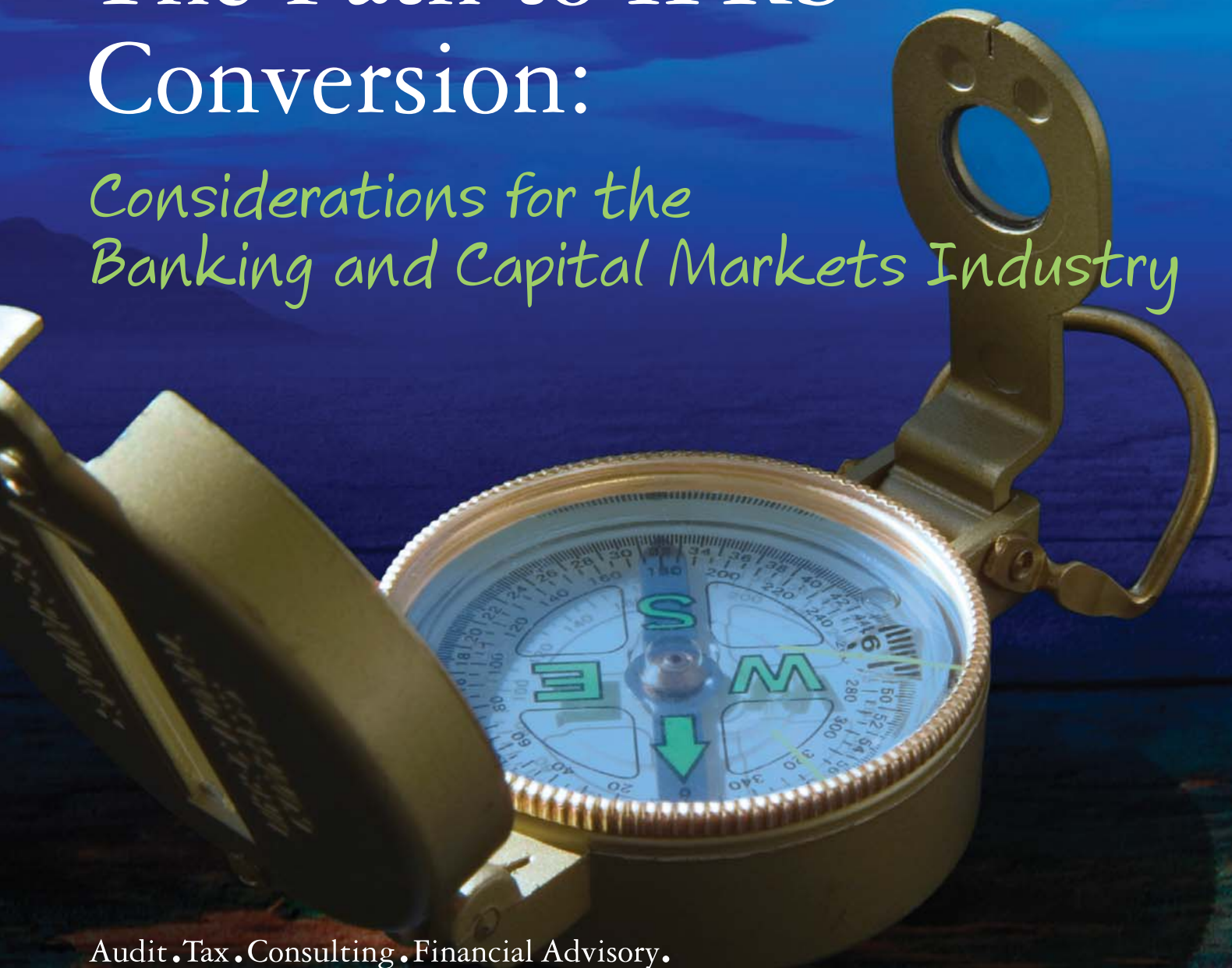


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The Path to IFRS Conversion:

*Considerations for the
Banking and Capital Markets Industry*



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Table of Contents

- The Only Constant is Change..... 1
- Tailor Your Own Roadmap..... 2
- Which Approach Will Work for You? 3
- Technical Accounting Issues for Banks and Capital Markets
Institutions 4
- More than Accounting and Financial Reporting..... 6
- A Well-Organized Conversion..... 9
- Time for Leadership 10
- Appendix: Banks and Capital Markets Institutions
Technical Accounting Issues Explained 10
- Resources and Contacts..... 17

Path to IFRS Conversion

Considerations for the Banking and Capital Markets Industry

The Only Constant is Change

Navigating the challenges and changes presented by the world's capital markets and economies has been difficult, to say the least, over the past 18 months. No industry has faced these challenges and changes more than banking and capital markets institutions. Whether U.S.-domiciled with no international operations or U.S.-domiciled with part of or a majority of revenue generated by international locations, no institution has been immune to the uncertainties presented. In light of the current economic uncertainty – as evidenced by unprecedented government intervention throughout the world – it would be a natural response to delay your institution's focus on International Financial Reporting Standards (IFRS) conversion. You want and need your best minds focused on navigating the daily challenges, not on some future mandate.

