The transfer pricing effects of implementing IFRS in the United States

The Securities and Exchange Commission (SEC) on November 14, 2008, released for comment its proposed roadmap for the mandatory transition from U.S. Generally Accepted Accounting Principles (U.S. GAAP) to International Financial Reporting Standards (IFRS) as the basis for financial reporting by U.S. registrants. According to the roadmap, large accelerated filers may be required to file IFRS financial statements for fiscal years ending on or after December 15, 2014, accelerated filers in 2015, and nonaccelerated filers in 2016. Although the SEC has not adopted a final roadmap and timeline, a movement to IFRS will likely directly affect transfer pricing, given that financial data is the backbone of many aspects of transfer pricing.

U.S. multinational corporations should be proactive in understanding how a conversion to IFRS could affect their transfer pricing.[1]

Overview of IFRS and the convergence initiative

History of IFRS – From 1973 until 2000, the International Accounting Standards Committee (IASC) issued the International Accounting Standards (IAS), which were disseminated to create a standardized set of accounting principles. In2001, after a full reorganization of the IASC, the International Accounting Standards Board (IASB) was formed. The standards published by the IASB are known as IFRS. The IASB, in addition to the precisely defined IFRS, has adopted all the IAS, which are broadly defined together as IFRS.

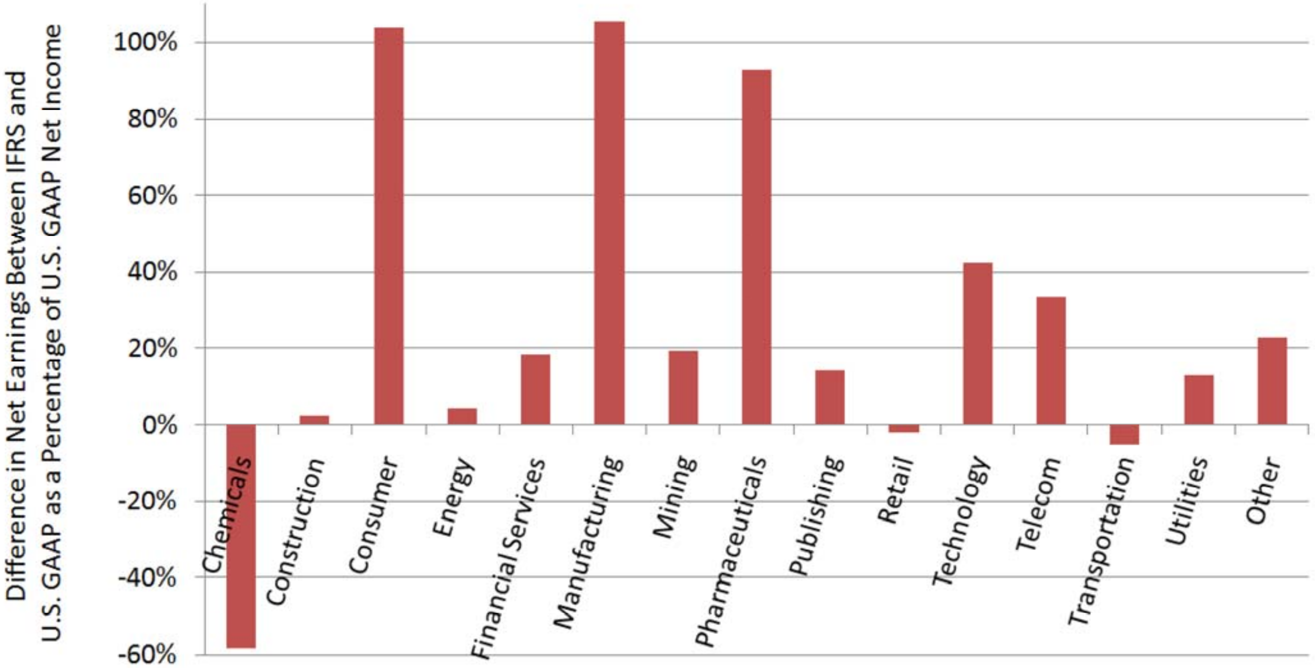
In the United States, the accounting principles issued by the Financial Accounting Standards Board (FASB) form U.S. GAAP. The SEC recognizes these accounting standards as authoritative. In general, U.S. GAAP contain "'rules-based' standards with specific application guidance," whereas IFRS are more "'principle-based' standards with limited application guidance."[2]

While the two sets of accounting standards are similar, the differences between the two may have significant transfer pricing implications for many multinational corporations.

