In the European Union, the Committee of European Securities Regulators (CESR) was established as a coordinating forum for national regulators. This action created a partner for the U.S. Securities and Exchange Commission (SEC) in its regulatory efforts.

The idea for greater collaboration came after CESR Chairman Docters van Leeuwen visited Washington at the end of 2003, and SEC Chairman William H. Donaldson followed with his meeting of the SEC officials in Brussels in January 2004. At the CESR’s plenary meeting on June 4, 2004 in Amsterdam, the SEC and CESR announced their intention to establish terms of reference for enhanced cooperation and collaboration. In a joint announcement, SEC Commissioner Roel C. Campos and CESR Chairman Docters van Leeuwen indicated two primary objectives of the enhanced dialogue between the two regulatory bodies [1]:

1. to identify emerging risks in U.S. and European securities markets and more quickly address potential regulatory problems;
2. to share information about potential regulation in an effort to find commonalities and possibly draft compatible regulations.

In practice, the work will involve officials from both regulatory agencies, including chairman of the respective organizations as well as other employees, speaking several times per year. For the rest of the 2004 and early 2005, Campos and van Leeuwen outlined several areas for discussion:

• the SEC’s review of U.S. national market structure,
• the CESR’s work on implementation of a new European Investment Services Directive,
• future mutual fund regulation, specifically as it relates to state price arbitrage,
• late trading and corporate governance, and
• implementation of IFRS.

The cooperation between SEC and CESR will complement other multilateral efforts to regulate securities markets, including work carried out in the International Organization of Securities Commissions (IOSCO), the Council of Securities Regulators of the Americas, the Financial Action Task Force and the U.S.-EU Financial Markets Regulatory Dialogue.

Conclusion

The scandals at Enron, WorldCom, Ahold and Parmalat were largely caused by questionable accounting practices, bad management and weak internal controls. These failures have effectively put an end to the principle of self-regulation of the accounting profession in the United States and in the European Union. Although the EU countries and the U.S. have different historical, cultural, economic, financial and legal traditions, the ongoing discussions between the EU authorities and the U.S. PCAOB have shown that there is a great deal of agreement on new regulations for governing the accounting profession. The European Commission and the PACOB have demonstrated that they can cooperate effectively to produce a compatible set of regulations.

The cooperation between the U.S. and EU regulators also extends to the securities markets. The U.S.-EU Financial Markets Regulatory Dialogue and the working relationship between the SEC and the CESR mark a new era of coordinated efforts to fight corporate abuses. The goal is to restore investor confidence in the world’s financial markets by strengthening corporate governance and improving transparency. This should result in a lower cost of capital for public companies around the world. A common comprehensive and effective regulatory framework is also necessary for world-wide convergence of accounting standards.

References


Endnotes

1. Unlike their U.S. counterparts, foreign companies listed in the United States have until July 15, 2005 to comply with the SEC’s foreign private issuer requirements.
2. Green papers - discussion papers published by the Commission on a specific policy area. They are documents addressed to interested parties - organizations and individuals - who are invited to participate in a process of consultation and debate. In some cases they provide an impetus for subsequent legislation.
Convergence of Accounting Standards: A Comparative Analysis of the U.S. Revised Standard on Share-Based Payment and the International Accounting Standards Board’s IFRS 2

Benjamin Rue Silliman, Queen’s College of the City University of New York

Abstract
The FASB’s recently revised standard, SFAS 123(R), Share-Based Payment, converges closely with the IASB’s identically titled standard, IFRS 2. Both standard-setting Boards continue to work closely together to achieve a coherent set of improved standards that will result in “greater international comparability.” This article examines and compares the similarities and remaining differences between the two recently issued standards on share-based payments.

Introduction
On December 10, 2004, the Financial Accounting Standards Board (FASB) published SFAS 123(R), Share-Based Payment, which was a nearly two-year effort by the Board to promulgate a revised standard that “provides investors and other users of financial information with more complete and neutral financial information by requiring that compensation cost relating to share-based payment transactions be recognized in financial statements” (8). FASB member Michael Croom commented on the revised standard:

Recognizing the cost of share-based payments in the financial statements improves the relevance, reliability, and comparability of that financial information and helps users of financial information to understand better the economic transactions affecting an enterprise and supports resource allocation decisions (8).

SFAS 123(R) is a United States standard in which a majority of the accounting treatments converge with the recent standard passed by the international standard-setting body, the International Accounting Standards Board.

Since late 2002, the Financial Accounting Standards Board and the International Accounting Standards Board embarked on a firm commitment to cooperate in order to achieve convergence on a whole host of accounting standards. Both standard-setting bodies issued a memorandum of understanding in October 2002 known as the “Norwalk Agreement” that spelled out the commitment to the convergence of U.S. and international accounting standards (7). More recently, the IASB Chairman, Sir David Tweedie, in his September 9, 2004 testimony before the U.S. Senate’s Committee on Banking, Housing, and Urban Affairs, argued that the FASB and IASB’s recent efforts in developing more global accounting standards are to “eliminate the differences between...existing standards in the near term and to work together on long-term projects to ensure that the principles behind, if not the wording of, new standards will be the same” (14). One important project where both the boards have worked simultaneously to promulgate convergence in standards is the accounting for equity-based compensation.

The reporting of equity-based compensation by public corporations has become one of the most controversial issues the FASB and IASB have ever placed on their respective agendas. Both boards began working in late 2002 on developing a coherent set of standards on share-based payments that would result in “greater international comparability” (7). In its exposure draft dealing with equity-based compensation, the FASB outlined the goal of developing a standard that would converge with that of the IASB, resulting in a common set of “high-quality accounting standards”:

Converging to a common set of high-quality financial accounting standards on an international basis for share-based payment transactions with employees improves the comparability of financial information around the world and simplifies the accounting for enterprises that report financial statements under both U.S. GAAP and international accounting standards (6).

As indicated, the issue of equity-based compensation is the first major test of the effort of convergence of accounting standards. The IASB issued International Financial Reporting Standard 2 (IFRS 2), titled Share-Based Payment, in February 2004, which requires corporations to recognize an expense for “all employee services received (or consumed)” in exchange for the corporation’s equity instruments, using a fair-value-based method for measuring such compensation (7). Likewise, on March 31, 2004, the FASB issued an Exposure Draft, Share-Based Payment—an amendment of Statements No. 123 and 95 (referred to as ED) with a comparable objective. The final standard (SFAS 123(R)) was issued on December 16, 2004. In the process, the FASB changed the name of the U.S. proposed standard from “Stock-based compensation” and adopted the IASB’s terminology, “Share-based payment,” as a gesture of convergence (6). This article examines the background of the accounting for share-based payments and provides a comparative analysis of the remaining differences between the U.S. revised standard (SFAS 123(R)) and the international standard, IFRS 2.

Background of Accounting for Share-based Payments
In 1972, the Accounting Principles Board issued APB Opinion No. 25, Accounting for Stock Issued to Employees, which required corporations to measure compensation expense for the cost of stock options issued using the intrinsic value method. This method required compensation expense to be computed as the excess fair market value of the exercisable shares under the stock option plan over its exercise price. In addition, the Opinion provided criteria for determining the measurement date of the stock option awards, including the date of the option awards where the terms are either known (or fixed) or unknown (or variable) at the grant date. According to the ED, the use of the intrinsic value method for fixed awards “generally resulted in little or no compensation cost being recognized for valuable equity instruments given to employees in exchange for their services” [6]. The ED further cites the complexity in distinguishing between fixed and variable awards [6].

Given the lack of proper recognition of compensation cost, the FASB issued Financial Accounting Standard No. 123 (SFAS 123) in 1995. SFAS 123 provides an alternative method to the intrinsic value method by allowing compensation expense to be measured at its fair market value using a fair value option model. The use of the fair-value method on stock options requires recognition of compensation expense over the period of employee service (service period).

However, although it issued SFAS 123 in 1995, the Board “encouraged but did not require” entities to adopt the fair-value method, thus allowing for continued use of APB Opinion No. 25’s intrinsic value method (6). The Board’s action to allow the use of the intrinsic value method was a compromise, because there had been a great deal of dissent on the part of many members of Congress to the then-proposed legislation (6). Even up until 2002, the majority of U.S. corporations continued to use the intrinsic value method instead of adopting SFAS 123’s fair value method. However, the financial reporting failures that emerged in late 2001 shed a new “light” on accounting and reporting issues, creating a need for “high-quality, transparent financial reporting” to investors by corporations (13). This need for clear financial reporting also ignited a demand for “entities to recognize compensation cost for employee share options,” and the FASB moved the issue onto its agenda in March 2003 [13].

Primary Reasons for the FASB’s Issuance of the Exposure Draft on Share-based Payments
The Board outlined four primary reasons for issuing its ED (included in the revised standard):

1. Continued use of APB Opinion No. 25’s intrinsic value method oftentimes resulted in no compensation expense recognition and thereby did not “faithfully represent” the economic transactions of issuing valuable stock options in exchange for services rendered [6,12].

2. The Board believes that the elimination of the intrinsic value method, used by a number of public corporations, will ultimately improve comparability of reported financial information. While many public entities have “voluntarily adopted or announced their intention” to use the fair-value method, corporations have continued to use the intrinsic value method [6,12].

3. The revised standard aims at simplifying United States GAAP reporting by accounting for share-based payments by allowing for only the fair-value method.

4. The revised standard will also result in “greater international comparability” in reporting share-based payments [6,12].

Comparison of U.S. and International Revised Accounting Standards
Many of the requirements of the revised international standard, IFRS 2, are similar to SFAS 123(R). Most importantly, both SFAS 123(R) and IFRS 2 require compensation for share-based payments to be reported fairly in general-purpose financial statements. While a majority of the central features of IFRS 2 and SFAS 123(R) are similar, a few differences remain. A primary focus of this article is to explore those differences in accounting for share-based payments. Five specific differences between
"The FASB and the International Accounting Standards Board have been working very closely on a project of convergence of accounting principles in an effort to provide greater comparability in international financial reporting."

SFAS 123(R) and IFRS 2 are highlighted. Each is discussed separately.

Share-based Payment Arrangements with Non-employees. In the United States, Emerging Issues Task Force Issue No. 96-18 (Issue No. 96-18) provides guidance on accounting for stock option arrangements that do not result in cash consideration in exchange for goods and services. However, in drafting the Exposure Draft on Share-Based Payment, the FASB decided to “recognize the existing guidance” for non-employees in the future [12]. IFRS 2 provides accounting for share-based payment arrangements for employees and non-employees using a modified grant-date fair value method. The International standard requires that stock options or other equity instruments issued in exchange for goods or services be measured at their fair value on the grant date. If a non-public entity provides services or are received. In contrast, Issue No. 96-18 requires that stock options or other equity instruments to non-employees be measured at the earlier of (a) the date at which a commitment for performance by the counterparty to earn the equity instruments is reached, or (b) the date at which the counterparty’s performance is complete” [12]. Issue No. 96-18, therefore, allows for the possibility of measuring the issuance of such options or other equity instruments for non-employees on the earlier of two different dates (the commitment date or the performance completion date). Since IFRS 2 allows for a single measurement date (the date goods or services are received) versus that allowed by Issue No. 96-18, a difference in the amount of compensation cost may result. The Board in redeliberation on this issue guidance to narrow this difference at a later date.