However, the challenge of IFRS conversion will not abate and is actually not that far in the future. Recent events suggest that reporting under IFRS will be allowed or required for most public companies in the U.S. and around the globe within the next few years. On November 14, 2008, the SEC issued its long-awaited proposed IFRS "roadmap" outlining milestones that, if achieved, could lead to mandatory transition to IFRS starting in fiscal years ending on or after December 15, 2014. The roadmap also contains proposed rule changes that would give certain U.S. issuers the early option to use IFRS in financial statements for fiscal years ending on or after December 15, 2009. The SEC believes that "the use of a single, widely accepted set of high-quality accounting standards would benefit both the global capital markets and U.S. investors by providing a common basis for investors, issuers and others to evaluate investment opportunities and prospects in different jurisdictions." The roadmap also notes that IFRS has the potential "to best provide the common platform on which companies can report and investors can compare financial information." The SEC is seeking comments on numerous questions raised in the proposed roadmap. The comment period is expected to run until mid-to-late February 2009.

The proposed roadmap outlines seven milestones. Milestones 1–4 discuss issues that need to be addressed before mandatory adoption of IFRS:

1. Improvements in accounting standards.
2. Accountability and funding of the International Accounting Standards Committee Foundation.
3. Improvement in the ability to use interactive data for IFRS reporting.
4. Education and training on IFRS in the United States.

Milestones 5–7 discuss the transition plan for the mandatory use of IFRS:

5. Limited early use by eligible entities: This milestone would give certain U.S. issuers the option of using IFRS for fiscal years ending on or after December 15, 2009.

Banks and Capital Markets Institutions that apply IFRS

Company	Market Cap (\$millions)	Total Assets (\$millions)
Banco Santander	\$67,650	\$1,343,674
Barclays	23,864	2,450,193
BNP Paribas	64,817	2,493,982
Credit Agricole	32,182	2,081,524
Deutsche Bank	20,880	2,975,772
HSBC Holdings	146,406	2,354,266
Royal Bank of Scotland	17,807	3,794,025
Société Générale	30,268	1,577,473
UBS	47,004	2,017,096
UniCredit Group	31,367	1,503,875

Sources:

*Market Cap Data: FT.com or finance.google.com as of 11/6/2008

*Total Assets: Corporate website or FT.com as of 12/31/2007

*Obtained exchange rates from oanda.com

6. Anticipated timing of future rule making by the SEC: On the basis of the progress made on milestones 1–4 and experience gained from milestone 5, the SEC will determine in 2011 whether to require mandatory adoption of IFRS for all U.S. issuers. Potentially, the option to use IFRS could also be expanded to other issuers before 2014.
7. Implementation of mandatory use: The roadmap raises many questions, including whether the transition to IFRS should be phased in. According to the roadmap, large accelerated filers would be required to file IFRS financial statements for fiscal years ending on or after December 15, 2014, then accelerated filers in 2015, and nonaccelerated filers in 2016.

Under the proposed roadmap, U.S. issuers that meet both of the following criteria would be eligible to use IFRS earlier in financial statements for fiscal years ending on or after December 15, 2009:

- The U.S. issuer is globally among the 20 largest listed companies worldwide in its industry, as measured by market capitalization.
- IFRS, as issued by the IASB, is used as the basis for financial reporting more often than any other basis of accounting by the 20 largest listed companies worldwide in the U.S. issuer's industry, as measured by market capitalization.

An issuer that meets these criteria and chooses to use IFRS (an "IFRS issuer") must prepare its financial statements in accordance with IFRS as issued by the IASB. Issuers electing to file IFRS financial statements with the SEC would be required first to do so in an annual report and would not be able to file IFRS financial statements with the SEC for the first time in a quarterly report, registration statement, or proxy or information statement.

Investment companies; employee stock purchase, savings, and similar plans; and smaller reporting companies, as defined by the SEC, are excluded from the definition of an “IFRS issuer” in the proposed roadmap and therefore would not be eligible to early adopt IFRS. For more information on the SEC’s action, visit www.deloitte.com/us/ifrs.

The only questions that remain are how and when your institution will begin its path to conversion. Now that the SEC has announced its proposed roadmap, we believe it is wise to create your own.

