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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 a number of important areas of financial reporting and taxation. Adoption of IFRS involved introduction of new accounting standards and changes to existing standards. Potentially, Australia's adoption of IFRS may adversely impact on an entity's thin capitalisation calculations. This is important as these firms may be denied income tax deductions relating to interest payments and associated borrowing fees on loans.

This study has important implications for accounting standard setting and income tax. Financial accounting concepts or accounting standards underpin or support a number of key provisions within the *Income Tax Assessment Act 1936* (ITAA 1936) and *Income 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 potentially may change as a direct consequence of IFRS adoption itself (Nethercott and Hanlon, 2004). This research will describe and quantify the impact of the introduction of IFRS on compliance with the Australian thin capitalisation provisions.

The Australian thin capitalisation provisions are designed to ensure that Australian and foreign owned multinational entities do not allocate an excessive amount of debt to their Australian operations or investments (Division 820 of the ITAA, 1997). This Division does this by limiting the debt deductions (interest payments and loan fees) an entity can claim against Australian assessable income when debt deductions are in excess of a 'maximum allowable debt' amount (ATO, 2006). These provisions apply to Australian entities and their associate entities investing overseas through an overseas permanent establishment or Australian controlled foreign entity, and foreign entities investing directly in Australia or through foreign controlled Australian entities (ATO, 2005)¹.

The next section outlines the significance of the study and significance of the study. Section 3 covers the research questions and issues while section 4 discusses the research approach. Section 5 provides the results of the empirical analysis while section 6 concludes the study.

2. SIGNIFICANCE OF THE STUDY

This study examines the impact of the Australian equivalents to the International Financial Reporting Standards on the thin capitalisation position of Australian listed companies. The objective of this project is twofold: to determine how and why the key IFRS could impact the thin capitalisation compliance of Australian companies and secondly to quantify these impacts and relate them back to accounting and taxation policy initiatives. Leading up to formal adoption of IFRS in Australia, several parties expressed concern over the impact of IFRS on compliance of Australian entities with the thin capitalisation provisions (The Group of 100, 2006; The Institute of Chartered Accountants in Australia, 2006), but there has been no in-depth research that quantifies the potential impact.

The adoption of IFRS in Australia on 1 January 2005 has the major consequences of impacting on a firm's dividend and franking policy, its thin capitalisation position, application of Australian withholding taxes and income tax consolidation (Leyden and Croft, 2004; Joseph, 2005). The Group of 100 (G100) and The Institute of Chartered Accountants in Australia clearly voice the view that the adoption of IFRS could have unintended negative and inappropriate tax consequences, particularly in respect to the thin capitalisation position of companies. Changes in the recognition and valuation of

¹ Potentially, the thin capitalisation provisions can apply to inward investing entities and outward investing entities. Inward investing entities are Australian entities that are foreign controlled Australian entities and foreign entities that directly invest in Australia or operate a business at or through a permanent establishment. Outward investing entities are Australian entities that control foreign entities or operate a business at or through overseas permanent establishments and associated entities.

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 financing mix of the entity or any changes to the business operations, but due to compliance with IFRS (The Institute of Chartered Accountants in Australia, 2006).

Following adoption of IFRS, the Federal Treasurer provided a three year transitional period to 31 December 2007 where entities may elect, on an annual basis, to use either IFRS or GAAP as they existed pre-1 January 2005 to calculate their thin capitalisation position (The Treasurer, 2006). The G100 and The Institute of Chartered Accountants in Australia vociferously argue that a longer term solution is required to ensure that companies are not worse off under the thin capitalisation rules following IFRS adoption than they were prior to IFRS adoption.

The introduction of IFRS has the following major consequences:

1. These new rules may increase the quantum of assets and liabilities reported on the balance sheet (The Institute of Chartered Accountants in Australia, 2006; The G100, 2006; The Treasurer, 2006). For instance, unrealised losses of derivative financial instruments will be recorded as liabilities in the balance sheet and is relevant in determining a net asset amount which forms part of the thin capitalisation calculations.
2. Overall, there may be a reduction in the net asset position of the company and the net asset position may be subject to volatility not previously encountered under GAAP (The Institute of Chartered Accountants in Australia, 2006).
3. With the move to fair value accounting under IFRS, certain assets, liabilities and equity not currently recognised under GAAP may be recognised under IFRS, and the treatment of certain assets and liabilities currently recognised may change.