Measurement of Share Options Granted by Nonpublic Entities. The IASB and the FASB standards differ slightly with regard to the measurement of share-based payments issued to non-employees. IFRS 2 and SFAS 123(R) both measure compensation cost using the fair-value method for both public and non-public entities. After the Exposure Draft was written, the Board revisited the issue in redeliberation. The ED language initially indicated that a nonpublic entity may determine whether to measure its share-based payment arrangements based on: “(a) their fair value at the date they are granted...or (b) their intrinsic value, remeasured at each reporting date through the date they are exercised or otherwise settled” [6]. In addition, the ED initially provided that if the fair value of the share option or other equity instrument is not reasonably determinable at the grant date, “the final measure of compensation cost” should be accounted for using the intrinsic value method at the settlement date [6]. However, concerns about nonpublic entities’ use of the intrinsic value method and other measurement concerns (such as measurement separation) caused the Board to revisit the issue on October 19, 2004. At that redeliberation, the FASB amended the language, requiring nonpublic entities to measure equity awards using the fair-value based modified grant-date method, unless:

1. It is not practicable for a nonpublic entity to make a reasonable estimate of the expected volatility of its own stock price. In that case, a nonpublic entity would use the historical volatility of an appropriate index, rather than using the expected volatility of its own stock price, as an input to a modified grant-date fair-value measurement. A nonpublic entity that follows this method would be required to disclose the index selected and how it selected that index.

2. A nonpublic entity concludes that it is not possible to reasonably estimate fair value because of a particular equity award’s features. In those rare circumstances, a nonpublic entity would be required to apply the same measurement method as a public entity; that is, the intrinsic value method described in the Final Statement [2].

IFRS 2 requires fair value measurement unless the fair value of options cannot be reasonably estimated at the grant date. In addition, the International standard requires nonpublic entities to demonstrate that the fair value of the options (or other equity instruments) cannot be reasonably estimated. The date in which a nonpublic entity would begin to allow for use of the intrinsic value method. The Board attempted to apply the same fair value measurement requirements to non-public entities and to public entities, minimizing any measurement differences between the two types of entities without imposing an undue burden on non-public entities” [12]. The next area of convergence between the FASB and IASB differences involve Type III modifications to share-based payment arrangements.

Accounting for Type III Award Modifications. In general, the Board “reaffirmed” the treatment of accounting for modifications of the terms of stock option compensation arrangements. Such modifications to an existing equity instrument transfer contract (between the granting corporation and the employee) oftentimes occur as a “repricing” arrangement, whereby the exercise price is subsequently reduced after the stock price has declined significantly [6]. SFAS 123 originally required the effect of such modifications “be measured as the difference between the fair value of the share option at the date it is granted and the award’s value immediately before the modification determined, based on the shorter of (a) its remaining initially estimated expected life or (b) the expected life of the modified award” [6]. SFAS 123R amended this provision in the original pronouncement, requiring the effects of a modification be measured by comparing the fair values of both the modified and original awards at the date of such modification. In addition, the Board amended SFAS 123’s treatment involving modifications to service and performance vesting conditions of share-based compensation arrangements.

Specifically, the effect of a change in vesting conditions is treated similarly to other types of modifications “by comparing the fair values of the award immediately before and after the modification” [12]. However, SFAS 123R requires that the resulting amount of compensation expense, as a result of an amendment to the original service or performance conditions, can be no less than the fair value of the original award at the grant date “unless at the modification date it is not probable that the original vesting conditions will be satisfied” [12]. Such modifications of performance and service vesting conditions are classified into four specific categories (Type I: Probable-to-Probable; Type II: Probable-to-Improbable; Type III: Improbable-to-Probable; and Type IV: Improbable-to-Improbable). While the FASB and IASB reached agreement on a majority of these categories of modifications, the two boards are in disagreement about Type III modifications. Before discussing the differing conclusions over Type III modifications, each of these categories will be briefly summarized, as they were presented in the ED and are reflected in the revised standard:

Type I Modification: Probable-to-Probable: The ED describes this as an amendment to a service or performance condition that does not impact the estimate of whether the award will vest. This may involve “a change from an original performance condition that is expected to be achieved for one that was not expected to be achieved” [6,12]. For instance, if a non-public entity provided 20% increase in market share of a product (that is not expected to be achieved) is subsequently amended to include a 15% increase in market share, which is “expected to be achieved”

Type II Modification: Probable-to-Improbable: A service or performance condition is met that “does not affect the estimate of whether the award will vest by substituting one condition that is not expected to be achieved for another that also [is] not expected to be achieved” [6]. The example in the ED involves a performance condition where a 25% increase in market share is adjusted down to 20%; both market share increases are not expected to be achieved [6,12].

Type III Modification: Improbable-to-Probable: The ED describes this as an amendment to a service or performance condition substitute “a condition that is expected to be achieved for one that was not expected to be achieved” [6]. The example in the ED describes a performance condition where a 20% increase in a market share of a product (that is not perceived to be achievable) is subsequently amended to include a 15% increase in market share, which is “expected to be achieved”

Type IV Modification: Improbable-to-Improbable: A service or performance condition is met that “does not affect the estimate of whether the award will vest by substituting one condition that is not expected to be achieved for another that also [is] not expected to be achieved” [6]. The example in the ED involves a performance condition where a 25% increase in market share is adjusted down to 20%; both market share increases are not expected to be achieved [6,12].

IFRS 2 is similar to SFAS 123(R) for Types I, II and IV modifications. However, the IASB and FASB reached differing conclusions with regard to Type III modifications. The revised U.S. standard provided the following example to illustrate the differences in the two board’s treatments of Type III modifications.

Example: On February 1, 2005, an entity grants its vice president for marketing $5,000 at-the-money options with a provision that the awards will vest only if the market share of Product A increases 20% by January 31, 2006. On September 1, 2005, market share has increased only 12%, and the 20% goal is not expected to be achieved. On that date, the entity modifies the performance condition to require only a 15% increase in market share, which is expected to be achieved. The estimated fair value of each option is $50 at the grant date and $30 on the date of modification [6,12].

This example is a Type III modification since the amendment to the original service and performance vesting conditions were adjusted downward from an improbable level (20%) to a probable level of achievement (15%). The FASB’s position in SFAS 123(R) is to account for this Type III modification by recognizing the adjustment on the date of such modification. Therefore, the fair value of the original award (on the modification date) would be $50 ($30 x zero option expected to vest under the original agreement), which is then to a 25% increase, which is not expected to be achieved.

The FASB and the International Accounting Standards Board have been working very closely on a project of convergence of accounting principles in an effort to provide greater comparability in international financial reporting.
The FASB and IASB both treat

An example is provided in SFAS 123(R). If a vested award of cash-settled SARs was modified to replace required cash settlement with net share settlement, an instrument that qualified as a liability before the modification is effectively converted to an equity instrument. If the value of the liability was $500,000 at the grant date and is $400,000 immediately before the modification, recognition is required for the additional compensation cost of $100,000 at the date of the modification. That accounting produced the same result as if the award had been an equity instrument from the grant date. Thus, the award is accounted for as equity beginning at the date of the modification, with an effective graded-date fair value of $400,000. The revised standard and redeliberation minutes point out that any modified award would be accounted for as an equity award from the date of such modification.

Classification of Certain Instruments as Liabilities or Equity

The ED indicates that U.S. GAAP and international accounting standards initially differed on classifying financial instruments as liabilities or equity. Different such instruments possess characteristics of both. IFRS 2 does not use the three classifications provided in SFAS 150 (Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity) to distinguish between liabilities and equity. The ED pointed out that the FASB and IASB would "undertake a joint project" to resolve differences with regard to this classification issue in the future. In the August 18, 2004 redeliberation, the Board unanimously reaffirmed the use of the classification scheme in SFAS 150 (paragraphs 8 through 14) in classifying an equity based compensation award [1]. Therefore, the Board's continued support classification scheme in SFAS 150 with regard to the definition of a liability and equity did not narrow the differences with IFRS 2. The language in the final standard (SFAS 123(R)) indicated that the FASB and IASB will reconcile such differences in a future meeting.

Certain Aspects of Accounting for Income Tax Effects of an Award of Equity Instruments. The FASB and IASB both treat the total tax deduction of an award as "arising from two separate transactions or events," which impact both the income statement and paid-in capital [6,12]. The tax deduction involves the following two transactions described in the ED as follows:

"[In the first transaction] employees render services as consideration for an award of shares, stock options or other forms of share-based payment." The company's use of those services results in compensation cost, impacting the income statement [6,12]. The second transaction involves an equity transaction, when the share options are later exercised. This transaction is impacted by "share price changes between the date an award of options is granted and the date the award is exercised or otherwise settled" [6,12]. Therefore, tax deductions in excess of recognized compensation costs as a result of an increase in the intrinsic value of an instrument after the grant date are considered equity transactions [6,12]. Likewise, in the second transaction, should the tax benefit for the intramonth date be less than the recognized deferred tax asset, such difference is referred to as a tax deficiency. In the text of the ED, the Board initially amended SFAS 123's treatment of combining the income tax effects of excess tax benefits and tax deficiencies. SFAS 123 required that any income tax deficiency be first allocated to paid-in capital "to the extent of remaining tax effects of previous awards...based on a portfolio view of income tax effects of share-based employee compensation" [6]. In essence, this "portfolio approach" involved combining tax deficiencies on some instruments with any excess tax benefits of other stock option instruments. In the text of the ED, the FASB initially concluded that the portfolio approach of SFAS 123 was not appropriate and recommended that the full amount of the tax benefit be recognized in the income statement (and not netted against any excess tax benefits of other stock option instruments). In other words, the tax effects of share-based compensation in the ED required recognition based on each individual employee (versus "netting" the excess tax deficiencies of one employee against the excess tax benefits of another employee). The FASB and IASB, however, arrived at different conclusions with regard to the income tax effects of equity instruments awarded to employees. In the U.S., the federal tax code generally does not allow for the deductibility of the total tax value of options. However, the FASB originally agreed with the IASB's approach in its redeliberation on September 22, 2004. During redeliberation, the Board ultimately decided to abandon the aforementioned proposal whereby an entity writes off the portion of the deferred tax asset related to a deficiency (net of any income tax valuation allowance), and recognizes it in the income statement. Instead (according to the summary of redeliberations), the Board decided to allow continued use of the tax benefit deficiency treatment originally promulgated in SFAS 123: "Under Section 123, that write-off, net of the related valuation allowance, is recognized in the income statement except to the extent that there is remaining additional paid-in capital (from excess tax benefits from previous share-based payments awarded for in accordance with the fair value based method in Statement 123" [8]. The Board noted that public entities had already been applying SFAS 123's portfolio approach and found that it was "not only familiar, but somewhat easier to implement than the method in the ED" [12].

Several board members also mentioned convergence with IFRS 2 as an important factor in overriding the approach in the ED. Accordingly, while the revised standard requires using a portfolio approach in calculating excess tax benefits of equity awards (to the extent of available paid-in capital), IFRS 2 requires "an individual instrument approach" [12]. Therefore, the treatment of "some write-offs of deferred tax
assets” recognized in paid-in capital under SFAS 123(R) “will be recognized in determining net income under IFRS” [12]. By the time the Reid revised standard was issued, the differences between the U.S. and the international standard had narrowed somewhat.

Conclusion
The Financial Accounting Standards Board and the International Accounting Standards Board have been working very closely on a project of convergence of accounting principles in an effort to provide greater international comparability in financial reporting. The FASB’s revised standard, SFAS 123(R), Share-Based Payment, closely mirrors the IASB’s standard, IFRS 2, which has the same title. The key provision of SFAS 123(R), along with the international standard, is for public entities to recognize the fair value of the compensation cost for vested employees over their service period, eliminating use of the intrinsic value method. While SFAS 123(R) and the international standard converge on a majority of the key issues, a few differences still remain. Some of the differences listed narrowed even further in the FASB’s redeliberations process, particularly with regard to measurement of equity awards by non-public companies and the income tax effects on equity awards. According to SFAS(R), the remaining differences “may be further reduced as the FASB progresses with the next phase of the project…when the two Boards will consider whether to undertake additional work to further converge their respective accounting standards on share-based payment…” [12]. While the basis of this article has been to highlight some of the differences between the two standards, it must be noted that the majority of the provisions in each of the standards on share-based payment do, indeed, converge.

SFAS 123(R) impacts quarters beginning after June 15, 2005 (the original date was set for quarters beginning after December 15, 2004, but was extended on October 13, 2004 by the Board “under pressure from companies and the staff of the Securities Exchange Commission”) [11,12].