Why is a roadmap specific to your institution important? “Why” is answered by the needs of and decisions made by stakeholders – investors, regulators, clients, customers, and employees (or potential employees). Stakeholders have various options and want the ability to compare, in a consistent manner, the strengths and weaknesses of companies domiciled in different countries. Publicly traded European banks have been IFRS-compliant since 2005. Countries such as Canada, Brazil, India, and Australia have adopted similar requirements and companies domiciled in those countries are accepting and responding to the required changes. Major global banking and capital markets institutions have converted to IFRS – institutions against which your organization is competing or with which your organization does business.

Conversion Factors to Consider

Conversion provides a fresh look at current practices. If your organization’s close process includes reconciling multiple GAAPs, and dealing with a variety of sub-ledgers, manual adjustments, data hand-offs, and accounting overrides, you may want to consider a fresh look at your accounting policies and procedures. IFRS provides this opportunity.

Conversion can be a catalyst for streamlining and consolidation. As your organization expands through organic growth and acquisitions, information technology systems may become increasingly convoluted. Many banks and capital markets institutions operate a patchwork of legacy accounting and enterprise resource planning (ERP) systems — systems that can’t talk directly, leading to error-prone adjustments. Moving to IFRS provides a chance to streamline and consolidate these disparate systems.

IFRS offers an opportunity to use principles-based accounting. Many finance professionals have become increasingly frustrated with U.S. GAAP and its voluminous rules for dealing with accounting issues. For a decade or more, many CFOs and other finance executives have desired principles-based accounting to help standardize and improve the reliability of financial reporting. IFRS answers that wish.

IFRS helps open the doors of the global marketplace. Adopting IFRS may improve access to foreign capital markets by giving foreign investors greater insight into a company’s financial performance. Such investors may be more comfortable with or have more confidence in a globally accepted set of accounting standards. Companies themselves can also benefit from improved ability to benchmark with peers and competitors.

Tailor Your Own Roadmap

Certain banks and capital markets institutions may have the option to early adopt IFRS (i.e., use IFRS in their financial statements for fiscal years ending on or after December 15, 2009). If this is your institution’s plan, the urgency of a tailored roadmap is evident. However, if your institution will adopt IFRS in 2014 or subsequent years, you may think your institution has plenty of breathing room. Think again.

A conversion effort that is both pragmatic (in the sense of avoiding the fire-drill type atmosphere that characterized compliance with Sarbanes-Oxley and the year 2000 computer issue) and successful (one that can stand up to the scrutiny of regulators, analysts, and your independent auditor) will require a lengthy runway. In mid-2008, the American Institute of Certified Public Accountants announced that it considered a year timeline to be reasonable for transition to IFRS. Other organizations have made similar determinations.

If you take only one action after reading this document, we suggest that you develop your own IFRS implementation roadmap. To kick off this effort, ask yourself and your team a few preliminary questions. The answers to these questions should help you gauge the potential effect of IFRS on your institution:

- How many local generally accepted accounting principles (GAAPs) do we currently report?
- How many of our business units already prepare IFRS financial statements?
- How might our access to capital be affected by an IFRS conversion?
- How many of our competitors have converted or are in the process of converting?
- Do we have a major enterprise resource planning (ERP) or finance transformation project in the works?
- Are we involved in or considering a major acquisition?
- What is the level of IFRS knowledge within the company, both domestically and globally?
- How would an IFRS conversion affect our business? Would we need to adjust or amend existing business contracts?
- Have we assessed the cost and benefits of adopting IFRS?

Of course, your IFRS implementation roadmap will be significantly more detailed than merely addressing these several questions. Given the far-reaching scope of IFRS, your roadmap may assess the potential effect on each department in your organization, including finance, human resources, tax, legal, information technology, and investor relations. Other stakeholders may also be involved, including the board, audit committee, shareholders, your internal and external auditors, and your regulators.

A carefully designed roadmap may empower your company to convert on its own terms. By taking a measured and informed approach, you increase the likelihood of identifying value in an exercise that otherwise may be reactive and solely compliance driven. The value may show itself in the form of reduced costs of implementation, standardization and centralization of statutory reporting activities and related controls, and possibly core finance transformation.

Which Approach Will Work for You?