Convergence initiative – The SEC has already allowed some foreign issuers to file financial statements using IFRS. On March 13, 2002, the European Parliament voted to endorse the use of the standards issued by the IASB for all listed companies, with some exceptions, starting no later than 2005. For fiscal years ending after November 15, 2007, the SEC issued a ruling providing that financial statements of foreign issuers prepared in accordance with IFRS no longer had to include a reconciliation to U.S. GAAP.

[1] As used in this document, "Deloitte Tax" refers to Deloitte Tax LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

[2] Deloitte, "IFRSs and U.S. GAAP: A Pocket Comparison," 29 December 2008.
URL: http://www.iasplus.com/dttpubs/0809ifrsusgaap.pdf



IFRS are more principles–based than U.S. GAAP, and provide limited industry accounting guidance. However, companies in all industries will be affected by a conversion to IFRS or the more gradual convergence of U.S. GAAP and IFRS, and will likely experience transfer pricing implications. To illustrate this point, we used information from a survey of 131 companies domiciled outside the United States that file IFRS-based financial statements with the SEC, spanning a range of countries and industries. The information was collected primarily from the companies' 2006 20-F forms. These forms were filed when the SEC still required companies that used IFRS to reconcile their financial data with U.S. GAAP.[3]

Using this data, profits recorded under IFRS were compared to net income recorded using U.S. GAAP. The difference in net earnings between IFRS and U.S. GAAP for these companies, expressed as a percentage of U.S. GAAP net income, is illustrated in Table 1.[4]

[3] Companies in the 2005 *Financial Times Global 500* with the largest market capitalizations were selected to be included in this analysis. A substantial number of companies were added and deleted during the data collection process. In transfer pricing analyses, the comparable companies selected are typically not Global 500 companies. The comparables should be independent companies that do not perform a mixture of activities. Thus, the results based on the 131 companies may not be representative for the midsize and smaller independent companies that are usually selected as comparable companies in transfer pricing analyses. However, some of the trends may be similar.
The companies in this sample should not be deemed to represent a random sample, and we do not represent that the results can be used for valid statistical analyses. Some of the sectors in the sample have a small number of companies included in them. Thus, caution should be taken before any broad generalizations are made.
The data are taken from many companies' first year of data after converting to IFRS. The survey of 131 companies did not allow for a multiple-year analysis, which would be preferred, because different companies converted at different points in time. Many of the differences between U.S. GAAP and IFRS found here may even out over time. However, for transfer pricing purposes, differences in accounting in the first year after converting may significantly affect a given company's transfer pricing for a number of years forward, because multiple years of financial data are typically used for transfer pricing benchmarking purposes.

[4] For each company, the difference between IFRS profit and U.S. GAAP net income is calculated. This difference is translated into a percentage of the absolute value of U.S. GAAP net income. This percentage is finally averaged across all companies in a given sector.

The conversion to IFRS will affect individual companies in different ways, but some of the effects may be consistent by industry. Others will be highly factually dependent on factors such as each company's specific financial situation, recent business combinations, or use of stock-based compensation. Until a more rigorous analysis has been conducted on a larger population of companies, we will present some findings based on the analysis of the 131 companies included in the survey across industries.

An example can help illustrate the possible differences by company and industry. In the manufacturing industry, several companies were affected by the accounting treatment of pensions. One company's pension expense reconciliation made U.S. GAAP net income 463 percent higher when converting to IFRS profit. For the average company in the manufacturing sector, the pension expense reconciliation made U.S. GAAP net income 42 percent higher when converting to IFRS profit. For the pharmaceutical sector, the average company in the sample had a change in U.S. GAAP net income when reconciling to IFRS due to differences in the accounting for business combinations, goodwill, and intangibles of 42 percent, with one company having a percentage change in U.S. GAAP net income of 482 percent when reconciling to IFRS.