References
The Amendments to IAS 36

Because goodwill amortization was eliminated in IFRS 3, the IASB felt that the impairment test in IAS 36 should be revised to accommodate goodwill. The IASB's initial proposal included in ED3 was a two-step impairment test for goodwill similar to that required under SFAS 142. However, significant concerns arose among IASB constituents about the practicality and complexity of the proposed impairment test for goodwill. Moreover, there were still some constituents, including two members of the U.S. Financial Accounting Standards Board and some of the respondents to ED3, who opposed even the elimination of goodwill amortization, regardless of the convergence objective.

SFAS 142's Two-step Goodwill Impairment Test

Under SFAS 142's two-step impairment test, the fair value of goodwill in periods subsequent to the date of acquisition is estimated in the same manner as it was at the date of the acquisition.

- The first step identifies a potential impairment by comparing the estimated fair value of a reporting unit to its carrying amount, including goodwill. If the fair value of the reporting unit is greater than its carrying amount, goodwill is not considered impaired, and the second step is not required. If the fair value of the reporting unit is less than its carrying amount, the second step of the impairment test is performed to measure the amount of the impairment, if any.
- In the second step, the estimated fair value of the reporting unit determined in Step 1 is allocated to the assets and liabilities of the unit (including any unrecognized identifiable intangible assets). The excess of the estimated fair value over the amounts assigned to the assets is the new estimated (or implied) fair value of goodwill. If the carrying amount of goodwill exceeds its estimated fair value amount, an impairment loss is recognized equal to that excess and is reported as a charge to income from operations.

The amounts determined in the new purchase price allocation are used for purposes of testing goodwill for impairment. That is, the entity would not record a "step-up" in net assets or any unrecognized intangible assets as a result of this process. Also, once written down for impairment, no future recovery of goodwill value may be recognized.

Goodwill Impairment: Convergence Not Yet Achieved

Despite the joint efforts...to achieve convergence in accounting for business combinations and related goodwill and intangible assets...some major differences remain, especially in the treatment of asset impairment.

Remaining Differences in Accounting for Impairment

Despite the joint efforts of the IASB and the FASB to achieve convergence in accounting for business combinations and related goodwill and intangible assets, evidences the significant changes adopted by the IASB in the issuance of IFRS 3 and the amendments to IAS 36 and IAS 38, some major differences remain, especially in the treatment of asset impairment. Key areas of divergence in dealing with impairment are shown in Box 4.

The impairment testing models of the IASB and the FASB have differing bases, in that the FASB compares the carrying value of an asset to its fair value, and the IASB compares its carrying value to the recoverable amount, which includes value in use. This difference may diminish if the FASB adopts its current Exposure Draft: Fair Value Measurement, because the draft incorporates a measure which is roughly equivalent to the IASB's value in use. Hence, the adoption of this draft would promote convergence by eliminating some of the remaining differences between the IASB and FASB in accounting for impairment.
EXHIBIT 1. DIFFERENCES IN ACCOUNTING FOR IMPAIRMENT

<table>
<thead>
<tr>
<th>IASB (International)</th>
<th>FASB (U.S.)</th>
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<tbody>
<tr>
<td>• Measurement of impairment</td>
<td>Compare carrying value recoverable amount (the higher of to fair value in use and fair value less costs to sell).</td>
</tr>
<tr>
<td>• Level of testing for goodwill</td>
<td>CGU, the lowest level to which goodwill can be allocated and for which management monitors goodwill. (Monitoring should be at least at the Segment level.)</td>
</tr>
<tr>
<td>• Calculating impairment of goodwill</td>
<td>One step: compare recoverable amount of a CGU to its carrying amount.</td>
</tr>
<tr>
<td>• Calculating impairment of Intangible assets</td>
<td>Goodwill and intangible assets with indefinite lives are not tested directly; the CGU, to which those assets have been allocated, is tested for impairment as a whole.</td>
</tr>
<tr>
<td>• Reversal of impairment losses</td>
<td>Applicable to all intangible assets, other than goodwill</td>
</tr>
</tbody>
</table>

The impairment testing models differ considerably, however, with respect to the application of the test to goodwill and intangible assets with indefinite lives. The IASB has retained the impairment test in IAS 36 for testing goodwill impairment, rejecting the FASB’s two-step test. The result is that the IASB requires application of goodwill to a CGU, and only tests its impairment at the level of the CGU or group of CGUs, without computing the implied value of goodwill at the time of the test. If impairment of the CGU is required, it is written down against goodwill first, and any remaining impairment, once goodwill is written off completely, is required to be applied on a pro rata basis to other long-lived assets in the CGU. The FASB, on the other hand, associates goodwill with a reporting unit (which may be different in description from a CGU), and if impairment of the reporting unit is required, then each of its assets is measured at fair value to determine the implied value of goodwill before it is written down. In fact, it may not be necessary to write down goodwill if the impairment is determined to be caused by other assets in the reporting unit, for which a different impairment model applies (that is, the two-step approach in SFAS 144).

Finally, a significant difference remains with respect to the reversal of impairment losses. The FASB prohibits reversals entirely. The IASB permits impairment losses to be reversed, up to the amount of what the depreciated historical cost would have been without the impairment loss, except if caused by unwinding of the discount rate. However, at least both have agreed that reversals of goodwill impairment should not be permitted.

These differences are substantive obstacles to convergence. They do not appear on the IASB’s agenda, but the IASB has asked the FASB to reconsider them during its deliberations on the Phase II of the Business Combinations Project.

Conclusion

With the recent pronouncements on business combinations, there has been an increase in the number of intangible assets with indefinite lives, including goodwill, that are not subject to amortization. Hence, impairment testing has become increasingly important. Nonetheless, despite their joint efforts to converge on new accounting pronouncements, the IASB and the FASB still have significant differences in their impairment testing models.

Resolving their differences and achieving convergence is important to global capital markets. For some time, Australia, Germany and the United Kingdom have permitted foreign companies that issue securities in those countries to prepare their consolidated financial statements using IFRS. After January 1, 2005, listed companies domiciled in those and other EU countries are required to use IFRS. The primary countries that still do not accept IFRS without reconciliation are Canada, Japan and the United States. The U.S. Securities Exchange Commission (SEC) has encouraged for several years the convergence of IASB and FASB standards so that the current requirement to reconcile certain financial information for Foreign Private Issuers for financial statements that were prepared on a basis other than U.S. GAAP could be eliminated. Because of the recent changes in the IASB and the EU adoption of IFRS, the SEC has indicated that it will review the need for reconciliation after 2005. The decisions taken as a result of this review will undoubtedly depend upon the degree of convergence achieved. The SEC may also face political pressure from the EU and the possibility of a requirement for U.S. companies listed in the EU to reconcile to IFRS.

Both the IASB and the FASB are in the second phase of the Business Combinations Project, which they are considering jointly. However, current developments on the project indicate that convergence in this area may not be accomplished in the short term.

References


Additional/Further Reading


The Concept of Control in Consolidated Financial Statements: Convergence of U.S. and International Accounting Rules

Patrick A. Casabona, The Peter J. Tobin College of Business, St. John's University

Alex Ashwal, Senior Manager, Deloitte & Touche LLP

Abstract
Recent progress has been made toward the convergence of a global set of accounting standards. However, more work needs to be done. A significant step in that continued direction will be complete when the FASB finalizes its proposed standard on consolidation policy, aligning its rules with international accounting standards. This paper focuses on the principle of control as it is applied in U.S. and international accounting consolidation rules and the convergence effort made in this area.

Introduction
The recent progress made toward the convergence of a global set of accounting standards has been well documented [1,3]. Significant progress has been made in attaining a global financial reporting framework, as the convergence of U.S. Generally Accepted Accounting Principles (GAAP) with International Financial Reporting Standards (IFRS) has accelerated in recent years. This paper focuses on the principle of control as it is applied in U.S. and international accounting rules. It also examines the progress being made towards convergence of these consolidation procedures and concludes that it has been moving forward slowly—but much more work needs to be done.

U.S. GAAPs Consolidation Rules
The Financial Accounting Standards Board's (FASB) consolidation policy project has for many years focused on developing new standards to determine which entities should be included in consolidated financial statements. This project is aimed at reconsidering the consolidation principles included in Accounting Research Bulletin No. 51, Consolidated Financial Statements (ARB 51), which was issued in 1959. ARB 51, which was subsequently amended by Statements on Financial Accounting Standards (SFAS) 94, SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets in 2001, and interpreted by FASB Interpretation No. 46 (Revised December 2003), Consolidation of Variable Interest Entities: An Interpretation of ARB No. 51 (FIN 46(R)), in 2003, describes the purpose of consolidated financial statements and the general rule of consolidation policy. Under ARB 51, consolidated financial statements are required when one of the companies in the group directly or indirectly has a controlling financial interest in the other companies, where control is defined as having ownership of a majority voting interest (i.e., over 50% of the outstanding voting shares of another company). SFAS 94 amended ARB 51 to eliminate all of the exceptions to consolidation, except when control is likely to be temporary or if it does not rest with the majority owner (as, for instance, if the subsidiary is in legal reorganization or in bankruptcy). However, SFAS 144 recently eliminated this exception.

The stated purpose of consolidated financial statements and the general rule of consolidation presented in ARB 51 focus on companies that issue voting shares, which generally are business enterprises organized as-for-profit corporations. Under these requirements consolidation is based on control, where control is generally measured as having more than 50% of an entity's outstanding voting shares of equity. However, during the years since ARB 51 was issued, both business enterprises and not-for-profit organizations have continued to conduct a growing and diverse range of activities through increasingly complex organizational structures. Therefore, during 1999, the FASB issued a proposed Statement of Financial Accounting Standards (SFAS) 145, Consolidation Financial Statements: Purpose and Policy: Revision of Exposure Draft issued October 16, 1995. This proposed Statement, which is one of the FASB's international accounting convergence projects, would supersede the provisions of paragraphs 1-3 and 5 of ARB 51, as previously amended, and would amend ARB 51 to extend its provisions to not-for-profit organizations. This Statement requires an entity (parent) to consolidate all entities that it controls, where control may exist through means other than a majority voting interest. The FASB determined in 1999 that there was not sufficient Board member support to proceed with a final statement on the consolidation policy exposure draft, although it believed that improved guidance in this area is desirable. However, because of the weakness in accounting guidance for consolidating special purpose entities and the resulting high profile scandals, that emerged during the 1990s and early 2000s (such as the Enron debacle), the Board decided to develop new rules for consolidating these entities first, as discussed below. Now that the Board has completed the consolidation project relating to variable interest entities, which resulted in the issuance of FIN 46(R) in 2003, it plans to begin the research necessary to develop comprehensive guidance on consolidation principles that would amend the proposed Statement on consolidation policy and procedures in 2005. Paramount to this guidance is the concept of control, which is to be used to determine which entities should be included in consolidated financial statements.

The FASB's Proposed Standard on Consolidated Financial Statements
Paragraph 6 of the exposure draft defines a new concept of control, which requires the presence of two essential characteristics: a) a parent's decision-making ability (that is not shared with others) that enables it to guide the ongoing activities of its subsidiary; and b) a parent's ability to use that power to increase the benefits that it derives and limit the losses that it suffers from the activities of that subsidiary. These characteristics, which are similar to those included in the control concept adopted by international accounting standards and already adopted by the European Union and many other foreign countries, as explained below, generally can result from a single source such as a controlling block of voting equity shares, but they may stem from multiple sources. For example, a parent's decision-making powers may stem from a subsidiary's governing instrument (articles of incorporation, partnership agreement or trust indenture), contractual arrangements with holders of voting rights, a voting trust or other legal device, while its ability to derive benefits stems from a holding of nonvoting equity shares or other beneficial interests.