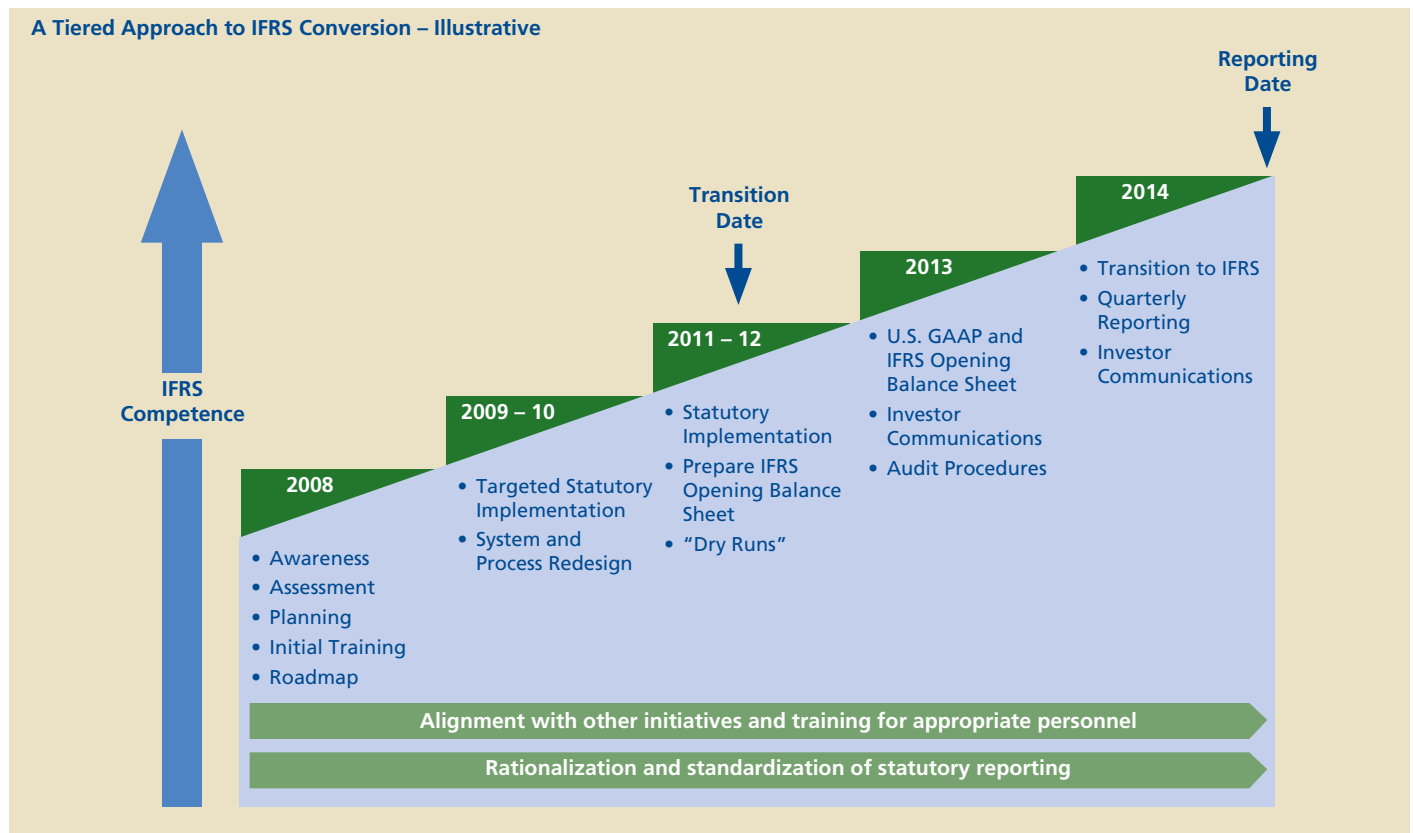
Generally speaking, two approaches to IFRS conversion predominate: all-in and tiered. The former is characterized by a relatively short time frame; simultaneous conversion of all reporting entities; dedicated project teams; and devotion of significant resources. The latter is conducted over a more extended period; with phased conversion of reporting entities; with at least some personnel retaining their “day job” duties; and with a spreading out of project costs.

When the European Union converted to IFRS in 2005, it was, for most companies, an all-in effort driven by the tight timelines imposed by the European regulators. Without the luxury of time to convert on

a staggered basis, most companies were forced to rush through the process, leading to inevitable inefficiencies and ineffectiveness (See sidebar, “The European Experience,” on page 9).

A tiered-approach – staged, rational, and measured – to IFRS conversion will likely provide better results. This advice comes with a seemingly self-contradictory caveat: You’ll have to act fast if you want to go slow. That is, if you want to reap the benefits of phasing in your conversion, you’ll need to start planning soon.

Companies that choose a tiered strategy should consider staggering their conversions on a country-by-country or region-by-region basis. As each group moves through the stages (see graphic, “A Tiered Approach to IFRS Conversion”), the processes developed and lessons learned are applied to the next group.



Technical Accounting Issues for Banks and Capital Markets Institutions

U.S. GAAP and IFRS differ in key ways, including their fundamental premise. At the highest level, U.S. GAAP is more of a rules-based system, whereas IFRS is more principles-based. This distinction may prove more vexing than it initially appears, because most accounting and finance professionals in the U.S. have been schooled in the rules of U.S. GAAP. The overriding lesson from years of study and work was, “If you have an issue, research it and consult with others.” Under U.S. GAAP, voluminous guidance attempts to address nearly every conceivable accounting problem that might arise. If guidance doesn’t exist, it generally is created. On the other hand, IFRS is a far shorter volume of principles-based standards, and consequently requires more judgment than U.S. accounting and finance professionals are accustomed to employing.