Table 1 above, combined with Table 3 below, illustrate the fact that across individual companies and industries there may be a large percentage change in net income when converting to IFRS from U.S. GAAP. However, across all companies in different industries, these individual differences on average may be less substantial. For transfer pricing purposes, comparable companies are chosen by selecting companies whose functions performed and risks assumed are most similar to the company being analyzed. So industry-specific differences may have an effect on transfer pricing analyses, for which industry often is a critical factor when selecting comparable companies.

Impact on transfer pricing economic analysis

Selection and application of transfer pricing methods – From a transfer pricing standpoint, the adoption of IFRS will affect different companies' transfer pricing policies in different ways, depending on each company's exact circumstances, functions, and risks. The Internal Revenue Service (IRS) has not yet indicated how it will handle intercompany pricing agreements that are written in the context of U.S. GAAP and continue to be in effect after conversion to IFRS.

For companies that use the comparable uncontrolled price (CUP) method to determine their transfer pricing for tangible goods, essentially no change to their transfer pricing should occur, because the CUP method uses market prices to determine the appropriate price that should be charged between related entities. Market prices are typically not affected by accounting standards.

For companies that use the comparable uncontrolled transaction (CUT) method to determine their transfer pricing for intangible property, the effect on their pricing will depend on the exact details of their contracts with related parties, as well as the contracts of their comparables. The total amount of gross royalty charges or license fees may change for several reasons. Royalty rates charged to or from unrelated parties may be determined by using financial statement data. This could affect the range of arm's length royalty rates. Additionally, an income statement item to which a royalty rate may be applied, such as net revenue, has the potential to change under IFRS.

For companies that use the resale price method (RPM) or the cost plus method, the calculation of gross profits is essential to determining the appropriate transfer price.[5] In calculating the margins/markups or the base to which those margins/markups are applied, financial earnings generally form the basis of these calculations, which are directly affected by

[5] According to IRC §1.482-3(c)(2)(i) and §1.482-3(c)(2)(iii), "The resale price method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review," where "(t)he appropriate gross profit is computed by multiplying the applicable resale price by the gross profit margin (expressed as a percentage of total revenue derived from sales) earned in comparable uncontrolled transactions." According to IRC §1.482-3(d)(2)(i)–(ii), "The cost plus method measures an arm's length price by adding the appropriate gross profit to the controlled taxpayer's costs of producing the property involved in the controlled transaction," where "(t)he appropriate gross profit is computed by multiplying the controlled taxpayer's cost of producing the transferred property by the gross profit markup, expressed as a percentage of cost, earned in comparable uncontrolled transactions."

the accounting standards used. It is feasible that a company's overall taxable results using the RPM or the cost plus method may change, solely because of the conversion to IFRS even though there has been no change in the underlying economics of the transactions.[6]

Alternatively, multinational corporations may decide to change their transfer pricing so that the change in accounting standards does not change their overall taxable results. In both instances, tax authorities may require an explanation for the new results.

Transfer pricing using the comparable profits method (CPM) may change substantially as a result of converting to IFRS. This method uses different profit level indicators (PLIs) to determine what the arm's length range of profitability should be for a given company. Common PLIs include the following:

- Return on operating assets = operating profits/operating assets;
- Operating margin = operating profits/sales;
- Berry ratio = gross profits/operating expenses;
- Net cost plus ratio = operating profits/(cost of goods sold + operating expenses)[7]; and
- Gross margin = gross profits/sales.

Financial statement data, most of which is above the EBIT (Earnings Before Interest and Taxes) line, is used to determine those ratios in transfer pricing studies. The change from U.S. GAAP to IFRS will most likely affect those ratios, which may cause a company whose transfer pricing was within the acceptable range of profitability to fall out of that range because the value of the PLIs the company was using changed, the value of the comparable companies' PLIs changed, or both. As an example of how this could occur, IAS 38 covers development costs, which are capitalized under IFRS if certain criteria are met. Similar costs are likely expensed under U.S. GAAP. Depending on whether development costs are expensed or capitalized, the numeric result of a company's PLIs could change. Deloitte Tax's Clark and Riisberg showed in their research comparing European companies that reported their financials under different local GAAPs that, on average, if the same corporation uses a different accounting standard, the value of its PLIs may significantly change.[8]

Decisions will also have to be made with regard to changing the best method selected, should accounting changes cause inconsistencies in the available data. According to IRC §1.482-1(c)(2), "in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis." If the quality of the necessary data for one method deteriorates due to accounting changes, other methods may have to be considered.