The proposed Statement also provides guidance for applying its definition of control, which includes the following situations identified in paragraphs 18 and 21 that lead to rebuttable presumptions of control:
- The entity has a majority voting interest in the election of a corporation's governing body or a right to appoint a majority of its members.
- The entity has a large minority voting interest in the election of a corporation's governing body and no other party has a significant voting interest.
- The entity has a unilateral ability to 1) obtain a majority voting interest in the election of a corporation's governing body or 2) obtain a right to appoint a majority of the corporation's governing body through the present ownership of convertible securities or other rights that are currently exercisable at the option of the holder and the expected benefit from converting those securities or exercising that right exceeds its expected cost.
- The entity is the only general partner in a limited partnership and no other partner has the ability to dispose of the limited partnership or otherwise remove the general partner.

FIN 46(R)’s Risk and Expected Return Model
In December 2003, the FASB issued FIN 46(R), which establishes consolidation guidance for variable-interest entities (VIEs) (formerly called special purpose entities), which is based on ownership of variable interests in a VIE, and then determining if there is an investor that shares the majority of its risks and returns, rather than on the old notion of control provided in ARB 51. VIEs are often created solely to carry out specific activities or a series of transactions directly related to specific purposes and may take any legal form that can be used to conduct business activities. VIEs may be used to set up favorable operating lease arrangements (such as a synthetic lease), obtain debt financing at lower costs through securitizations and asset-backed commercial paper conduits, shelter certain assets from bankruptcy, hedge risks, achieve tax benefits or efficiencies and many other purposes. If an enterprise determines that it holds a variable interest in a VIE as defined in FIN 46 (R), then it has to determine if it should consolidate the entity. In order to do this, it must also determine whether it or someone else is the primary beneficiary and which group must consolidate the VIE. In order to do this, the expected residual losses and expected residual returns of the VIE must be estimated and then allocated to the enterprises that hold variable interests in the VIE. A primary beneficiary, if any, should consolidate a VIE if it has a variable interest that will absorb a majority of the entity's expected residual losses or expected residual returns.

“... during the years since ARB 51 has been issued, both business enterprises and not-for-profit organizations have continued to conduct a growing and diverse range of activities through increasingly complex organizational structures.”
Although the proportion of voting rights is one of the important factors that should be considered when determining control, other factors should also be considered. Thus, if Entity A, which holds only 14% of the voting rights of Entity B and has 14% of the voting rights of Entity B, but has only 35% of the voting rights of Entity B, has 14% of the voting rights of Entity B, and has 14% of the voting rights of Entity B, and has 14% of the voting rights of Entity B, then it may be possible to demonstrate that such ownership does not signify control, especially when a significant minority interest exists or when another party has the ability to dominate the board of directors of the entity. The substance of the arrangement must be considered, as it may provide evidence to rebut the presumption. In addition, control can exist even when an entity owns less than 50% of an entity's voting share capital (or equity capital).

EXHIBIT 1. ILLUSTRATION OF CONTROL, SIGNIFICANT INFLUENCE OR NO SIGNIFICANT INFLUENCE

<table>
<thead>
<tr>
<th>Situation</th>
<th>Control</th>
<th>Significant Influence</th>
<th>No Significant Influence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entity A has obtained 10% of the voting rights of Entity B</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Entity A has been trying to obtain representation on the board of directors of Entity B</td>
<td>x</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Entity A has obtained 10% of the voting rights of Entity B and by virtue of an agreement with other investors the ability to obtain another 9%. This, however, does not provide it the power to govern the financial and operating policies of Entity B</td>
<td>x</td>
<td>x</td>
<td></td>
</tr>
</tbody>
</table>

X means that the combination should be accounted for by using the method attached to the substantive criterion (control, significant influence or investment).


1. Although the proportion of voting rights is one of the important factors that should be considered when determining significant influence or control, other factors should also be considered. Thus, if Entity A, which holds only 14% of the voting rights of Entity B, also has a representation on the board of directors and the remaining 86% of the voting shares of Entity B is spread over a large number of investors, a strong argument could be made that entity A exercises significant influence, if not control influence.

2. All of the important factors that may contribute to control must be considered in the circumstances, when determining significant influence or control. That is, factors in addition to the proportion of voting rights, which may provide an entity with excessive rewards or indirect control must also be considered. Thus, the ability to sell products with the potential for substantial gains may signify significant influence, if not control, given the factors presented above, and possible others that have not been considered. For example, the power of control may also be evident if Entity A also has some kind of representation on the board of directors of Entity B.
Exhibit 1 provides a few illustrative investment scenarios involving the concept of control; significant influence; or no significant influence. In addition to the control indicators in IAS 27.13, the potential voting rights identified in IAS 27.14 also should be considered in evaluating whether or not control exists. Potential voting rights are when an entity owns share warrants, share call options, debt or equity instruments that are convertible into ordinary shares or other similar instruments that have the potential, if exercised or converted, to give the entity voting power or reduce another party’s voting power over the financial and operating policies of another entity. It is important to note, in order to be considered in determining control, the potential voting rights must be currently exercisable or convertible.

The Concept of Control for Special Purpose Entities (SPEs) — SIC 12

SIC 12, an interpretation relating to IAS 27, provides further indicators for control as they apply to SPEs and explains when such entities should be consolidated by a reporting entity under the provisions in IAS 27. Basically, an entity should consolidate a SPE when, in substance, the entity controls the SPE. The concept of control in IAS 27 that is applied to SPEs by SIC 12 requires an enterprise to have the ability to direct or dominate the decision making power of the entity, accompanied by the ability to obtain benefits from the SPE’s activities. This is very similar to an important aspect of the concept of control defined in the FASB’s proposed Statement on consolidation policy, discussed earlier. SIC 12 provides the following examples of indications of when control of an SPE may exist:

- The SPE is involved in activities on behalf of the reporting entity.
- The reporting entity has decision-making powers over the SPE, and
- The reporting entity has rights to the majority of the benefits and exposure to significant risks of the SPE.

The last indicator presented above reflects FIN 46 (R)’s guidance which must be used to determine the primary beneficiary of a VIE, which must consolidate the entity.

Conclusion

Convergence of U.S. and international consolidation standards has moved forward, although progress has been less rapid than in other areas, such as stock-based compensation, earnings per share, business combinations, etc. These convergence efforts will promote the global cross-border movement of the capital that is necessary to sustain economic growth. The progress made to date has led to more consistent and translucent financial statements that should enhance investor confidence in domestic and international financial reporting, however more work still needs to be done. The FASB and IASB have taken many steps toward the development of a global set of accounting standards that will accommodate the needs of all investors and creditors. A significant step in that direction will be complete when the FASB finalizes its proposed standard on consolidation policy so that its rules are more in line with international accounting standards.

References


Additional/Further Reading

accounting for research and development costs

Accounting for Research and Development Costs: A Comparison of U.S. and International Standards

Sylwia Gornik-Tomaszewski, The Peter J. Tobin College of Business, St. John’s University

Miguel A. Millan, Deloitte & Touche LLP

Abstract

Accounting for research and development (R&D) activities is an area of divergence between U.S. Generally Accepted Accounting Standards (U.S. GAAP) and International Financial Reporting Standards (IFRS). Under U.S. GAAP, all R&D expenditures are charged to expense when incurred. According to IFRS, an intangible asset arising from development is recognized if specific criteria are met. Little progress has been achieved towards convergence on this issue.

Introduction

The Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) continue their efforts to converge their accounting standards into a single set of high-quality financial reporting standards. These efforts, which started in earnest in 2002, have lead to the identification of areas where the accounting models for similar transactions differed. Accounting for research and development (R&D) activities is one of the areas of divergence between the two accounting frameworks. This paper focuses on the differences between Generally Accepted Accounting Principles in the United States (U.S. GAAP) and International Financial Reporting Standards (IFRS) or IAS when accounting for R&D activities and covers the progress being made towards convergence.

Common Definition of R&D Activities in FASB and IASB Standards

Many costs have characteristics similar to those resulting from R&D activities, for example, start-up costs for a new plant or new retail outlet; marketing research costs; promotion costs of a new product or service; and costs of training new personnel. To differentiate R&D costs from other similar costs, the FASB and the IASB defined R&D activities in their respective standards, which are:

- The conceptual formulation; design; evaluation; modification of the formulation or design; and administrative costs, which must be clearly related to R&D activities. These costs include: (1) costs of materials, equipment and facilities that have no alternative future uses; (2) salaries, wages and other related costs of personnel engaged in R&D activities; (3) purchased intangibles that have no alternative future uses; (4) contract services; and (5) a reasonable allocation of indirect costs, except for general and administrative costs, which must be clearly related to R&D activities.

- The design, construction and operation of a pilot plant that is not of a scale economically practical or commercially feasible.

- The design of tools, jigs, moulds and dies involving new technology.

- The design, construction and testing of pre-production or pre-use prototypes and models.

- The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.

- The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services to the point that they meet specific functional and economic requirements and are ready for manufacture.

The definitions of “research and development” in FAS 2 and IAS 38 are almost identical. These two standards also share common examples of research and development activities. Accounting treatment of these intangible assets, however, differs between U.S. GAAP and IFRS.

Differences in the Accounting for R&D Activities

According to FAS 2, issued in 1974, all R&D costs encompassed by this statement shall be charged to expense when incurred. These costs include: (1) costs of materials, equipment and facilities that have no alternative future uses; (2) salaries, wages and other related costs of personnel engaged in R&D activities; (3) purchased intangibles that have no alternative future uses; (4) contract services; and (5) a reasonable allocation of indirect costs, except for general and administrative costs, which must be clearly related to R&D activities. The total R&D costs charged to expense should be disclosed in the financial statements in each period for which an income statement is prepared. Also, under FASB Interpretation No. 4, Applicability of FASB Statement No. 2 to Business Combinations, the FASB required the following method: In-process R&D costs should be written off to expense on the day they are acquired. The FASB disregarded the alternative R&D accounting and reporting practices, including capitalization, which had both been followed by business practice before 1974. In concluding that all R&D costs should be charged to expense, the Board considered such factors as uncertainty of future benefits of individual R&D projects and lack of causal relationship between expenditures and benefits. The Board considered an accounting method of selective capitalization, which is to capitalize R&D costs when incurred only if specific conditions are fulfilled and to charge to expense all other R&D costs. This method, requiring establishment of conditions that must be fulfilled before R&D costs are capitalized, has been practiced in many countries. For example, capitalization of selected R&D costs has been allowed under certain conditions in Japan and France, while capitalization of development costs has been practiced in the United Kingdom and, as discussed below, is required under international accounting standards.

Exhibit 1. Comparison of Definitions of Research and Development Activities Included in FAS 2 and IAS 38, Including Common Examples

<table>
<thead>
<tr>
<th>Definition</th>
<th>FAS 2</th>
<th>IAS 38</th>
</tr>
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<tbody>
<tr>
<td>Research</td>
<td>Planned search or critical investigation aimed at discovery of new knowledge, with the hope that such knowledge will be useful in developing a new product or service, or a new process or technique, or in bringing about a significant improvement to an existing product or process</td>
<td>Original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding</td>
</tr>
<tr>
<td>Examples</td>
<td>• Activities, like laboratory research, aimed at obtaining new knowledge</td>
<td>• The search for, evaluation and final selection of applications of research findings or other knowledge</td>
</tr>
<tr>
<td></td>
<td>• The search for alternatives for materials, devices, products, processes, systems or services</td>
<td>• The search for alternatives for materials, devices, products, processes, systems or services</td>
</tr>
<tr>
<td></td>
<td>• The conceptual formulation; design; evaluation; modification of the formulation or design; and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services</td>
<td>• The conceptual formulation; design; evaluation; modification of the formulation or design; and final selection of possible alternatives for new or improved materials, devices, products, processes, systems or services</td>
</tr>
</tbody>
</table>

Development

Translation of research findings or other knowledge into a plan or design for a new product or process, or for a significant improvement to an existing product or process, whether intended for sale or use

| Examples | • The design, construction and testing of pre-production or pre-use prototypes and models | • The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services prior to the commencement of commercial production or use |
| | • The design of tools, jigs, moulds and dies involving new technology | • The design, construction and operation of a pilot plant that is that is not of a scale economically feasible for commercial production |
| | • The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production | • The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services to the point that they meet specific functional and economic requirements and are ready for manufacture |

...
The selective capitalization method requires prerequisite conditions that are based on such factors as technological feasibility, marketability and usefulness. FASB members argued that considerable judgment is required to identify the point in the R&D process at which a new or improved product is defined and determined to be technologically feasible, marketable or useful. The FASB decided to reject this method because, in practice, no set of conditions that might be established for capitalization of costs could achieve comparability among enterprises. In addition, selective capitalization is applied only to costs incurred after fulfillment of the specified conditions, and the capitalized amount would not indicate the total costs incurred to produce future benefits, nor would the amount of periodic amortization of capitalized costs represent a matching of costs and benefits.