Beyond the issue of rules versus principles, IFRS also can pose particular technical accounting challenges to banks and capital markets institutions. When addressing the technical accounting challenges, banks and capital markets institutions must not lose sight of the effects, potentially significant effects, those changes may have on tax, regulatory, processes (including internal controls over financial reporting), and information technology.

The table below and detailed discussions contained in the appendix highlight some of the U.S. GAAP/IFRS differences and challenges that are particularly important to banks and capital markets institutions. For a more comprehensive list of U.S. GAAP/IFRS differences, refer to Deloitte’s IFRS and U.S. GAAP comparison publication, which can be found at www.deloitte.com/us/ifrs.

U.S. GAAP/IFRS Differences and Challenges

	Accounting	Technology and Process	Regulatory Considerations
Transfers of Financial Assets	<ul style="list-style-type: none"> U.S. GAAP (i.e., Statement 140) assesses recognition or derecognition of assets based upon control, as compared to a multi-step model that primarily focuses on the risks and rewards of ownership within IFRS (i.e., IAS 39 and 12). QSPE – “qualifying special purpose entity” – is a concept recognized within U.S. GAAP, but not recognized under IFRS. 	<ul style="list-style-type: none"> Consolidation implications with respect to the treatment of Special Purpose Entities (SPEs) and QSPEs may necessitate a change in general ledgers, sub-ledgers and the applicable internal controls over financial reporting. 	<ul style="list-style-type: none"> New SPE consolidations will likely lead to higher Basel II capital requirements as it would entail directly calculating capital for the underlying exposures as opposed to applying securitization rules.
Available for Sale Securities and Impairment	<ul style="list-style-type: none"> U.S. GAAP (i.e., Statement 115) recognizes an impairment loss when the decline in fair value is other than temporary. However, IFRS (i.e., IAS 39) indicates that an impairment loss should only be recognized if there is an occurrence of a loss event. Under IFRS, in certain circumstances subsequent recoveries of previous losses may be recognized in income. U.S. GAAP does not allow subsequent recoveries of previous losses to be recognized in income. 	<ul style="list-style-type: none"> Risk management and internal control processes may need to be revisited as a result of changes in impairment evaluation. Current systems may not allow securities to be “written-up” after impairment has been recognized. Accordingly, systems may need to be evaluated and adjusted, as necessary. Furthermore, amortization and accretion processes may be affected. 	<ul style="list-style-type: none"> Subsequent recoveries of previously recognized losses could have a positive effect on Tier I capital under Basel I and Basel II.
Fair Value Measurements of Financial Instruments	<ul style="list-style-type: none"> U.S. GAAP (i.e., Statement 157) requires fair value to be determined based upon exit price. In certain instances, exit price could differ from the value recorded at initial recognition – potentially resulting in “day one” gains or losses. Generally, IFRS (i.e., IAS 39) does not allow for the recognition of “day one” gains or losses if those gains or losses are based upon unobservable market data. Statement 157 allows companies to use mid-market pricing, but IAS 39 assumes the use of bid prices for assets and ask prices for liabilities. Statement 157 provides three fair value hierarchy levels, yet IFRS has two defined levels.¹ 	<ul style="list-style-type: none"> Internal controls over financial reporting, as well as risk management processes and systems, may need to be evaluated to adjust appropriately (e.g., data feeds from pricing sources, update policies regarding security pricing, etc.). 	<ul style="list-style-type: none"> Earnings/losses would flow through Tier I capital and may increase the volatility of Tier I. To the extent that changes also result in different classification of instruments (e.g., product types, banking book versus trading book), risk-weighted assets may also be affected.

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U.S. GAAP/IFRS Differences and Challenges, cont.