One potential issue that could arise concerning the availability of data is that the U.S. Internal Revenue Code currently contains numerous references to U.S. GAAP. The IRS recognizes this as an issue and is working with corporate and industry stakeholders on a resolution to these and other issues arising in connection with a conversion from U.S. GAAP to IFRS.

During the transition period, some companies may decide to file their financials using U.S. GAAP, whereas others may choose to use IFRS. This may cause the comparable data of one or more of the potential comparables to be filed using a different accounting standard than that of the tested party. If adjustments cannot be made for differences in the data, this may affect the results of the transfer pricing analysis.

[6] For example, the point in time when revenue is recognized could affect the taxable results from the RPM. One of the major topics being covered in the convergence initiative is when revenue should be recognized. Currently, IAS 18 provides general principles on this topic. However, U.S. GAAP gives much more specific guidance, as does the SEC.

7 For intercompany services transactions, the net cost plus margin is the ratio of operating profit to total services costs. Total services costs are defined in IRC § 1.482-9(j).

[8] Clark, Dick and Kristine Riisberg, "Differences in European and U.S. GAAP: Implications for Transfer Pricing Analysis," *BNA Tax Management Transfer Pricing Special Report*, 13(13) 2004.

Profit-based methods – CPM

General expectations – Over time, we can expect the wider adoption of IFRS to render the CPM more reliable, as more companies turn to IFRS. Differences in profitability between comparable companies solely attributed to differences in accounting standards and procedures should be substantially reduced. The remaining differences will be due to other factors, such as geographical differences.

Selection of comparable companies – As previously mentioned, there may be a lengthy transition period during which U.S. public companies shift to IFRS. That period will ultimately be determined by the SEC. During the transition period, some companies will convert their books and records to IFRS, whereas others will continue to report under U.S. GAAP. If appropriate adjustments cannot be made to make the financial data of the comparable companies and the tested party commensurate with each other, the companies and their transfer pricing advisors will have to decide what is the best way to deal with this situation on a case-by-case basis. The tradeoff will be between using highly comparable companies that do not use the same accounting standards as the tested party and using companies with functions, risks, and asset bases that may not be as similar to the tested party as other comparables, but that do use the same accounting standards as the tested party. The IRS has not provided guidance on this issue yet, but companies will be expected to take the initiative in evaluating and documenting why their position supports the arm's length price.

Accounting adjustments – Once the comparable companies are chosen, transfer pricing practitioners make accounting adjustments to each company's financial data to confirm that all the companies are recording their data in a consistent manner. For example, a company in the United States can choose to use the Last In, First Out (LIFO) accounting method to account for its inventory, or the First In, First Out (FIFO) accounting method. A company's choice of which inventory method to use should not affect the comparability of its functions and risks to those of other companies, so adjustments are made to the financial data to determine that the companies are on an equal footing in terms of their financial reporting. The use of IFRS will change the need for some of these adjustments. For example, under IAS 2, the LIFO method is prohibited.

Other accounting adjustments that transfer pricing practitioners typically make include, for example, adjustments to operating expenses, because costs associated with the amortization of intangibles from acquiring another company would not be consistent across all comparable companies that did not acquire another company. Additionally, items recorded in the net periodic pension cost that are not the result of the current period's operating activities are also removed. Under IFRS, these adjustments will still have to be made; however, the underlying figures to which these adjustments are applied may be different under IFRS when compared to U.S. GAAP. For example, differences exist in the way intangibles are treated under IFRS and U.S. GAAP. IAS 19 also deals with how to account for employee benefits, which is different than how employee benefits are handled under U.S. GAAP.[9]

Impact on capital adjustments – Transfer pricing practitioners also make capital adjustments to the financial data of the tested party and the comparables to improve the reliability of the comparisons between them, which can include adjustments for differences in financing terms. For example, if Comparable A pays for a purchase immediately, while Comparable B pays for the exact same purchase at a later date, and thus increases its accounts payable on its balance sheet, Comparable A should pay a lower price, because it paid for its purchase immediately. Since both transactions have the same economic substance, but are treated differently on the two companies' respective financial statements, adjustments are made so that the companies' financial data actually reflect the economic substance of those transactions. Similar types of capital adjustments are made for accounts receivable and for inventories. Capital adjustments will still have to be made under IFRS, just as they are under U.S. GAAP; however, as with accounting adjustments, the underlying line items to which the adjustments are applied may contain different figures under IFRS when compared to U.S. GAAP.