The requirement that all R&D costs incurred internally be expensed immediately is a conservative, practical solution, which insures consistency in practice and comparability among companies. Defendants of this accounting method argue that from an income statement point of view, the same whether there is immediate expensing or capitalization and subsequent amortization. Critics of the practice of immediate expensing of all R&D costs emphasize the long-run application of this standard. For example, the choice of research and development activities is the fact that R&D accounting for R&D activities is the fact that R&D expenses will reflect those expenditures as operating expenses, which will be classified as cash flows from operating activities, and subsequent amortization of development costs means that development expenditures will not be reported as operating cash flows, but will be classified as cash flows from investing activities, whereas companies expensing development costs will reflect those expenditures as operating cash outflows in the year incurred.

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In 1998, the IASB developed a new standard on accounting for R&D costs, IAS 38. The revised IAS 38 is applied to the accounting for intangible assets acquired in business combinations after March 31, 2004, and to all other intangible assets classified as such at that date. The revised IAS 38 applies to the accounting for intangible assets acquired in business combinations after March 31, 2004. The revised IAS 38 is applied to the accounting for intangible assets acquired in business combinations after March 31, 2004. Additionally, if an entity decides to apply IFRS 3 retrospectively, it should apply IAS 38 retrospectively as well.

In accordance with the revised IAS 38, expenditure on research is recognized as an expense. An enterprise is recognized as an intangible asset arising from research or from the research phase of an internal project. An intangible asset arising from development or from the development phase of an internal project is recognized only if the enterprise can demonstrate all of the following:

1. The technical feasibility of completing the intangible asset, so that it will be available for use or sale;
2. Its intention to complete the intangible asset and use or sell it;
3. Its ability to use or sell the intangible asset;
4. It is probable that the enterprise will generate probable future economic benefits from the intangible asset or the output of the intangible asset, or the internal usefulness of the intangible asset;
5. The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset; and
6. Its ability to reliably measure the expenditure attributable to the intangible asset during its development.

The core conceptual difference between IFRS and U.S. GAAP with respect to accounting for R&D activities is the fact that IAS 38 assumes that, in some instances the enterprise is able to identify expenditures during the development phase of the project that fulfill the requirements to be recognized as an intangible asset. Such intangible assets should not be accounted differently than those acquired externally, as long as the same accounting criteria for intangible assets are met.

If an intangible asset does not meet the criteria for recognition as an asset, the expenditure is recognized as an expense when incurred. Also, an expenditure that was initially recognized as an expense should not be later included in the cost of an intangible asset.

Subsequent to initial recognition, a capitalized development cost is carried at either:

- Cost, less any accumulated amortization and any accumulated impairment losses; or
- A revalued amount, less any subsequent accumulated amortization and any accumulated impairment losses. The revalued amount is fair value at the date of revaluation and is determined by reference to an active market. Revaluation should be made with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using its fair value at the balance sheet date.

An intangible asset can only be carried at a revalued amount if there is an active market for the asset. This restriction assures reliability of the measurement. A revaluation increase should be credited directly to an equity account called "revaluation surplus," unless it reverses a revaluation decrease of the same asset previously recognized in the income statement. Any revaluation decrease is recognized as an expense in the income statement if there has not been a previous revaluation increase that was credited to equity. It should be noted that revaluation of intangible assets subsequent to initial recognition is not permitted under U.S. GAAP.

An entity should assess whether the useful life of an intangible asset is finite or infinite. Finite intangible assets are amortized over their useful lives. Assets with indefinite useful lives are not amortized, but are tested for impairment at least annually. Impairment of intangible assets is recognized in accordance with IAS No. 36, Impairment of Assets.
“The core conceptual difference between IFRS and U.S. GAAP with respect to accounting for R&D activities is the fact that IAS 38 assumes that in some instances the enterprise is able to identify expenditures during the development phase of the project that fulfill the requirements to be recognized as an intangible asset.”

R&D Issues in the Short-term International Convergence Project

In October 2002, the FASB and the IASB pledged to make their existing financial reporting standards fully compatible as soon as practicable. Therefore, they added to their respective active agendas a high-priority short-term convergence project. The scope of this project is limited to resolving those differences between IFRS and U.S. GAAP, in which convergence around a high-quality solution appears to be achievable in the short term.

One of the issues considered in the short-term convergence project is the accounting for R&D activities. At their meeting on April 22, 2004, the FASB and the IASB directed their staffs to develop an inventory of individual differences that were candidates to be eliminated in this phase of the project. The Boards noted that elimination of the differences in accounting for R&D activities between IFRS and U.S. GAAP could involve consideration of fundamental conceptual issues and that those issues were part of a longer-term research project on intangible assets. They agreed, however, that possibilities to eliminate some differences in the short-term should be explored. The Boards instructed their staffs to consider:

- The criteria for capitalization of costs under FAS No. 86. Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed, to see if they could be used to make the criteria for internally-generated intangible assets in IAS 38 more operational; and
- Whether there are any aspects of U.S. GAAP that could be moved closer to IAS 38.

Unfortunately, this work has been temporarily suspended to allow the FASB to focus on other higher priority areas.

Conceptual Questions

The accounting treatment of R&D costs represents one of the many trade-offs among relevance, reliability and cost-benefit considerations. Several early studies tried to determine whether the 1974 change in accounting methods for R&D costs in the U.S., which was the change from capitalizing to expensing R&D expenditures, would result in reductions in outlays for research and development. The evidence is mixed. Horowitz and Kolodny [1,2] document a significant effect of FAS 2 for a sample of over-the-counter (OTC) firms. Duques, et al., [3] failed to detect a significant effect for a sample of firms listed on either the New York Stock Exchange or the American Stock Exchange. Elliot, et al., [2] identified significant relative declines in R&D expenditures for companies that used to capitalize R&D before 1974. This effect was observed among both the OTC and listed companies. But substantial questions were raised as to other economic factors, such as the financial health of the companies in the research sample as well as the generally poor economic conditions from 1970 to 1977, which likely influenced the results.

The key issue differentiating the FASB’s and IASB’s approaches for accounting for R&D costs is the question of whether expenditures for such intangibles generate future revenues and earnings. Clear evidence of a link between current expenditures and future revenues and earnings will strengthen the argument in favor of recognizing at least part of R&D costs as assets. Lev and Sougiannis [6] developed a model relating companies’ earnings (output) to their investment inputs, including expenditures on R&D. The authors reported that the average duration of R&D benefits varies across industries from five to nine years and the estimated benefits of these R&D programs vary from $1.66 to $2.63 per dollar of R&D spending. Research also examines the relative risk of investments in R&D projects. Kohari, et al., [5] found that future benefits of R&D spending are more uncertain and less reliable than those on capital equipment. Shi [7] concludes that R&D projects are substantially riskier than other types of projects, because, on average, R&D spending increases the riskiness of bondholders’ claims on the company. More empirical research is needed to resolve the conceptual issues underlying the inconsistent approach to accounting for R&D activities under the U.S. GAAP and IFRS.

Conclusion

Little progress has been achieved towards the convergence of U.S. GAAP and IFRS accounting standards for R&D activities. The convergence process has been rather slow, since this issue by itself is not considered a priority for either FASB or IASB. The fundamental conceptual issues leading to differences in the accounting models will be addressed in a long-term convergence project on intangibles. In the meantime, the short-term convergence project will focus on issues which would not fundamentally change the accounting for R&D. Therefore, it is clear that convergence in this area will not occur for at least another few years.

References


Additional/Further Reading


Tax Reform in a Global Economy: Shifting the Tax Burden

Thomas Boyd, The Peter J. Tobin College of Business, St. John’s University

Abstract

Tax reform is President Bush's priority as his second term progresses. This undertaking is ideologically problematic, economically complex and politically risky. It does, however, offer an opportunity to correct some systemic problems in the tax system. The shift of taxes by corporations to individuals has been in part a result of multinational companies exploiting low tax rates in foreign nations. Tax reform that taxes businesses on their economic activity in the United States rather than profits could correct this. This would be a backdoor approach to a consumption tax and would bring the U.S. tax system more in line with that of other countries. It could also provide much-needed funds to correct problems in the individual income tax structure such as the alternative minimum tax.

Introduction

On the campaign trail in Florida, President Bush, in response to a question about whether the United States ought to consider replacing the income tax with some sort of national sales tax, remarked, “It’s kind of an interesting idea that we ought to explore seriously.” This was followed up by a comment from Representative Bill Thomas, Chair of the tax-writing House Ways and Means Committee, that he favored looking at “well-thought-out alternative tax structures” and that the Committee planned to do so. He added, “We have one of the more regressive tax structures in the world today that is basically a 19th century concept” [2]. President Bush has made tax reform one of his top domestic priorities for his second term. He has not, however, specified what design these reforms may take.

In his first term, President Bush made major cuts in individual income taxes, as did his predecessor, President Reagan. The centerpiece of Reagan’s second term was tax reform that resulted in the 1986 Tax Act. Now the question that many people are asking is “Will Bush, like Reagan, push for real tax changes?”

Need for Tax Reform

Tax reform is a loaded phrase. One man’s reform may be another’s outrage. Tax reform is much more complex than lowering or raising taxes. It implies shifting the burden among taxpayers, or changing the financial activity being taxed. The complexity of our tax laws has reached the point where many taxpayers and practitioners believe that it is undermining voluntary compliance. Frequent change, the lack of deliberation in the legislative process, and the increased magnitude and complexity of the Internal Revenue Code are our principal concerns [6].

It was not always so. Tax reform by President Reagan did overhaul much of the Code. But in the years after 1986, lawmakers started adding dozens of provisions to the individual and corporate income tax system. This contributed to its complexity and helped the tax preparation industry prosper. The majority of taxpayers are forced to seek assistance from accountants and others in order to comply. Last year’s individual instruction manual was an overwhelming 126 pages, a big increase from the 56 pages needed in 1987 after the revision took place [1].

Another reason for reforming the tax system is fairness. From the start, the U.S. income tax was progressive, that is, increasing rates for higher income. This required an amendment (16th) to the Constitution in 1913. The bottom tax rate was then 1%, rising to 7% on incomes over $50,000. This top rate was applicable to only a very small fraction of the population. Very few taxpayers were even affected by the income tax system. Thus, it was very easy to get support for this tax. George Bernard Shaw put it very well when he said, “A government which robs Peter to pay Paul can always depend on the support of Paul” [10]. The problem today is that with a bottom rate of 10% increasing to 39%, most of us are Peter, and even many Pauls view the system as unjust.

In the 1990s, talk of tax reform was based on changing the progressive tax system to a Flat Tax system. This was put forth by such people as Congressman Dick Armey and Steve Forbes, a presidential candidate. Today there seems to be more interest in a consumption tax. The time is right for a major tax overhaul. The system is broken and needs to be fixed.

Taxes Have Shifted from Corporations to Individuals

Business taxes at the federal level are made complex by a code that taxes various entities differently and by a basic problem inherent in the determination of net taxable income. Certain business entities such as partnerships, small businesses, and limited liability companies are treated for tax purposes as conduits and pay no federal tax at the entity level. Their profits or losses flow through to the owners in proportion to their interest in the entity. On the other hand, corporations (C Corporations) without special designation must pay taxes at the entity level in the form of corporate income taxes. Their shareholders must also pay individual income taxes on earnings of the corporation that are distributed to them in the form of dividends. This unfair treatment, referred to as a double tax, has been partly addressed in the 2003 tax legislation. Under this act, dividends may be taxed at the same rate as capital gains. That rate is 15% for most taxpayers [7].