	Accounting	Technology and Process	Regulatory Considerations
Hedge Accounting	<ul style="list-style-type: none"> IAS 39 contains a special hedge accounting method for a portfolio fair value hedge of interest rate risk (a currency amount, instead of individual assets or liabilities, can be designated as the hedged item). U.S. GAAP does not contain this special hedge accounting method. IAS 39 does not permit the “short cut” method for assessing hedge effectiveness. Under IAS 39, hedge effectiveness is assessed whenever the entity prepares its interim or annual financial statements. U.S. GAAP contains specific eligibility requirements for applying the short-cut method. When an entity is eligible for, and applies, the short-cut method, it assumes that the hedging relationship has no ineffectiveness. 	<ul style="list-style-type: none"> The chart of accounts, general ledger and sub-ledgers may need to be updated/adjusted to accommodate the hedge accounting changes/differences. Policies, procedures and documentation requirements related to the availability of portfolio hedges will need to be addressed. The move from the short-cut method under U.S. GAAP to the long-haul method under IFRS may require system and process changes to gather and continuously monitor hedge effectiveness. 	<ul style="list-style-type: none"> Regulatory capital may be affected from changes to earnings affected by the number of financial instruments that may qualify (or not) for hedge accounting.
Netting/Offsetting of Financial Instruments	<ul style="list-style-type: none"> Netting/Offsetting is elective under U.S. GAAP (Interpretation 39 and Interpretation 41), while it is not elective under IFRS (IAS 32). IFRS require that the entity always have the “intent” to settle net, but U.S. GAAP provides two exceptions. In unusual circumstances, IFRS permit offsetting amounts due from a third party debtor against amount due to a different creditor – this is never allowed under U.S. GAAP. 	<ul style="list-style-type: none"> Policies, procedures and documentation (and the underlying, associated internal controls) will likely need to be adjusted to accommodate the differences. For example, International Swaps and Derivative Association (ISDA) master netting agreements may not be sufficient to apply netting. 	<ul style="list-style-type: none"> Currently, regulatory capital rules (both Basel I and Basel II) include a set of specific netting/offsetting eligibility requirements that are generally aligned to applicable accounting standards; however, if assets and liabilities increase or decrease upon IFRS adoption, regulatory capital could be affected.
Loan Impairment	<ul style="list-style-type: none"> IAS 39 contains specific examples of loss events and additional guidance for evaluating and measuring impairments on a portfolio. U.S. GAAP does not contain the same examples and guidance. IAS 39 requires estimated cash flows to be discounted in measuring impairment for groups of loans. U.S. GAAP does not contain this requirement. 	<ul style="list-style-type: none"> Internal controls and risk management processes will need to be evaluated and may need to be adjusted to accommodate the requirements of IAS 39. Systems used to accumulate the group of loans to be discounted, continually track those loans and groups of loans, and calculate discounted cash flows should be assessed and may need to be enhanced. 	<ul style="list-style-type: none"> Loan impairment differences could affect Tier II calculations if the allowance for loan losses (ALLL) is changed because ALLL is limited to 45% in Tier II calculations. For Basel II, Tier I and II capital could be affected to the extent the conversion to IFRS affects general credit reserves and the expected loss (EL) determination. More specifically, excesses or shortfalls of reserves over EL are reflected in Tier I/II capital calculations.

U.S. GAAP/IFRS Differences and Challenges, cont.

	Accounting	Technology and Process	Regulatory Considerations
Risk Disclosures	<ul style="list-style-type: none"> • IFRS 7 consolidates and enhances disclosures (currently maintained within various FASB statements or SEC regulations) about the nature and extent of risks arising from financial instruments. • For U.S. public registrants, certain risk disclosures required by IFRS 7 are currently included in management's discussion and analysis (MD&A) on Form 10-K. Upon adoption of IFRS, the disclosures will be provided in the notes to the financial statements, thereby, making them an integral part of the audited financial statements. • Generally, disclosure requirements are closer to the requirements of Basel II's "Pillar III." 	<ul style="list-style-type: none"> • Internal risk and management reporting systems will need to be assessed to ensure the information required for disclosures will be available, reliable, and auditable. • Front-end systems, sub-ledgers, and other financial systems and processes will need to capture data at the transaction level. • With disclosures moving from MD&A to an integral part of the audited financial statements, the processes underlying the data capture will, perhaps for the first time, be subject to Sarbanes-Oxley requirements. Accordingly, internal controls over the financial reporting relating to the accumulation of the data may need to be enhanced and will need to be tested. 	<ul style="list-style-type: none"> • Basel I does not have explicit requirements related to risk disclosures. • Basel II mandates specific disclosures, referred to as Pillar III, that require institutions to provide information to market participants on the capital structure, risk exposures, risk assessment processes, and overall capital adequacy of a bank. • IFRS 7 reporting requirements are more in line with Pillar III disclosure guidance. Accordingly, institutions not transitioning to Basel II will likely be more affected by the adoption of IFRS.

More Than Accounting and Financial Reporting

Without question, IFRS will affect the general ledger and the financial statements. But in a relative sense, the accounting and financial reporting may be the easy part. How you handle the nonfinancial aspects of the conversion may be a far more accurate indicator of your success. Among the areas warranting your attention are human resources, legal, regulatory, tax, treasury, contract management, and information technology.

Human Resources: As noted, IFRS involves much more than reorganizing the chart of accounts. It represents a change that cascades well beyond the finance department.

Consequently, human resources issues may be a major concern. A conversion project will place increased demands on your personnel, which may come at a time when you are least able to handle it. Finance organizations have streamlined in recent years, downsizing accounting functions through reduced hiring, layoffs, and attrition, as well as outsourcing or offshoring key functions. Unfortunately, these personnel reductions may mean that the people who could best help with your IFRS efforts are no longer available.