Jubb (2006) examined the GAAP-IFRS reconciliations within the half year and annual reports of 146 Australian listed companies to determine the extent of disclosure of expected IFRS impacts. Using an AIFRS disclosure score (ranging from 0 to 11), she found that some 66% of firms voluntarily disclosed information on their GAAP-IFRS reconciliations above the minimum requirements mandated under AASB 1. IFRS adoption impacted negatively on equity in all reconciliation statements while impact on profit was variable. In a similar study, Goodwin, Cooper and Johl (2007) noted that about one-third (356) Australian listed firms changed their GAAP-IFRS reconciliations for earnings, cashflows or equity in their annual financial statements including some large individual negative adjustments to equity following application of AASB 139 *Financial Instruments: Recognition and Measurement*. Adjustments to reconciliations related largely to a lack of knowledge of the standards or incorrect application of standards by the CFO and their auditors. The authors argue that these firms were largely unprepared for IFRS at transition. Lack of accounting preparedness is also likely to have tax flow-on sequences including application of the thin capitalisation provisions.

Ahmed and Goodwin (2006) reported an increase in total assets (mean \$1,614.76 million under GAAP compared to mean \$1,675.39 under IFRS) and total liabilities (mean \$1,305.84 million under GAAP compared to mean \$1,400.72 under IFRS) and

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 need to be re-examined in light of these changes.

For some Australian companies, a key concern is that the debt to capital ratio could increase under IFRS to the extent that they exceed the safe harbour debt limit of 75%, particularly if they had debt to capital ratios in the order of 60% to 75% prior to the introduction of IFRS. The safe harbour debt limit is 75% of the average asset value of Australian operations net of non-interest bearing liabilities and investments in associates. The consequence is that debt deductions² (e.g. interest payments, loan fees) can be disallowed when that entity's debt used to fund Australian assets exceeds the safe harbour debt amount³. Larger multinational companies commonly undertake recapitalisation programs whereby debt to capital ratios of 50% to 75% are maintained for the Australian corporate group (Australian Taxation Office, 2006). This range for asset to capital ratios is achieved through the introduction of debt into the Australian corporate group⁴ and adjusting the asset position through asset revaluations (Nethercott and Smith, 2007). The introduction of IFRS may cause further adjustments to balance sheet elements thereby influencing compliance with the thin capitalisation provisions of these companies.

There are some key differences between the older GAAP and the newly implemented IFRS rules. These variations have flow-on impacts in calculation of the thin capitalisation position of an Australian entity relating to the recognition, measurement and classification of financial assets and liabilities, intangibles, asset impairments and goodwill and income taxes (AASB, 2004). The reason for this is that values adopted for assets and liabilities as well as the entity's debt capital and equity capital must comply with accounting standards (ATO, 2006). The IFRS that are likely to have the greatest impact on the application of the thin capitalisation provisions are:

1. AASB 112 *Income Taxes*;
2. AASB 132 *Financial Instruments: Presentation and Disclosure*;
3. AASB 138 *Intangible assets*; and
4. AASB 139 *Financial Instruments: Recognition and Measurement*;

The impact of these accounting standards on the thin capitalisation position of a company is likely to be industry specific (The ICAA, 2006). The adoption of AASB 139 *Financial Instruments: Recognition and Measurement* has resulted in entities

² Debt deductions relate to a debt interest under the Division 974 debt equity rules.

³ In such an instance, the entity is referred to as being thinly capitalised.

⁴ It can be tax effective for entities with cross-border investments to allocate a disproportionate and excessive amount of debt to their Australian operations and thereby maximise income tax deductions available in Australia. This in turn would enable these entities to minimise their Australian income tax liability (Australian Taxation Office, 2005; 2006).

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 total of deductible funding expenses to its Australian operations could artificially lower taxable income in Australia whilst increasing such amounts in other lower tax jurisdictions. The rules seek to limit the amount of debt used to fund Australian operations or investments. This is achieved by disallowing the debt deductions (e.g. interest payment or loan fees) an entity can claim against Australian assessable income when the entity's debt used to fund Australian assets exceeds the safe harbour debt to equity ratio of 3:1.

