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Impact of Adoption of IFRS on the Thinly Capitalised Position of Australian Companies

Grantley Taylor and Greg Tower*

Abstract

This article investigates the impact of the adoption of the International Financial Reporting Standards (IFRS) in Australia on the thin capitalisation position of the top 105 ASX listed companies. Leading up to formal adoption of IFRS in Australia, several parties have expressed concern with the impact of adoption of the IFRSs on compliance of Australian entities with the thin capitalisation provisions. The results of the paired t-tests demonstrate that the thin capitalisation structure of Australian listed firms has changed as a direct consequence of IFRS adoption in Australia. Overall, the introduction of new IFRS rules in Australia does not present a major thin capitalisation compliance risk to listed firms.

1. INTRODUCTION

The Australian Financial Reporting Council (FRC) announced on 3 July 2002 that Australia would formerly adopt the International Financial Reporting Standards (IFRS) for reporting periods commencing on or after 1 January 2005. The FRC advanced the argument that the adoption of IFRS by Australian companies would facilitate cross-border comparisons by improving comparability and transparency in financial reporting thereby leading to more efficient contracting between various capital market participants, a lower cost of capital and an increased ability to raise finance or list overseas (FRC, 2005). Adoption of the International Financial Reporting Standards (IFRS) in Australia has had a profound impact on the recognition, measurement and disclosure of assets, liabilities, equity and profitability (Jubb, 2005; Jubb, 2006). The Australian Accounting Standards Board issued the Australian equivalents to the International Financial Reporting Standards to incorporate requirements that are specific to Australian entities. The conversion to IFRS has a fundamental impact on the way companies report their financial performance and

ted borrowing fees on loans.

ady has important implications for accounting standard setting and income tax. al accounting concepts or accounting standards underpin or support a number provisions within the *Income Tax Assessment Act 1936* (ITAA 1936) and *Tax Assessment Act 1997* (ITAA 1997) including debt/equity classification,

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income tax consolidation and the thin capitalisation provisions. Consequently, accounting standard setters need to be mindful of the potential Australian income tax implications of IFRS adoption, particularly in the case of large multinational firms that operate between Australia and several other tax jurisdictions. The tax value of assets, liabilities and equity capital under the thin capitalisation rules are determined by reference to accounting standards and compliance of entities with these rules

assets, liabilities and equity under IFRS may result in some entities that were able to comply with the thin capitalisation rules under Australian Generally Accepted Accounting Principles (GAAP), to now fail the test, not because of any changes in the

a decline in equity for a sample of 1386 Australian listed firms on transition to IFRS relating largely to the recognition of new assets and liabilities, reclassifications and changes in measurement of these balance sheet elements. They concluded that the two most common adjustments to equity are income tax and goodwill with mean total equity declining from \$308.72 million under GAAP to \$274.55 million under IFRS. The leverage ratio (total liabilities/total assets) increased under IFRS leading to Ahmed and Godwin (2006) suggesting that debt covenants and lending criteria may

recognising available-for-sale investments and all derivative financial instruments as assets or liabilities at fair value in the balance sheet. Under GAAP, these instruments are not recognised in the financial statements. The effect of this is that the assets can change substantially, particularly if there are marked valuations at fair value up or down which will in turn impact on the thin capitalisation calculations of companies under IFRS. Under AASB 132, more financial instruments are classified as debt rather than equity. Under AASB 112 *Income Taxes*, companies are required to use the balance sheet method which compares carrying values with the tax bases of assets and liabilities to determine temporary differences which then formed the basis of deferred tax balances. Deferred tax assets and deferred tax liabilities are recognised for all temporary differences with certain exemptions such as goodwill. Deferred tax is also recognised in respect of asset revaluations and fair value adjustments made on a business combination. Under AASB 138, *Intangible Assets*, internally generated goodwill, brands, mastheads, publishing titles, customer lists and items similar in substance are not recognised as assets. The application of AASB 138 results in companies not being able to recognise some of the intangibles that are currently reflected on company balance sheets such as brand names and costs related to research activities. Under AASB 138, the recognition of internally generated brand names and items of similar nature is prohibited. Some companies, on transition to IFRS, have to derecognise some intangible assets which were previously recorded in the company's book as an asset. For those companies which had a large amount of assets comprising these intangibles, the write-down of these assets impacted their asset base for thin capitalisation purposes.

3. KEY RESEARCH ISSUES

Australian Accounting standards are used to determine what are a company's assets and liabilities, and in valuing assets, liabilities, debt and equity capital for the purpose of applying the thin capitalisation provisions⁵. The thin capitalisation rules focus and intent are on entities whose assets are funded by a high level of debt and relatively little equity. The official concern is that allocation of a disproportionate level of the

institution⁶) Australian companies including the key accounting standards

31 December 2004 reconciliation data was used. For 30 June balance day companies, 30 June 2005 reconciliation data was used.