Recruiting may pose another challenge, particularly in the United States. College accounting programs across the country represent an important pipeline for keeping finance functions staffed and operating. Yet, most U.S. university accounting programs are only now beginning to develop comprehensive instruction on IFRS.

This issue can be addressed through training programs in the U.S. and internationally to help key personnel become proficient in both IFRS and U.S. GAAP.

Legal: The ripple effects of conversion to IFRS will surely be felt by your legal department. Many contracts will need to be re-examined for possible effects and some contracts may need to be renegotiated and restructured.

Your lawyers are already acutely aware that banks and capital markets institutions have a propensity for joint ventures, structured investments, and other collaborative arrangements. The contractual underpinnings of all these relationships will need to be revisited and analyzed for triggers that would require these arrangements to be consolidated. The legal team should take a proactive approach to heading off problems and steering clear of litigation, sanctions, or proceedings.

As with other employees, education and retraining will come into play for the legal team. IFRS principles and associated guidance from the SEC and proposed rule-making as a result of conversion to reliance upon IFRS-based financial statements will need to be analyzed and understood from a legal perspective.

Regulatory: Banks and capital markets institutions have a number of local, national, and international regulatory requirements that can trip up even the most sophisticated enterprise. Thus, the prospect of adding IFRS to the existing collection of regulatory acronyms (Sarbanes-Oxley Act (SOX), Foreign Corrupt Practices Act (FCPA), Anti-Money Laundering (AML), etc.) may seem daunting. Yet, paradoxically, the worldwide trend toward IFRS adoption may actually ease certain compliance burdens

Certainly, the opportunity to drastically reduce local GAAP reporting and coalesce around a single set of accounting standards will provide some relief. For example, until recently, companies doing business in Western Europe had to track financial information using more than 20 different GAAPs. The EU's 2005 conversion to a single set of accounting standards harmonized and simplified compliance. Today, there is more cross-border consistency in the application of rules and standards.

But IFRS holds even greater promise of collaboration among various regulatory bodies. The model for this was provided by the Committee of European Securities Regulators, an independent body that works to improve coordination among EU securities regulators. This group, formed in 2001, played an important role in the IFRS conversion effort by bringing together regulators from across the EU to discuss issues, help identify compromises regarding differences,

and reconcile complex points of view. Consistent with the European model, it is anticipated the banking regulators (under the auspices of the Federal Financial Institution Examinations Council) will play a role in coordinating with the SEC. However, U.S. bank regulatory agencies are in the early stages of evaluating developments related to IFRS conversion. The regulatory agencies have yet to determine the effects IFRS conversion will have on the regulatory supervisory process for banks, either for U.S.-based banks or U.S. branches of foreign-domiciled banks.

Currently, all financial regulatory reporting requirements are based upon U.S. GAAP, including numerous accounting guidance, reporting instructions, and supervisory manuals. Implementing changes dictated by IFRS would require a significant analysis and implementation effort on behalf of the regulatory agencies

Tax: The tax considerations associated with a conversion to IFRS, like the other aspects of a conversion, are complex. For banks and capital markets institutions, tax accounting differences are of great significance. However, the effects of a conversion go beyond these complex tax matters and also include matters such as pre-tax accounting changes on tax methods, global planning strategies, and tax information systems. If a conversion to IFRS is approached properly and well in advance of conversion, it has the potential to strengthen an entity's tax function by providing an opportunity for a detailed review of tax matters and processes.

It is important to address the impact that pre-tax accounting differences between IFRS and U.S. GAAP may have on tax methods. The starting point for calculating U.S. taxable income is book income as reported in accordance with U.S. GAAP (Internal Revenue Code (IRC) Section §446). Change the starting point and half the tax equation changes. For differences that impact pre-tax accounting methods, banks and capital markets institutions will need to consider the following questions:

- Is the new financial reporting standard a permissible tax accounting method?
- Is the new book method preferable for tax reporting purposes?
- Is it necessary to file changes in methods of accounting?
- Will there be modifications in the computation of permanent and temporary differences?
- Do planning opportunities exist?

Convergence

Financial institutions should continue to monitor the status of convergence between IAS 12 and Statement 109. The Financial Accounting Standards Board (FASB) recently reviewed the overall direction of its convergence project to align the two standards and discussed various options, including whether to issue a revised version of Statement 109, or replace Statement 109 with IAS 12, or do nothing. The FASB has put its convergence efforts on hold indefinitely. However, the International Accounting Standards Board (IASB) continues to move ahead with convergence efforts and is expected to issue an exposure draft of a revised IAS 12 over the next few months. The FASB has given some indication that it will revisit its convergence efforts after soliciting feedback on the revised IAS 12 standard. The status of this matter is constantly changing and should be monitored on an ongoing basis.