The determination of net income, which underlies the computation of taxable income, is a rather difficult accounting concept. It comprises numerous rules involving the timing of revenue recognition and the matching of expenses. Many entities, particularly multinational corporations, can manipulate their reported net income so as to avoid or minimize the corporate tax. These global corporations set up their corporate structures, a big business of itself, in the U.S. or American corporations with foreign subsidiaries.

What strategies do these entities pursue? Exploiting low tax rates in foreign countries is one of the common schemes used. This may be done by increasing income reporting in low-tax nations while shifting expenses to high-tax countries. Multinational corporations will frequently use transfer pricing to avoid paying U.S. taxes. For example, a corporation manufacturing a radio in Japan to be sold in the U.S. could avoid U.S. taxes on its profits by transfer pricing schemes. Let’s assume that it costs $50 to make the radio, and the Japanese corporation transfers the radio to an affiliate in Hong Kong for $60. This allows the Japanese corporation to receive its selling and administrative costs and report a small profit in Japan. This avoids or lowers its taxes in Japan. In Hong Kong the product is packaged and shipped to the U.S. at a cost of, say, five dollars. The Hong Kong corporation sells it to its U.S. affiliate for $85 thereby reporting a profit of $20 per radio ($85-$60=$3) in Hong Kong. It does not, however, have to pay any tax on it due to a special treaty exempting the corporation from taxes for a specified period of time in Hong Kong. This acts as a tax haven. The radio is sold by the U.S. affiliate for $100. This allows the U.S. affiliate to recover its selling and administrative cost of $15 and report no taxable income in the U.S. ($100-$85-$15). The goal is to report the profit in a tax haven in this case, Hong Kong, where there are little or no taxes.

Tyco International, Ltd. used extreme measures to avoid U.S. taxes when they incorporated in Bermuda in 1997. By 2001 the company reported tax savings of $600 million a year. Cooper Industries, Ingersoll Rand Co., and many others have made similar moves in recent years. This great tax shift can be illustrated in Exhibit 1 [3]. Companies that move to tax havens have an advantage over other corporations who pay federal income tax rates of 35% and state or local taxes that can add another 10%.

A recently published study by Citizens for Tax Justice and its affiliate, The Institute of Taxation and Economic Policy, shows that America’s largest and most profitable companies paid less in corporate income taxes in the last three years, even as they increased profits. The study surveyed public filings by 275 of the nation’s largest and most profitable companies from the Fortune 500 list for 2004. The 275 companies reported pretax profits from U.S. operations of $1.1 trillion from 2003 to 2003 through 2003. However, they reported half of this amount to the IRS as taxable income and paid tax on this lower amount. The study went on to report that corporate taxes as a share of national economic prosperity are at their lowest level since World War II, and financed only six percent of the government’s expenses in the last two fiscal years [12].

Somewhere between $70 to $100 billion is lost to the U.S. Treasury every year as corporations and individuals fictitiously report income in tax havens that is actually earned in the United States. Legal tax avoidance often evolves into illegal tax evasion because America has inadequate tax treaties with offshore havens. This means reporting of such income may not be correct, and investigation is often impossible. This undermines the entire system and rule of law. Efforts to correct it have failed, and we can expect the American Jobs Creation Act of 2004 will do little to improve the situation. What is needed is a fundamental change in how we tax business income and collect taxes.

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MAny entities, particularly multinational corporations, can manipulate their reported net income so as to avoid or minimize the corporate tax.

A backdoor approach to consumption taxes would be to tax businesses on their economic activity in the United States. Taxing businesses on their revenue from product sales or services could do this.

The tax rate on such economic activity could be much lower than the income tax rate because it is computed on a larger base than the income tax. It would be a replacement for the income tax system on business activity, and as such, much more difficult to avoid. The tax would be viewed by all business entities as a cost of doing business and passed along to consumers in higher prices. Since all entities would be paying the tax based on their financial activity in the U.S., it would level the playing field. This approach to a consumption tax would not generate the voters' ire that could be expected by the introduction of a national sales tax. If presented properly, the public could accept it.

Taxes on businesses are a cost of doing business and are passed on to consumers in the form of higher prices. Thus, the tax should be levied on all commercial activity on an equal basis regardless of the form or structure under which the business operates. The amount of tax to be paid should be relatively simple to determine, and all commercial entities should know what their tax burden is. A tax on economic activity falls in this regard, and no number of changes in the rules will correct this. It is fundamentally flawed. A business should pay on its economic activity, not on whether or not it is successful.

There is much talk about shifting taxes from income to consumption. This could be done by establishing either a national sales tax or a value-added tax (VAT), which could replace all income taxes imposed on both corporations and individuals. Such a drastic change in the tax system is probably not politically possible. As Robert Kuttner, writing in the Economic Viewpoint for Business Week pointed out (September 13, 2004, "The Latest Bush-Plan Consumption Taxes"), a change to consumption taxes would benefit mainly wealthy people with substantial discretionary income to save. A higher proportion of the burden would fall on lower income people who must spend a higher proportion of their income. He also stated that, there is no evidence that a consumption tax would actually promote savings, investment, or growth. A VAT or a national sales tax would strike many voters as just another new tax [1].

This current environment does offer an opportunity to reform the way businesses are taxed. A backdoor approach to consumption taxes would be to tax businesses on their economic activity in the United States. Taxing businesses on their revenue from product sales or services could do this. Deductions would be allowed for expenditures for the cost of purchased products or services, but only if the suppliers’ revenue were subject to U.S. taxes. The tax would be collected on all imports as they enter the U.S. This tax system would be similar to a VAT and bring the U.S. tax system in line with other nations. As an example of how it might function, we could take an auto dealer who sells a car for $30,000. The dealership would be allowed to deduct the amount it paid to the manufacturer, say $20,000, and pay tax on the net revenue of $5,000 ($30,000-$25,000). The manufacturer will pay tax on its revenue of $25,000; the auto dealer will pay tax on its revenue of $5,000. This avoids a double tax, but the government collects tax on the total revenue of $30,000.

The same situation could occur with service revenue. A company bills its customer for $100,000 for services rendered on a contract. However, the company used sub-contractors and paid them $60,000 for services performed by them on that contract. If the sub-contractors paid the tax on the $60,000 revenue they earned, the company would pay the tax on only $40,000 ($100,000-$60,000). Again the government collects the tax on all revenue.

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Alternative Minimum Tax Problem

Taxpayers have always used special tax provisions to carefully plan their financial affairs so as to substantially reduce or eliminate their income tax liability. This has been particularly true of the wealthy who had more to gain from tax planning and strategies. As a result, a set of rules was implemented in 1969 to ensure that wealthy taxpayers would pay at least a minimum amount of income tax. This was referred to as Alternative Minimum Tax (AMT) and was considered an add-on minimum tax because it was added to the taxpayer’s regular income tax liability. At that time, very few taxpayers were affected by AMT.

The present AMT system, created in 1978, is no longer an add-on tax but actually a separate tax system. Taxpayers compute their regular income tax liability and then compute their tax under the AMT system. Taxpayers must adjust their regular taxable income by a number of adjustments and preferences and then subtract an exemption amount to determine an AMT base. This AMT base is then multiplied by a set of AMT rates to compute the AMT. Taxpayers then pay the greater of the regular income tax or the AMT. AMT applies to individuals, corporations, estates and trusts. Most individuals are not subject to the AMT because their regular income tax is greater than the AMT. This is because the AMT exemption ($58,500 for married individuals filing jointly and $40,250 for single individuals) is greater than their preferences and adjustments.

AMT was originally designed to ensure that high-income earners pay at least a minimum amount of tax by limiting certain preferential deductions. However, an increasing number of taxpayers are being subject to AMT. Many of these people are not the type of taxpayers that AMT was designed for. In 1999 there were fewer than one million taxpayers subject to AMT—mostly upper-bracket taxpayers with various tax preferences and adjustments. About three million taxpayers were subject to it for 2003 filings, and this number is expected to soar unless changes are made. According to estimates released by the House of Representatives Joint Committee on Taxation, AMT taxpayers under the present law increase from 3.3 million in 2004 to 26.2 million in 2010 [4].
How Did This Happen and Can It Be Fixed?

The Tax Act of 2001 lowered the tax rates but did not affect the AMT rates. The AMT rate is 26% of the first $175,000 alternative minimum taxable income (AMTI) and 28% on the excess. Even though the AMT rates may be lower than some individual rates, many taxpayers become subject to it by the very structure of the system. Under the minimum tax system, many deductions are denied, including those for children; the taxpayers themselves; and for state and local taxes. Also, AMT is not indexed to inflation.

Congress is aware of the problem but fixing it will be costly. According to the Tax Policy Center in Washington, it could cost as much as $591 billion over the next decade to return to the original intent of the law. A one-year curb in the AMT, as proposed by the House in May 2004, would cost $17.8 billion in lost tax revenue in 2005 (11).

Probably the only way Congress and the White House might corral the runaway Alternative Minimum Tax is to make it part of a tax reform package. As the public grows more irate with the complexities of AMT and the requirement to compute their taxes twice, this may become politically possible.

Conclusion

Most taxpayers dislike the current tax system. But, as President Bush undertakes tax reform, he is confronting an issue that is ideologically problematic, economically complex and politically risky. The tax system is full of loopholes that are exploited by special interest groups. No one wants his or her taxes increased.

The President says he wants to name a bipartisan commission to study the issue and make specific recommendations. He says he wants to retain the mortgage interest deduction and charitable giving deduction and that the bill should be revenue neutral. Just maybe the commission will think out of the box and realize that the problem with the tax system is that the government is trying to collect too much money from a single source—individual personal income. Some sort of consumption tax is needed. Maybe the answer is in restructuring business taxes and shifting tax collections from individuals to business. This would result in the government collecting half of its revenue from businesses. This revenue would be based on their financial activity in the United States. The tax rate would be relatively low and applied to all businesses. Businesses in turn would pass it on to consumers. It would be a tax on consumption.

Individuals, however, would continue to pay tax on their incomes. This tax could stay as a progressive tax or could change to a flat tax. What really matters is that it could be simplified by the elimination of the need to calculate taxes under a dual tax structure as is done currently with AMT. Under this system, individual taxes could be lowered. The entire tax package should be revenue neutral to the government.

References

New Regulations Curtail Abuse of Foreign Tax Credit by Partnerships

Laura Lee Mannino, The Peter J. Tobin College of Business, St. John’s University

Richard Lai, The Peter J. Tobin College of Business, St. John’s University

Abstract

The IRS recently issued temporary regulations that target foreign tax credit abuse by partnerships. The new regulations, which require that foreign taxes be allocated in accordance with the partner’s ownership interests in the partnership, are consistent with the purpose of the foreign tax credit.

Introduction

Although partnerships generally are granted a high degree of flexibility with regard to the allocation of the partnership’s income and expenses, new treasury regulations restrict allocations of partnership expenditures relating to foreign tax liabilities. Through these regulations, the Internal Revenue Service (IRS) and the Treasury Department are targeting certain abusive foreign tax credit transactions. These regulations involve allocations of partnership liabilities that allow a partner to take a foreign tax credit for foreign taxes paid on partnership income, even though the partner is not required to include the income that was subject to tax. The effect is that the partner can apply the credit for income from other sources, a result that is inconsistent with the purposes of the foreign tax credit.

The new regulations are designed to prevent such abuse.