The key research questions are:

1. What is the nature and scale of the expected impact of IFRS on the thin capitalisation position of non-financial, non-ADI (authorised deposit-taking

⁵ Section 820-680 of the ITAA 1997 requires compliance with 'accounting standards' both in determining what are a company's assets and liabilities, and in valuing assets, liabilities, debt and equity capital under the thin capitalisation rules. The ATO issued Taxation Ruling TR 2002/20 Income Tax: Thin Capitalisation which states that the definition of assets and liabilities for thin capitalisation purposes must be determined in accordance with Australian accounting standards.

institution⁶) Australian companies including the key accounting standards causing the impact?

2. How do these adjustments influence Australian accounting and taxation policy initiatives in relation to thin capitalisation?

4. RESEARCH METHOD

Data was collected from the annual financial reports of 150 top Australian listed companies by market capitalisation (Australian Financial Review, 2007⁷) in the year immediately pre-IFRS adoption and in the year in which companies had to prepare their first full year annual report under IFRS. The top 150 companies were chosen as these are more likely to be subject to the Australian thin capitalisation regime and also are potentially more likely to have their thin capitalisation position change as a direct consequence of IFRS adoption. Determination of whether an entity was subject to the thin capitalisation provisions was made based on segment assets and liabilities and source of borrowings. Finance, ADI and insurance companies were excluded from the sample set as the thin capitalisation calculation fundamentally differs for these entities. Consequently, data was only collected in respect of general, non-financial, non-ADI companies. Companies that did not provide their annual report online for both the immediate pre-IFRS and post-IFRS years were also excluded from the sample set. This resulted in a final sample size of 105 companies.

AASB 1047 *Disclosing the Impacts of Adopting the Australian Equivalents to the International Financial Reporting Standards*⁸ requires an entity to restate comparatives and provide reconciliation of GAAP to IFRS (AASB, 2004^f). These reconciled financial statement notes show the changes in assets, liabilities, equity and profit on transition from GAAP to IFRS. Further AASB 1 *First-Time Adoption of Australian Equivalents to International Financial Reporting Standards* allows an entity to make choices when first applying IFRS which may in turn impact on the thin capitalisation position of a company.

Reconciliation data⁹ relating to the most recent balance sheet date where the annual report was prepared under GAAP was used. For 31 December balance day companies,

⁶ ADIs are bodies corporate that have been granted the authority to carry on banking in Australia by the Australian Prudential Regulatory Authority.

⁷ Market capitalisation as at 15 June 2007.

⁸ The purpose of AASB 1047 was to keep stakeholders informed of the likely impacts of IFRS adoption as well as how companies were preparing for adoption (AASB, 2004^f). This standard, which applied to all reporting entities for reporting periods preceding the adoption of IFRS, required entities to disclose, pursuant to section 334 of *Corporations Act 2001*:

- information in respect to planning for the transition to IFRS and any key differences in accounting policies that are expected to arise on the adoption of IFRS for interim and annual reporting periods ending on or after 30 June 2004; and
- known or reliably estimable information about the impacts on the financial reports of annual reporting periods on or after 30 June 2005 had the financial report been prepared using IFRS.

Where quantitative information was not known, or was not reliably estimable, the entity was to make a statement to that effect. Where possible, the impact of IFRS on operating profit before tax, profit after tax, net profit, total assets, total liabilities and net assets for example was to be disclosed

⁹ Data on financial statement elements including interest bearing liabilities, the source and quantum of borrowings and segment assets, liabilities and equity were collected from annual reports to quantify the impact of adoption of key IFRS on the thin capitalisation position of these companies.

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 average debt amount is compared with the

¹⁰ Method statements refer to the sequence of instructions that are to be used to calculate an entity's thin capitalisation position.

¹¹ The fixed safe harbour gearing ratio is adopted as the first tier test and if exceeded, an arm's length test or test based on worldwide gearing limit is then applied. Entities, including associated entities, that claim debt deductions less than \$250,000 (section 820-35) or have 90% or more of the value of its assets represented by Australian assets (section 820-37) or have their operations confined entirely within Australia or entirely outside Australia are excluded from application of the thin capitalisation provisions.

¹² Determination of the maximum allowable debt using the arm's length test or worldwide gearing ratio will not be made as these methods are reliant on firm specific assumption and factors.