[9] However, in "Completing the February 2006 Memorandum of Understanding: A Progress Report and Timetable for Completion," published on September 11, 2008, by the FASB and the IASB, the two boards agreed as part of their convergence initiative to make post-employment benefits one of the major fields on which to work to achieve convergence by 2011.

Another issue is the fact that there is more flexibility in the grouping of accounts under IFRS than under U.S. GAAP. There may be more judgment calls by companies on how they want to present their financials under IFRS than there are under U.S. GAAP. Thus, rigorously examining the notes of financial statements to see which items are included in each line item (and which ones are not) may become significantly more time-consuming under IFRS.

Selection of comparable profit level indicators – During the transition period to IFRS, certain PLIs may no longer be useable for a given company. If adjustments cannot be made to the financial data, then other PLIs, which might not be as appropriate as indicators of profitability, may have to be used. For example, this could occur because under IAS 16, the basis of measurement of property, plant, and equipment may be recorded using either the historical cost or fair value at the date of revaluation minus subsequent accumulated depreciation and impairment losses. Under IAS 17, the requirements for capitalization of leases are different than under U.S. GAAP. If adjustments cannot be made for those differences, the return on operating assets PLI, which is often used for asset-intensive manufacturers, may not be feasible.

Effects on the interquartile range – As previously mentioned, another issue that may arise from a conversion to IFRS is that the interquartile ranges may change even though the economics of the comparable companies did not change. To illustrate this, we examined the 2006 20-F forms of several companies in the same geographic area, industry, and with similar functions, determined by SIC code. For some of the companies we examined, the 20-F contained operating profit and revenue for fiscal years 2006, 2005, and 2004. From those companies' data, we were able to calculate the three-year average operating margin, as illustrated below.

	Three-Year Average U.S. GAAP Operating Margin	Three-Year Average IFRS Operating Margin	2006 U.S. GAAP Operating Margin	2006 IFRS Operating Margin
Company 1	15.9%	19.5%	9.7%	15.6%
Company 2	19.6%	20.3%	19.2%	18.6%
Company 3	28.6%	28.1%	30.2%	28.0%
Company 4	20.4%	25.2%	17.7%	23.8%
Company 5	19.2%	19.7%	19.6%	20.3%
Company 6	13.9%	14.2%	16.0%	16.2%
Upper Quartile	20.4%	25.2%	19.6%	23.8%
Median	19.4%	20.0%	18.4%	19.5%
Lower Quartile	15.9%	19.5%	16.0%	16.2%

As can be seen, the analyzed companies had a three-year average operating margin interquartile range of 15.9 percent to 20.4 percent under U.S. GAAP, and 19.5 percent to 25.2 percent under IFRS. The median of the three-year average operating margin under U.S. GAAP is 19.4 percent, which is not in the interquartile range of the three-year average IFRS operating margin. In some circumstances, a company may need to adjust its transfer pricing to remain in the arm's length interquartile range after converting to IFRS. Thus, it is possible that a company's overall taxable income could change just by virtue of comparable companies converting to IFRS.[10]