Foreign Tax Credit

General Characteristics

The foreign tax credit (FTC) is designed to prevent the double taxation of income that often results from international transactions. As a general matter, there are two bases for which a country may impose a tax. The first is based on the relationship between the taxing country and the subject, such as citizenship, residence or place of formation of the income-producing entity. Pursuant to this relationship, the country of residence taxes all of the income of all of the persons and entities formed or residing within its boundaries. The second basis for taxing stems from the relationship between the country and transactions that result in income. In this scenario, the country of source, as it is referred to, imposes a tax on income that is derived from activity within the country. The taxing regime of the United States (U.S.) falls within the first category. Commonly referred to as a worldwide system of taxation, the U.S. taxes all U.S. persons on “all income from whatever source derived.” Accordingly, U.S. persons are subject to tax on income from sources within the U.S., as well as from foreign sources. As a result, U.S. persons with income from transactions that occur in a country other than the United States may be subject to two separate taxes—one in the U.S. (the residence country) and another in the country where the activity took place (the source country).

The purpose of the foreign tax credit is to provide relief from this double taxation. Avoidance of double tax is considered important to promote international trade. The FTC promotes tax neutrality in decisions to invest domestically or internationally. For example, under the worldwide system of tax, a U.S. taxpayer with foreign source income would likely bear a greater total tax burden than a competitor that has only U.S. source income. Without an FTC, this increased burden may cause the U.S. taxpayer to cease international investment in favor of domestic investment. The FTC, however, decreases the taxpayer’s total tax burden, and essentially removes tax as both a factor in investment decisions and as a barrier to international trade and investment.

Mechanics and Limitations of the FTC

Subject to limitations, an FTC is granted for foreign taxes paid on foreign source income. U.S. persons calculate a tentative U.S. tax liability and then take a dollar-for-dollar credit against such tax liability for certain taxes or levies paid to other countries. A levy is generally creditable if it is in fact a tax (as opposed to a fee), and its predominant character is that of an income tax. Further, no FTC is allowed for foreign taxes paid on U.S. source income. Where the U.S. and foreign taxes are equal in amount, the U.S. will allow a full credit against U.S. taxes for foreign taxes paid or accrued. For example, assume ABC Inc. is a corporation formed in the U.S. and is in the 35% bracket. ABC Inc. has $10 million of taxable income from sources within the U.S. and $1 million of taxable income derived from Country X. Country X imposes a 35% tax on income derived therein. Accordingly, ABC Inc. pays foreign taxes of...
Generally, an allocation has substantial economic effect. First, allocations of items must be accurately reflected in the partners' capital accounts, liquidation distributions based upon positive balances must be paid out pursuant to the partnership agreement, and the income which generated both the tax liability and the credit must be included in the gross income of the taxpayer. For example, suppose in the example above that Country X has a tax rate of 35%. The foreign tax liability essentially replaces the U.S. tax liability. In effect the allocations will be based on the facts and circumstances. The purpose of this FTCL is to prevent foreign tax credits from reducing U.S. taxes paid. Thus, if the allocation and resulting maintained balances will substantially determine the amount each partner will receive from sources within the U.S., ABC Inc. would bear the same total tax burden as its competitor, albeit to two different countries. The tax rate in the foreign country is below that of the U.S., the FTC can be used to offset the U.S. tax liability on other income. For example, the foreign tax credits claimed did not necessarily match the income subject to U.S. tax. Partners could take credits even though the income which generated both the tax liability and the credit was not included in the partner's income. To address this abuse, the IRS and the Treasury Department recently issued regulations which address the allocation of creditable foreign taxes. Effective April 1, 2004, partnerships allocate creditable foreign taxes may not be based solely on the substantial economic effect test. Thus, the allocation of such items must be in accordance with the partners' interests in the partnership. The new regulations ensure that persons taking an FTC include the income from which the credit derives.

Operational Allocations

Operating as a partnership allows several owners to combine their resources at relatively low costs: avoid complex corporate administrative and filing requirements and avoid the entity level taxation incurred by corporations. As a conduit, the partnership itself is not subject to tax. Rather, the income, gain, loss, deductions or credits of a partnership pass through directly to its partners. The partners' shares of partnership income and expense are generally determined in accordance with the partnership agreement.

The purpose of the foreign tax credit is to provide relief from double taxation. The combination of the foreign tax credit and the flexibility afforded to partners in allocating items of expense leaves room for abuse. In the past, a good number of partnerships' allocations of foreign tax liabilities did not clearly reflect their distribution to the partners. For example, the foreign tax credits claimed did not necessarily match the income subject to U.S. tax. Partners could take credits even though the income which generated both the tax liability and the credit was not included in the partner's income. To address this abuse, the IRS and the Treasury Department recently issued regulations which address the allocation of creditable foreign taxes. Effective April 1, 2004, partnerships allocate creditable foreign taxes may not be based solely on the substantial economic effect test. Thus, the allocation of such items must be in accordance with the partners' interests in the partnership. The new regulations ensure that persons taking an FTC include the income from which the credit derives.
New Regulations Curtail Abuse of Foreign Tax Credit by Partnerships

Z. Pursuant to the RST Partnership Agreement, all partnership items including creditable foreign taxes are allocated one-third to each partner. Accordingly, Reed, Silver and Tang are each allocated $200,000 of income ($600,000 ÷ 3) and $600,000 of Country Z taxes ($1,800,000 ÷ 3). This allocation is permissible because the creditable foreign taxes and the income which generated the taxes are allocated based on the partners’ interests in the partnership.

Assume the same facts as above, except that under the RST Partnership Agreement, Reed is allocated 50% of all partnership items including creditable foreign taxes, and Silver and Tang are each allocated 25%. Pursuant to this allocation, Reed would be allocated $300,000 of net income and $900,000 of foreign taxes, while Silver and Tang would be allocated $150,000 of net income and $450,000 of foreign taxes each. This allocation is also permissible because it falls within the safe harbor. First, the partnership allocations satisfy the substantial economic effect requirements, because the RST Partnership Agreement provides that allocations will be accurately reflected in the partners’ capital accounts, and any partner with a deficit balance in his capital account following the liquidation of his interest will be required to restore the deficit to the partnership.

Secondly, the allocation of the Country Z taxes is in proportion to the allocation of the income to which the foreign taxes relate. In this example, Reed is allocated 50% of the foreign taxes, and Silver and Tang each receive 25% of the taxes. This is true of many U.S. life insurance companies selling life insurance and annuity contracts to nonresident alien individuals in foreign markets and issuing nonresident alien certificates of deposit (Bonds) or Puerto Rican certificates (Stocks). Typically, due to business, legal, and regulatory considerations, U.S. insurance companies will sell the Contracts through foreign branches. U.S. taxation of the payments made on the Contracts has a direct impact on the ability of the company to market and sell the Contracts. If the payments are not subject to U.S. taxation, the insurance company may be able to charge more for the Contract than if the payments were subject to U.S. taxation. Conversely, the impact of the U.S. taxing the payments may place U.S. insurance companies at a serious competitive disadvantage with foreign insurance companies.

In Revenue Ruling 2004-75, the Treasury Department recently issued guidance, taking the position that income received by nonresident alien individuals from the Contracts is U.S.-source income that is subject to a flat 30% tax and withholding under Sections 871(a) and 1441 of the Internal Revenue Code of 1986, as amended (Code) [17, 19]. Also, Rev. Rul. 2004-75 provides that income received by bona fide residents of Puerto Rico pursuant to Contracts issued by a Puerto Rican branch of a U.S. life insurance company is U.S.-source income that is subject to the graduated U.S. income tax imposed by Code § 1 on U.S. citizens and residents (U.S. tax rates), rather than the 30% tax.

Conclusion

The temporary regulations prevent partnership allocations of creditable foreign taxes that do not match the allocation of the income to which the taxes relate. These anti-abuse regulations are necessary because, unlike most business expenses which are allocated among partners, foreign taxes may be credited against a partner’s U.S. taxes. The regulations are consistent with the purpose of the foreign tax credit, which is to prevent the double taxation of foreign source income. They are also consistent with the goal of the foreign tax credit limitation, which prevents foreign tax credits from reducing U.S. taxes on U.S. source income. Issuance of these temporary regulations is just one step towards addressing abuses of the foreign tax credit regime, and additional limitations are expected in the future.

Endnotes

3. Code § 901.
5. Code § 904(d).
6. In addition, Code § 904(d) places further limitations on the foreign tax credit based on type of income (i.e., commonly referred to as “baskets”).
7. Code § 904(a).
8. Code § 901(b)(5).
10. Code § 904(b).
11. Code § 904(c).
13. The capital accounts must be determined and maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv).
17. See e.g., Treas. Reg. § 1.704-1(b)(4)(ii) (dealing with revaluations) and Treas. Reg. § 1.704-2 (dealing with noncorporate deductions).

Tax Guidance Issued on Life Insurance and Annuity Payments to Nonresident Aliens and Residents of Puerto Rico

Mark Aquilio, Esq., The Peter J. Tobin College of Business, St. John’s University

Abstract

Revenue Ruling 2004-75 provides that income received by nonresident alien individuals under life insurance or annuity contracts issued by a foreign branch of a U.S. life insurance company is U.S-source income subject to a 30% tax and withholding. Similar income of Puerto Rican residents from contracts issued by a Puerto Rican branch will be considered U.S-source income subject to graduated U.S. tax rates. Revenue Ruling 2004-75 will be applied prospectively.

Introduction

In today’s business world, the overseas operations of many U.S. companies have become an ever-increasing component of the companies’ sales revenues. This is true of many U.S. life insurance companies selling life insurance and annuity contracts to nonresident alien individuals in foreign markets and issuing nonresident alien certificates of deposit (Bonds) or Puerto Rican certificates (Stocks). Typically, due to business, legal, and regulatory considerations, U.S. insurance companies will sell the Contracts through foreign branches. U.S. taxation of the payments made on the Contracts has a direct impact on the ability of the company to market and sell the Contracts. If the payments are not subject to U.S. taxation, the insurance company may be able to charge more for the Contract than if the payments were subject to U.S. taxation. Conversely, the impact of the U.S. taxing the payments may place U.S. insurance companies at a serious competitive disadvantage with foreign insurance companies.

In Revenue Ruling (Rev. Rul.) 2004-75, the Treasury Department recently issued guidance, taking the position that income received by nonresident alien individuals from the Contracts is U.S.-source income that is subject to a flat 30% tax and withholding under Sections 871(a) and 1441 of the Internal Revenue Code of 1986, as amended (Code) [17, 19]. Also, Rev. Rul. 2004-75 provides that income received by bona fide residents of Puerto Rico pursuant to Contracts issued by a Puerto Rican branch of a U.S. life insurance company is U.S.-source income that is subject to the graduated U.S. income tax imposed by Code § 1 on U.S. citizens and residents (U.S. tax rates), rather than the 30% tax.

Effective Date

The temporary regulations have the full force of law and apply to all partnerships and to all allocations of income and gain or loss. The regulations are necessary because, unlike most business expenses which are allocated among partners, foreign taxes may be credited against a partner’s U.S. taxes. The regulations are consistent with the purpose of the foreign tax credit, which is to prevent the double taxation of foreign source income. They are also consistent with the goal of the foreign tax credit limitation, which prevents foreign tax credits from reducing U.S. taxes on U.S. source income. Issuance of these temporary regulations is just one step towards addressing abuses of the foreign tax credit regime, and additional limitations are expected in the future.

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Statutory Overview: Subchapter B-Tax Based on Income from Sources Within or Without the U.S.

U.S. citizens are taxed by the U.S. on their worldwide income at the U.S. tax rates. In general, resident aliens are taxed similar to U.S. citizens by the U.S. However, nonresident aliens are generally subject to U.S. tax on U.S.-source income which is not effectively connected with the conduct of a U.S. trade or business at a flat 30% tax rate under Code § 871 and on income which is effectively connected with the conduct of a U.S. trade or business at the U.S. tax rates [9]. In addition, a treaty may limit the U.S. tax imposed on the income of the nonresident alien and/or the amount of the income to be taxed. Furthermore, special U.S. income tax provisions apply to bona fide residents of certain U.S. possessions, such as Puerto Rico.