¹³ As an example, ABC Ltd is a listed Australian company with an average value of assets of \$100 million. The average values of its relevant associate entity debt, associate entity equity, controlled foreign debt, controlled foreign entity equity and non-debt liabilities are \$10million, \$8million, \$5million, \$2million and \$5million respectively. Deducting these amounts from the average asset value leaves \$70 million. Multiplying \$70 million by 3/4 results in \$52.5 million, the safe harbour debt amount. The average debt amount (predominantly interest bearing liabilities) is compared to the safe harbour debt amount. If the average debt amount is greater than \$52.5 million, debt deductions on that excess amount may be denied. The proxy measure of safe harbour debt amount and whether an entity can be regarded as thinly capitalised are based on the accounting definition of assets and liabilities (ATO, 2002; 2006). Furthermore, the thin capitalisation tax provisions rely on the valuation rules in the accounting standards to provide the value of assets and non-debt liabilities (ATO, 2002).

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 the overwhelming majority of companies subject to the thin capitalisation rules adopt the safe harbour test, an entity may use alternative tests to derive a MAD amount. Calculation of the impact of the IFRSs on the MAD using these alternative methods is not possible using annual financial report information only. A second limitation is that only an approximate measure of the SHDA for a company can be calculated utilising information derived from the annual financial report. Third, not all companies provided complete GAAP-IFRS reconciliation statements showing changes in assets, liabilities and interest bearing liabilities on transition to IFRS adoption. Despite these limitations, the proxy measure of the SHDA on transition to IFRS does provide an insight into the impact of the new standards themselves on thin capitalisation compliance.

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 CAPITALISATION POSITION UNDER GAAP

AGAAP (millions)	<i>Assets</i>	<i>Liabilities</i>	<i>Equity</i>	<i>non-IBL</i>	<i>IBL</i>	<i>SHDA</i>	<i>MAD</i>
Mean	3,718	1,969	2,301	885	1,104	1,517	37.98
Standard Error	592	364	338	173	238	258	3.51
Median	2,006	969	1,312	385	461	439	34.87
Standard Deviation	5,025	3,094	3,464	1,423	1,949	2,621	28.71
Kurtosis	25.21	22.64	20.58	11.94	23.45	30.83	0.55
Skewness	4.31	4.16	4.17	3.24	4.21	4.62	0.64
Minimum	50	1	-116	0.99	0	0	0.00
Maximum	36,310	21,429	24,163	8,095	13,334	21,161	131.00
Count	72	72	105	67	67	103	67

Descriptive statistics of the top Australian listed firms (by market capitalisation) sample firms immediately prior to IFRS adoption. All data was obtained from reconciliation tables of GAAP-IFRS financial statement elements on transition to IFRS adoption. Not all companies showed the reconciliation of assets and liabilities from GAAP to IFRS. All sample companies (105) provided the reconciliation of equity from GAAP to IFRS. Only 72 of the 105 companies provided reconciliation of assets and liabilities from GAAP to IFRS. Total interest-bearing liabilities (IBL) comprise both current borrowings and non-current borrowings. Non-IBL refers to non interest bearing liabilities. A proxy measure of Safe Harbour Debt Amount (SHDA) is measured as total assets less non-interest bearing liabilities multiplied by 75%. The proxy measure of SHDA is measured in accordance with the method statement provided in section 820-95 of the Income Tax Assessment Act (ITAA) 1997. The MAD refers to a proxy measure of IBL/SHDA.

Descriptive statistics provided as Table 2 show the mean assets, liabilities, equity and maximum allowable debt for all sample firms immediately following IFRS adoption. The mean MAD is 42.99%. Again there is a diversity of MAD values which range from 0.0 to 131.65. Post-IFRS adoption, there are three companies with a MAD value greater than 100%, eight companies with a MAD value greater than 80% and eighteen companies with a MAD value greater than 60%. There is one company out of the sample of 67 companies whose MAD has increased from 25.59 pre-IFRS to 131.65 post-IFRS. There were been two companies with MAD values less than 80% pre-IFRS

that have exceeded 80% post-IFRS and another three companies with MAD values less than 60% pre-IFRS that have exceeded 60% post-IFRS. These changes are the result of the changes in existing accounting standards and the introduction of new accounting standards on IFRS adoption in Australia.