The thin capitalisation provisions, through the use of method statements¹⁰, outline the process with which an entity can calculate the maximum amount of interest bearing debt that can give rise to interest deductions in a year of income, herein referred to as the 'maximum allowable debt'. The method applied to calculate the 'maximum allowable debt' varies depending on whether the entity is an inward investor or an outward investor, whether the entity is a general entity or a financial entity and whether or not the entity is an ADI. For instance, for an outward investing entity (non-ADI; non-financial), the maximum allowable debt is the greater of a 'safe harbour' test, an 'arm's length' test or a 'worldwide gearing amount'¹¹.

In this study, a company's thin capitalisation position is calculated utilising the safe harbour test¹². This test involves calculation of a safe harbour debt amount (SHDA). The safe harbour debt amount is calculated using the method statement outlined in section 820-95 of the ITAA 1997 (for outward investing general entities) or section 820-195 of the ITAA 1997 (for inward investing general entities) and is 75% of the average asset value of Australian operations net of non-interest bearing liabilities and investments in associates¹³. The method statement provided in section 820-95 of the ITAA 1997 is outlined in the Appendix.

The ratio of average debt to the SHDA (maximum allowable debt) was calculated using the financial statements of the consolidated entity immediately pre-IFRS and immediately post-IFRS adoption. The proxy measure of SHDA and average debt are reasonably close measures of the actual SHDA and average debt levels of sample companies.

Importantly, the direct link between the thin capitalisation provisions and accounting standards should result in a change in the safe harbour debt amount and consequently the ratio of average debt to the SHDA. In determining whether an entity has complied with the thin capitalisation provisions, the

SHDA. An entity subject to the thin capitalisation provisions that has an average debt amount below the safe harbour debt amount of 75% of the average value of Australian assets is in compliance with those provisions. However, negative consequences occur if the average debt amount exceeds the SHDA as interest payments and loan fees may be denied as an allowable deduction against assessable income if that entity is subject to the thin capitalisation provisions.

A proxy measure of the safe harbour debt amount is calculated in accordance with section 820-95 of the ITAA 1997 under GAAP immediately prior to IFRS adoption and also at the commencement of IFRS adoption as follows:

$$\text{safe harbour debt amount (SHDA)} = (\text{Total assets} - \text{non-IBL}) \times 75\%$$

Where non-IBL refers to non-interest bearing liabilities

A proxy measure of average debt was calculated as:

$$\text{Average Debt} = \text{Total interest bearing liabilities (IBL)}$$

A proxy measure of maximum allowable debt was then calculated as:

$$\text{Maximum Allowable Debt (MAD) ratio} = \text{average debt}/\text{SHDA}$$

Companies with a MAD ratio in excess of 1.0 are potentially non-compliant with the thin capitalisation provisions. Conversely, companies with a MAD ratio less than 1.0 are potentially compliant with the thin capitalisation provisions. The focus of this study is to determine the change in this ratio as a direct consequence of IFRS adoption.

The change in assets, liabilities including interest bearing liabilities and equity on transition to IFRS adoption were obtained from the reconciliations of GAAP-IFRS financial statement elements as at 30 June 2005 (for June financial year end companies) or at 31 December (for December year end companies) provided in accordance with AASB 1047. Consequently, the change in average debt and SHDA was derived from these reconciliation statements. The change in average debt and SHDA on transition to IFRS is then used to determine whether IFRS adoption itself had a statistically significant impact of Australian listed companies' compliance with the thin capitalisation provisions.

There are a number of limitations and assumptions made in this study. First, although

5. RESULTS

Descriptive statistics provided as Table 1 show the mean assets, liabilities, equity, safe harbour debt amount (SHDA) and maximum allowable debt (MAD) for all sample firms under GAAP. The mean MAD is 37.98%. The range in MAD values from 0.00 to 131.00 indicates diversity in quantum of assets, debt and non-debt liabilities and therefore potential compliance with the thin capitalisation provisions. For companies with MAD values in excess of 100%, interest payments and loan fees in excess of that amount could be disallowed as tax deductions. Under GAAP, there are two companies with a MAD value greater than 100%, five companies with a MAD value greater than 80% and twelve companies with a MAD value greater than 60%.

TABLE 1: AUSTRALIAN COMPANIES' THIN C

TABLE 4: AUSTRALIAN COMPANIES' IMPACT OF KEY IFRSS ON EQUITY

Impact of IFRSs on Equity (millions)	<i>AASB 2 Share Based Payments</i>	<i>AASB 3 Business Comb- inations</i>
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Overall, the introduction of the new IFRS rules in Australia does not present a major thin capitalisation compliance risk to listed firms.

Nethercott and Hanlon (2004) highlighted that the introduction of IFRS and convergence of tax and accounting standards in Australia would likely to lead to a reduction in thin capitalisation compliance costs. For those companies whose thin capitalisation position changed significantly as a consequence of IFRS adoption, the government may be required to legislate to remove the change relating to IFRS adoption. However, to modify the existing thin capitalisation provisions relating to a small group of companies may introduce unwarranted complexity into these provisions and associated increased administration costs. The Institute of Chartered

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