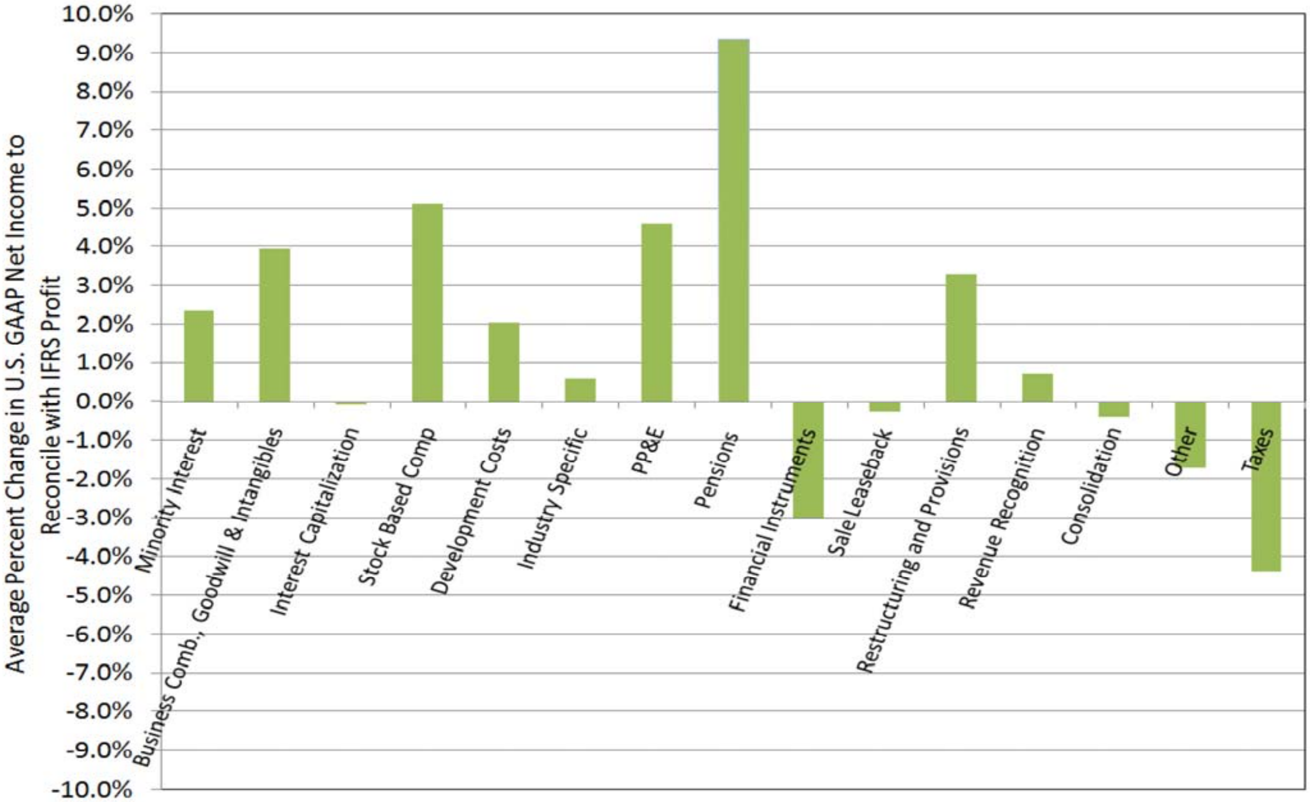
To further illustrate this point, and some of the issues that might arise if not all companies convert to IFRS at the same time (a likely scenario), suppose the tested party is similar to Company 1 in Table 2. Also suppose it has not converted to IFRS yet, but all the comparable companies have. Under U.S. GAAP, Company 1's operating margin of 15.9 percent would be within

[10] This example is not meant to be representative of results that a typical company may expect to see. The example is for illustrative purposes only on the possible effects of converting to IFRS. Each company's individual transfer pricing results will vary on a case-by-case basis. No accounting or capital adjustments were made to the data. In a typical transfer pricing analysis, those types of adjustments would usually be made to improve the reliability of the results of the comparable companies.

the arm's length range. However, when analyzed with companies that have converted to IFRS, its transfer pricing is no longer in the interquartile range. If the tested party, which is assumed to be similar to Company 1, did nothing, its transfer pricing results could be adjusted to the median of the comparable company's IFRS interquartile range for 2006, which would be 19.5 percent. Thus, it is feasible that during the transition period, companies could find themselves outside of the arm's length interquartile range, even though their economics did not change. Companies may need to evaluate their transfer pricing more frequently during this transition period and vigorously document their transfer pricing policies.