TABLE 2: AUSTRALIAN COMPANIES' THIN CAPITALISATION POSITION ON TRANSITION TO IFRS ADOPTION

IFRS (millions)	Assets	Liabilities	Equity	non-IBL	IBL	SHDA	MAD
Mean	3,616	2,031	2,011	599	1,110	1,315	42.99
Standard Error	613	394	314	128	229	239	3.87
Median	1,914	1,068	1,088	201	461	395	41.87
Standard Deviation	5,022	3,229	3,217	1,299	1,876	2,427	31.67
Kurtosis	24.12	21.35	23.74	23.17	20.19	31.37	0.26
Skewness	4.28	4.12	4.46	4.43	3.90	4.69	0.58
Minimum	44	1,	-153,	0	0	0	0.00
Maximum	35,211	21,553	23,573	9,105	12,448	19,579	131.65
Count	67	67	105	103	67	103	67

Descriptive statistics of the top Australian listed firms (by market capitalisation) sample firms immediately following IFRS adoption. All data was obtained from reconciliation tables of GAAP-IFRS financial statement elements on transition to IFRS adoption. Not all companies showed the reconciliation of assets and liabilities from GAAP to IFRS. All sample companies (105) provided the reconciliation of equity from GAAP to IFRS. Only 72 of the 105 companies provided reconciliation of assets and liabilities from GAAP to IFRS. Total interest-bearing liabilities (IBL) comprise both current borrowings and non-current borrowings. Non-IBL refers to non interest bearing liabilities. A proxy measure of Safe Harbour Debt Amount (SHDA) is measured as total assets less non-interest bearing liabilities multiplied by 75%. The proxy measure of SHDA is measured in accordance with the method statement provided in section 820-95 of the Income Tax Assessment Act (ITAA) 1997. The MAD refers to a proxy measure of IBL/SHDA.

Descriptive statistics provided in Table 3 show the change in assets, change in liabilities and change in equity on transition to IFRS adoption. Also provided in Table 3 is the overall percentage change in MAD on transition to IFRS adoption. The key point in this study's evaluation of thin capitalisation compliance is that MAD increased from 37.98% (Table 1) to 42.99% (Table 2) as a direct consequence of adoption of the IFRSs. Mean equity declined by 9.07% (n = 105) on transition to IFRS adoption.

TABLE 3: AUSTRALIAN COMPANIES' CHANGES IN FINANCIAL STATEMENT ELEMENTS AND THIN CAPITALISATION POSITION ON TRANSITION TO IFRS

Change on Transition to IFRS	<i>Change in Assets</i>	<i>Change in Liabilities</i>	<i>Change in Equity</i>	<i>Change in MAD</i>
Mean	-6.16	6.70	-9.07	16.74
Standard Error	4.02	7.79	2.04	7.62
Median	0.00	0.49	-3.81	2.71
Standard Deviation	33.91	65.63	20.86	58.51
Kurtosis	6.75	11.64	6.87	37.98
Skewness	-0.32	2.65	-1.92	5.74
Minimum	-100.00	-100.00	-100.00	-32.01
Maximum	135.52	333.74	47.07	414.45
Count	71	71	105	59
Confidence Level(95.0%)	8.03	15.53	4.04	15.25

Descriptive statistics of the change in assets, liabilities, equity and thin capitalisation position of top Australian listed firms (by market capitalisation) sample firms on transition to IFRS adoption. All data used to calculate the change in financial statement elements was obtained from reconciliation tables of GAAP-IFRS financial statement elements on transition to IFRS adoption. Not all companies showed the reconciliation of assets and liabilities from GAAP to IFRS. All sample companies (105) provided the reconciliation of equity from GAAP to IFRS. Only 71 of the 105 companies provided reconciliation of assets and liabilities changes from GAAP to IFRS. Total interest-bearing liabilities (IBL) comprise both current borrowings and non-current borrowings. A proxy measure of Safe Harbour Debt Amount (SHDA) is measured as total assets less non-interest bearing liabilities multiplied by 75%. The proxy measure of SHDA is measured in accordance with the method statement provided in section 820-95 of the Income Tax Assessment Act (ITAA) 1997. The MAD refers to a proxy measure of IBL/SHDA.