Code § 861 addresses a central issue regarding the U.S. taxation of income of nonresident alien individuals, namely whether the income is from sources within the United States. While many of the U.S.-source rules are enumerated in the Code, areas not addressed in the Code have been addressed in the underlying Regulations and by the judiciary. Neither Code § 861 nor the Regulations directly address the U.S. sourcing of payments made on Contracts. Furthermore, Code § 862 does not specify that the payments are income from sources without the United States.

Code § 861(a)(1) generally provides that interest income is U.S.-source income when paid by the United States or on bonds, notes or other interest-bearing obligations of non-corporate residents or domestic corporations. Thus, interest is considered U.S.-source income when it is paid by a U.S. obligor. Also, Code § 861(a)(2) generally provides that dividends paid by a domestic corporation are U.S.-source income.
“Revenue Ruling 2004-75 holds that income received by bona fide residents of Puerto Rico under life insurance or annuity contracts issued by a Puerto Rican branch of a U.S. life insurance company is U.S.-source income subject to the U.S. tax rates.”

Code § 863 gives the Treasury broad authority to promulgate Regulations to determine whether items are U.S.-source when they are not specifically sourced in Code § 861(a) or Code § 862(a). Interestingly, no Regulations have been issued under Code § 863 with regard to the sourcing of payments made on life insurance and annuity contracts.

Whenever the source of an item of income is not specified in the Code or Regulations, ultimately it is the role of the judiciary to determine its source. Generally, the courts have made the sourcing determination by comparing the item of income in question to classes of income specified in the Code and drawing analogies [1,5]. One such case is Clayton v. U.S. wherein the court ruled that earnings and accretions on pension fund assets are U.S.-source when the foreign participants were U.S.-source income [2].

The ruling notes that bona fide residents of Puerto Rico who are citizens or permanent residents of the U.S. and, pursuant to Code § 861(a) (1)(A), provides that a tax of 30% is imposed on or before July 12, 2004. Rev. Rul. 2004-97 further states that payments made on Contracts before January 1, 2005, provided that the payments are made pursuant to binding prospective effective date, it subjected many U.S. life insurance companies to the U.S. tax rate. The ruling provides that income received from the life insurance or annuity contract is FDAP income as it is not gain derived from the sale of property or income excluded from FDAP income by the IRS in published guidance. In fact, annuity payments are specifically included as FDAP income in Code § 871(a)(1)(A).

The facts in Rev. Rul. 2004-75 provide that a U.S. life insurance company is conducting business through separate branches in Country A and Puerto Rico. Each branch sells to individuals various types of life insurance and annuity contracts as defined in the Code [3]. Also, there is no income tax treaty in effect between the U.S. and Country A.

The individuals in Country A and Puerto Rico pay premiums to the U.S. insurance company. In exchange for the premiums the U.S. insurance company agrees to pay death benefits under the life insurance contract and annuitants a certain amount each year starting upon their retirement and ending upon their death. The U.S. insurance company invests the premiums it receives in domestic and foreign income-producing assets, such as stocks and bonds.

The facts provide that the life insurance and annuity contracts have cash values. The individuals in Country A and Puerto Rico withdraw amounts from the cash values of their contracts and receive regular annuity payments, both of which are gross income.

Since Code § 861(a) is silent with regard to sourcing gross income received due to a life insurance or annuity contract, the IRS determined the source of the income from the parallel and analogy to other classes of income specified in the Code and by analogy to other classes of income specified in the Code and by analogy to other classes of income specified in the Code.

The IRS reasoned that the income is analogous to interest on a debit obligation, dividends on a stock and earnings and accretions on pension fund assets. Accordingly, since Code § 861(a)(1) and (2) provide that interest and dividends are U.S.-source income when the obligor or corporation, respectively, is domestic and earnings and accretions on pension fund assets are U.S.-source when the pension trust is domestic, Rev. Rul. 2004-75 states that income received due to a life insurance or annuity contract is U.S.-source income when the issuer of the contract is a domestic corporation.
In Rev. Rul. 2004-75, the IRS determined the payments to be U.S.-source as the issuer of the contract was a domestic corporation. U.S. insurance companies should consider taking the position that certain annuities payments should be sourced based on the residence of the recipient of the payments. This would be in accord with the sourcing rule promulgated in Reg. § 1.863-7 regarding the allocation of income attributable to certain notional principal contracts under the broad regulatory authority afforded the IRS.

The Regulation provides that a notional contract is “a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts” and that the source of notional principal contract income is the residence of the taxpayer. Thus, payments made by a U.S. obligation to a nonresident alien individual under a derivative contract, such as a notional contract, are not subject to the 30% tax or withholding. Arguably certain annuities are derivatives exempt from the 30% tax and withholding pursuant to the Regulation. If not considered a derivative, by analogy and comparison, the annuity payments possibly are not U.S.-source income as their source is the residence of the recipient of the payments.

Possibly, viewing the statutory rules on the sourcing of underwriting income, defined in Code § 863(b)(3) as net premiums earned on insurance contracts, merits an approach whereby the sourcing of the payments made on the Contracts should be based on the situs of the risk. Code § 861(a)(7) provides that amounts received as underwriting income derived from issuing or reinsuring any insurance or annuity contract is U.S.-source income if it is derived in connection with property or an activity in the U.S. or the lives or health of U.S. residents. Also, Code § 863(a)(7) provides that underwriting income, other than that which is U.S.-source income per Code § 863(a)(7), is income from sources without the U.S. By analogy and comparison, if payments made on Contracts are sourced based on the situs of the risk, the payments will not be U.S.-source income.

"The reasoning in Revenue Ruling 2004-75 may be challenged as flawed.

Applying the statutory principle of sourcing underwriting income according to the situs of the risk to the type of payments addressed in Rev. Rul. 2004-75 would eliminate a seeming incongruity. If Rev. Rul. 2004-75 is applied, the payments on the Contracts will be treated as U.S.-source income. However, under the Code, the premiums paid to the U.S. insurance companies as underwriting income that generated the Contracts would not be U.S.-source income. At best, that seems contradictory.

U.S. insurance companies should determine if there are any treaties in effect which govern the tax treatment of the payments on the Contracts. Also, depending upon the business and legal exigencies involved, U.S. insurance companies should consider doing business via a foreign subsidiary rather than a foreign branch."

Analysis and Tax Planning

Revenue Rulings provide administrative guidance and do not have the force and effect of the Code and Regulations. They deal with the application of the Code, Regulations and case law to a specific set of facts set forth in the Revenue Ruling. Thus, Revenue Rulings serve to provide the taxpayer with insight as to how the IRS views the law with regard to a particular transaction, but they do not have legislative authority and are not considered to have a precedential value by the judiciary, although some courts will give them deference. In fact, a Revenue Ruling may not apply to a taxpayer’s situation based on the facts. Accordingly, taxpayers should parse the facts of Rev. Rul. 2004-75 to determine if there are any significant distinguishing facts that would render it inapplicable to their transactions.

A critical element in determining whether an item of income is U.S.-source income is characterizing the income. Historically, many U.S. insurance companies did not subject payments made on Contracts to the 30% tax or withholding. They treated the payments either as from sources without the U.S. or as qualifying for the exceptions from the 30% tax and withholding for portfolio interest or for the other exceptions provided for interest. Accordingly, characterizing payments on the Contracts as interest rather than life insurance or annuity payments could result in the payments being exempt from the 30% tax and withholding. Unfortunately, to date, there is no statutory, administrative or judicial guidance available in this regard.

On life insurance or annuity contracts that are issued by a U.S. life insurance company without the substantial involvement of a foreign or Puerto Rican branch (which involvement is contemplated by Revenue Ruling 2004-75)."

"... depending upon the business and legal exigencies involved, U.S. insurance companies should consider doing business via a foreign subsidiary rather than a foreign branch."

Conclusion

In Rev. Rul. 2004-75, the IRS has taken the position that income received by nonresident alien individuals under life insurance or annuity contracts issued by a foreign branch of a U.S. life insurance company is U.S.-source income that is subject to a flat 30% tax and withholding. Rev. Rul. 2004-75 also holds that income received by bona fide residents of Puerto Rico under life insurance or annuity contracts issued by a Puerto Rican branch of a U.S. life insurance company is U.S.-source income subject to the graduated U.S. tax rates. As amplified by Rev. Rul. 2004-97, Rev. Rul. 2004-75 will be applied prospectively.

The reasoning in Rev. Rul. 2004-75 may be challenged as flawed. The courts possibly may determine that the Contract payments constitute interest payments and qualify for one of the exceptions from the 30% tax and withholding. Alternatively, the courts may rule that the payments are from sources without the U.S. by sourcing the payments based on the residence of the recipient of the payments or the situs of the risk: relevant to the payments. In addition, there may be treaties in effect which govern the tax treatment of the payments. In any event, with so much tax revenue at stake, it is likely that either the courts will resolve this matter or Congress will amend the Code to resolve the issue. In the interim, U.S. insurance companies with foreign or Puerto Rican branches should be aware that the IRS will be aggressively applying Rev. Rul. 2004-75. With millions of tax dollars at stake, let the battle begin!

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Master of Science in Taxation

This intensive program allows the candidate to select tax courses that are most applicable to his or her career. The degree requires 11 upper level graduate course (31 credits). Ten of these courses are in taxation and one may be a general business elective.

Required tax courses are:

• Research and Writing
• Estates and Gifts
• Corporations
• Practice and Procedure
• Partnerships
• Research Project

The first research course, (Tax Research and Writing) will be taken during the candidate's first semester. This course is designed to prepare the candidates for all subsequent tax courses by enabling them to research tax questions and to clearly communicate their findings.

The final research course, (Research Project), will allow the candidate, with guidance from the course instructor, to research a current tax topic and write a paper. The written work would be expected to be of publishable quality.

Elective tax courses include:

• Planning for High Net-Worth Individuals
• Income of Trusts and Estates
• Corporate Distribution/Liquidations/Reorganizations
• Consolidated Tax Returns
• Interstate Commerce
• Foreign Operations
• Compensation, Benefits and Retirement Plans
• Real Estate
• Financial Products
• Tax-Exempt Institutions
• Specialized Industries
• Tax Accounting
• Special Topics

The elective Business Course (three credits) allows the candidate to select one course from the offerings of the Graduate Division of the Tobin College of Business or one additional tax course.

Admission Requirements

Candidates for admission must satisfy the following requirements:

• Possess an undergraduate or graduate degree in accounting or a related business field. Students must have completed core business courses or must take such courses before completing the degree.

• Successful completion of the GMAT (or an appropriate alternative examination). The successful completion of the uniform certified public accountants examination (CPA), the certified management accountants examination (CMA) or an equivalent examination could be used in lieu of the GMAT examination.

References

3. I.R.C. § 101(f), § 817(h), and § 7702.
7. Reg. § 1.863-7(a)(1).
8. Reg. § 1.863-7(b)(1).
10. Reg. § 1.871-7(a)(2).
11. Reg. § 1.871-7(b)(1).
12. Reg. § 1.871-1(b)(2) and § 1.871-12.
15. Reg. § 1.1441-2(b)(2)(i) and (ii).

Tobin College of Business launches NEW M.S. – Taxation to meet the increasing demand for specialists

As the demand for specialists in the field of taxation continues to increase, the need for targeted training almost becomes a requirement of future employment. With this need in mind, St. John’s Master of Science in Taxation program was born. Its mission is to provide tax professionals with in-depth knowledge of the Internal Revenue Code, tax regulations, judicial decisions and Treasury rulings. Students learn to research tax questions, facilitate tax compliance and develop tax-planning strategies—all skills necessary for future career success.

• Our taxation faculty hold the highest academic credentials and have acquired professional experience in leading New York City accounting and law firms.

• Extensive course selection allows for a high degree of program focus.

• Taxation internships are available with “Big Five” firms for those not currently working full-time.

• Classes are held Monday-Thursday evenings and Saturdays in convenient New York Metro locations to meet the needs of working tax professionals.

• All courses meet CPE credit requirements in NY and NJ.

• This program is accredited by AACSB International – The Association to Advance Collegiate Schools of Business.

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