Treatment of intangibles and other types of adjustments

IFRS and U.S. GAAP affect different types of line items in varying ways. Intangibles, which even without the convergence initiative can make a basic transfer pricing analysis significantly more complicated, provide a good example. To illustrate how the treatment of different types of items, including intangibles, contribute to the differences between IFRS profit and U.S. GAAP net income, Table 3 shows the percentage change in U.S. GAAP net income that is necessary to obtain IFRS profit by type of adjustment.[11] Across the 131 analyzed companies, a 4.0 percent average difference in U.S. GAAP net income and IFRS profit is found due to differences in accounting for business combinations, goodwill, and intangibles only.[12]



[11] In other words, Table 3 shows the factors contributing to an increase or decrease in U.S. GAAP net income relative to IFRS profit. For example, the adjustment when reconciling pension expenses makes IFRS profit higher than U.S. GAAP net income. This figure is calculated by first categorizing each adjustment necessary to go from U.S. GAAP net income to IFRS profit into one of the designated categories, such as pensions or PP&E, for each company. Then, for each type of adjustment for each company, the adjustment is translated into a percentage of U.S. GAAP net income. This percentage is finally averaged across all companies in the sample for each category of adjustment. As previously discussed, the inferences made from the companies included in this sample, while informative, should not be considered to have come from a random sample of companies.

[12] In general, many aspects of the treatment of intangibles under IFRS can be found in IAS 36 and IAS 38.

However, it should be noted that during the selection of comparable companies, including the financial data analysis stage of a transfer pricing study, the effects of business combinations, goodwill, and intangibles when converting from U.S. GAAP to IFRS are expected to have limited impact on the transfer pricing analysis. Those line items will typically either be removed from the financial data, or the potentially comparable company with these attributes will be excluded from the set of comparable companies altogether. A much more extensive analysis of how intangibles affect transfer pricing under IFRS and U.S. GAAP can be found in an article written by William F. Finan and Susan Work, from Taj Société d'Avocats, a Deloitte Touche Tohmatsu member firm.[13]

Other differences in how certain items are accounted for under U.S. GAAP and IFRS have the potential to significantly change a PLI for a given company. For example, the differences in the accounting of stock-based compensation under U.S. GAAP net income and IFRS profit, on average across the companies in the survey, accounted for a 5.1 percent change in U.S. GAAP net income. Stock-based compensation directly affects the operating costs of a company in the profit and loss statement, and may therefore affect the calculation of the PLIs that include costs.[14] The same is true for pensions, for which the differences in accounting between U.S. GAAP net income and IFRS profit accounted for a 9.4 percent increase in U.S. GAAP net income. Differences in accounting for property, plant, and equipment caused an average change in U.S. GAAP net income of 4.6 percent. Those differences in property, plant, and equipment will most likely directly affect the calculation of the return on operating assets PLI.

Conclusion

When companies in the United States convert to IFRS, their transfer pricing may be affected in various ways. Some companies may see inconsistencies in the available data of their comparable companies, because some may continue to use U.S. GAAP while others may convert to IFRS. The process of converting could take a decade or longer to complete (taking into consideration non-public companies), and there may be a long period during which different accounting standards may affect transfer pricing analyses. Other companies may see the range of arm's length profits shift due to the use of IFRS, even though the economics of their companies and the economics of the comparable companies did not change. It may be the case that a company whose transfer pricing was within the arm's length range of profitability under U.S. GAAP may find itself outside of the arm's length range of profitability under IFRS.

Some of the effects on transfer pricing analyses due to converting to IFRS may also be more industry dependent, as some changes in the accounting standards may affect companies in a particular industry more than others. Much research still needs to be done to examine how converting to IFRS will affect transfer pricing, both on an individual company basis and in the aggregate.

We have attempted to give a brief description of some of the issues that might affect transfer pricing as companies convert from using U.S. GAAP to IFRS. Depending on each company's individual situation, some or all of these issues may apply. To avoid transfer pricing adjustments and penalties, companies should be especially proactive in reviewing and updating their transfer pricing documentation and intercompany agreements during this transition period.

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[13] Finan, William F., and Susan Work, "Comparing Valuations of Intangible Assets Performed for Transfer Pricing & Accounting Standards Purposes: Similarities & Potential Differences" *BNA Tax Management Transfer Pricing Special Report*, 17(2), February 5, 2009.

[14] Stock-based compensation is of particular interest to the IRS, as it is specifically mentioned in the recently issued temporary services regulations, the cost sharing regulations, and has further been discussed in the *Xilinx* decision from the United States Court of Appeals for the Ninth Circuit, issued on May 27, 2009.

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