Table 4 shows the quantum of mean change in equity as a direct consequence of adoption of specific IFRS. The IFRS that have had the greatest impact on equity are AASB 3 Business Combinations (mean \$61.12 million increase in equity), AASB 139 Financial Instruments (mean \$-61.72 million decrease in equity) and AASB 2 Share-Based Payment (mean \$-14.74 million decrease in equity).

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

Impact of IFRSs on Equity (millions)	AASB 2 <i>Share Based Payments</i>	AASB 3 <i>Business Combinations</i>	AASB 112 <i>Income Taxes</i>	AASB 116 <i>PPE</i>	AASB 123 <i>Borrowing Costs</i>	AASB 128 <i>Investments in Associates</i>	AASB 137 <i>Provisions</i>	AASB 138 <i>Intangibles</i>	AASB 139 <i>Financial Instruments</i>
Mean	-9.55	36.43	-48.31	-2.78	-4.89	3.01	-1.57	-3.89	-36.46
Standard Error	4.69	43.92	18.17	1,35	4.37	9.41	1,14	43.55	67.95
Median	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Standard Deviation	48.08	447.97	181.77	13.89	44.86	96.43	11.76	442.02	696.31
Kurtosis	68.06	91.32	28.39	24.78	102.89	68.00	72.96	54.31	62.09
Skewness	-7.74	9.12	-5.07	-4.72	-10.10	6.66	-8.04	4.82	-5.15
Minimum	-448.00	-1,002.08	-1,229.00	-90,40	-458.00	-308.40	-110.63	-1,919.10	-6,089.90
Maximum	21.05	4,417.00	90.60	26.70	10.00	877.55	15,74	3,723.00	3,524.72
Count	105	104	100	105	105	105	105	103	105

Descriptive statistics of the impact of specific IFRSs on equity on transition to IFRS of top Australian listed companies. The number of companies (count) varies depending on availability of data.

Table 5 provides the results of a paired t-test for the 105 sample companies. The introduction of IFRS itself has increased the MAD amount by a notable 13.19%. This increase is statistically significant for both one-tail and two-tail t-tests. This result is consistent with the findings of Ahmed and Goodwin (2006) who found a statistically significant increase in leverage (total liabilities/total assets) on transition to IFRS adoption.

TABLE 5: Paired t Test of the Maximum Allowable Debt Pre- and Post-IFRS Adoption

<i>Thin Capitalisation Position</i>	<i>MAD (GAAP)</i>	<i>MAD (IFRS)</i>
Mean	37.98	42.99
Variance	824.04	1003.19
Observations	67	67
Change %	13.19	
Hypothesised Mean Difference	0	
t Stat	-2.48	
P(T<=t) one-tail	0.01	
t Critical one-tail	1.67	
P(T<=t) two-tail	0.02	
t Critical two-tail	2.00	

Paired two sample t-test comparing mean maximum allowable debt (MAD) on transition to IFRS adoption The MAD refers to a proxy measure of IBL/SHDA. The mean MAD has increased by 13.18% on transition to IFRS adoption. This is statistically significant using both one-tail and two-tail t tests.

A MAD value exceeding 1.0 indicates that the quantum of interest bearing liabilities is excessively high compared to the SHDA amount. Consequently, interest payments and loan fees could be denied as an allowable deduction under the Australian thin capitalisation provisions. There is one company in the sample set that had a proxy measure of MAD ratio less than 1.0 pre-IFRS that then exceeded 1.0 post-IFRS, purely as a consequence of adoption of the new standards. In the absence of the three year transitional election provided by Treasury, debt deductions potentially could be denied for this company under the thin capitalisation provisions. Further, there are several other companies whose MAD ratio increased from less than 60% (80%) pre-IFRS to greater than 60% (80%) post-IFRS which may put those companies (be it significant or not) under pressure in meeting the thin capitalisation provisions. A consequence of this is that these companies may have to adjust the nature, quantum and source of new capital raisings (debt or equity) which inturn may be incompatible with the firm's business objectives.

6 DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

Using a sample set of 105 top (by market capitalisation) non-financial, non-ADI, non-insurance Australian listed companies, this study analyses the income tax thin capitalisation consequence of the Australian movement to full adoption of IFRS rules.

This is important because the thin capitalisation rules apply to entities whose assets are funded by a high level of debt and relatively little equity. Companies that use debt to finance projects or investments do so to maximise the tax deductibility of interest payments in Australia.

The Treasury (2006) outline benefits associated with using accounting standards to value financial statement elements for thin capitalisation purposes. They state that IFRS are comprehensive, transparent and objective and that they reduce compliance costs as accounting standards are used for calculating thin capitalisation positions. Further as companies that are subject to the thin capitalisation rules are multinational companies operating in several jurisdictions, use of IFRS for thin capitalisation purposes facilitates comparability as these jurisdictions are also likely to use Australian IFRS equivalents.

There is a statistically significant increase in the ratio of interest bearing liabilities to a proxy measure of safe harbour debt amount on transition to IFRS adoption. This ratio increased by 13.19% from a mean of 37.98% under GAAP to 42.99% on commencement of IFRS adoption in Australia. This demonstrates that adoption of IFRS in Australia has had an important effect on the thin capitalisation position of Australian listed firms.

There are a number of policy implications arising from these results. One important policy implication revolves around the application of fair value accounting. A significant change with the introduction of IFRS is the fair value measurement and recognition of financial assets and financial liabilities. Determination of fair value may involve significant assumptions by management leading to inherent uncertainty in valuation of assets, liabilities and equity. Consequently, fair value measurement and recognition of financial statement elements may in turn impact on the thin capitalisation position of an entity and its compliance with those provisions (Joseph, 2005). Determination of fair value may have policy implications with respect to calculation of an entity's thin capitalisation position. However, as the thin capitalisation position of only one of 105 sample companies was significantly impacted by the introduction of IFRS, no significant policy implications involving fair value appear to be required. A second important policy implication centres on thin capitalisation compliance costs. Compliance costs may increase as companies require independent valuations or independent verifications of revalued assets under IFRS and fair value measurement of financial assets and liabilities for instance. Alignment of taxation provisions and accounting standards purportedly reduces compliance costs and ensures consistency in application thereby reducing uncertainty for stakeholders (Joseph, 2005). However, if the thin capitalisation position of companies varies greatly depending on fair value measurements of financial statement elements, then this may increase compliance costs.

Through calculation of a safe harbour debt amount and comparison of that amount with the interest bearing liabilities of the firm (i.e. debt interest), the impact of IFRS adoption in Australia on the thin capitalisation position of 105 Australian listed companies was quantified. There is one sample company that pre-IFRS adoption had no potential thin capitalisation compliance exposure but, as a direct consequence of IFRS adoption, now has thin capitalisation compliance exposure. Although the introduction of IFRS has had a significant impact on the thin capitalisation position of Australian listed firms, there is only one company with the sample set of 105 that potentially does not comply with those provisions as a direct result of IFRS adoption.

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 Accountants (p. 7) has stipulated that their preferred option would be to allow these impacted companies to “recognise and/or establish their own valuation of certain assets or liabilities for thin capitalisation purposes, where those assets and liabilities would not be recognised or would be given a different value under AIFRS”. They further indicate that the IFRS impacts are not necessarily restricted to a limited number of special interest companies and should therefore be available to all companies and other entities on an optional elective basis. New tests relating to valuation and revaluations for thin capitalisation purposes are required based on the results. For instance, the ICAA highlight that internally generated intangibles could be provided with a particular asset value for thin capitalisation purposes even though they may not be recognised as assets in the balance sheet under IFRS. Integrity of valuations and revaluations would also be required. The results of this study indicate that the suggested policy initiatives of the ICAA could be implemented in respect of the small number of companies that do not or are in danger of not complying with the thin capitalisation provisions following the introduction of IFRS. Application of the ICAA policy initiatives would not unduly increase compliance costs or reduce consistency in application of the thin capitalisation rules. An alternative is to extend the existing grandfathering rules (i.e. GAAP) for thin capitalisation purposes as suggested by The G100 although this option was not supported by the ICAA. The findings of this study indicate that an extension of the previous accounting GAAP treatment of financial statement elements specially used to calculate the thin capitalisation position of firms could also be undertaken. These factors need to be considered by relevant stakeholders including the AASB, ATO, Treasury, auditors, lenders and company management.

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