Even after considering the IASB's current convergence efforts, upon conversion to IFRS, tax professionals at banks and capital markets institutions may need to assess, or assist others in the institution to understand, the tax effects of conversion in the following areas:

Regulatory Capital

Unquestionably, one of the most important considerations for banks and capital markets institutions is the maintenance of adequate regulatory capital. Deferred tax assets (DTAs), subject to certain conditions, limitations, and restrictions, are included in the regulatory capital calculations. Accordingly, differences between IFRS and U.S. GAAP that affect DTAs will also affect regulatory capital.

Fair Value

A critical item that remains to be determined is whether the valuation safe harbor under Treasury Reg. §1.475(a)-4 that permits a taxpayer to use the values of positions reported on certain financial statements in accordance with eligible methods as the fair values of those positions for purposes of IRC. Section 475. Currently, only U.S. GAAP has been determined to be an eligible method and not IFRS. The Internal Revenue Service is seeking comments on expanding the eligible methods to include IFRS.

Special Purpose Entities

As described on pages 10-11, U.S. GAAP and IFRS have different requirements for the consolidation of SPEs. This may cause changes in the amount of deferred tax recorded for outside basis differences. For instance, a SPE, such as a securitization vehicle, could be considered to be a "qualifying SPE" under U.S. GAAP and not be consolidated, whereas IFRS may require that same SPE to be consolidated. Factors to consider in determining whether to record deferred taxes for outside basis differences include whether the entity is a pass-through or corporate entity, the ability and intent to control the timing of the reversal of the temporary difference and whether the temporary difference will reverse in the foreseeable future.

Hedge Accounting

There are numerous differences between IFRS and U.S. GAAP with regards to hedge accounting. Tax directors should verify upon conversion that any required hedge accounting identifications to qualify for tax hedge accounting still apply so that timing and character issues do not develop.

Share-Based Compensation

For many banks and capital markets institutions, share-based compensation is a significant component of competitive remuneration plans. A conversion from U.S. GAAP to IFRS will affect the amount and timing of the DTA recognized as well as the effective tax rate associated with share-based compensation. Under U.S. GAAP, the DTA for a stock option is determined based on the option's fair value on the date the option is granted. Although a stock option may be "out of the money," a DTA is still recorded under U.S. GAAP and the DTA is generally not adjusted for changes in the fair value of the underlying stock prior to the exercise or expiration of the option right. Under IFRS, the DTA is based on the tax deduction that would be available based on the current share prices at each reporting date, and thus, where the tax deduction is based on intrinsic value a DTA is recognized only when the option has become "in the money."

Since the financial accounting treatment for share-based compensation varies greatly between local GAAPs, IFRS, and U.S. GAAP, and the tax deduction is driven by local tax rules, an institution must evaluate the effect of converting to IFRS in each jurisdiction from both a financial accounting perspective and a tax perspective. Such an assessment will allow an organization to determine the effect on deferred taxes, the effective tax rate, as well as the ability to deduct share-based compensation in the local tax return. Further, an evaluation should consider the interplay between local tax rules and corporate recharge, reimbursement, and transfer pricing arrangements for share-based compensation.

Debt versus Equity Classification of Investments

Hybrid instruments, such as those for which the recipient of “interest” is treated as receiving a dividend but for which the payer gets an interest deduction, are common in international planning. Unlike the U.S., some jurisdictions rely heavily on the financial accounting treatment to characterize a financial instrument for tax purposes. A change in the definition of equity arising from a change in accounting standards may unexpectedly eliminate the tax benefits of hybrid instruments because the income may be treated as interest rather than a dividend and thus impact global tax planning and the effective tax rate.

For more information related to the tax considerations during an IFRS conversion, visit www.deloitte.com and see, among other items, “IFRS for U.S. Companies: Tax Implications of an Accelerating Global Trend” (www.deloitte.com/dtt/cda/doc/content/us_tax_ifrs_pov_061708.pdf), “Global Tax Implications of IFRS” (www.deloitte.com/dtt/cda/doc/content/us_tax_ifrs_globaltaximplications_082808.pdf), and “Five Ways a Conversion to IFRS Could Impact a Global Tax Structure,” (<http://www.deloitte.com/dtt/article/0%2C1002%2Ccid%25253D224404%2C00.html>)

Treasury: Moving to a global financial reporting model may open up access to new sources of capital. Many banks and capital market institutions are already faced with volatility in their own debt and volatility in their ability to access additional capital. IFRS reporting will not significantly change those considerations. However, IFRS may

affect the treasury function in the following ways:

- Banks and capital markets institutions may need to assess the need to revise debt terms for covenants based on U.S. GAAP metrics or financial results that no longer make sense or are no longer attainable under IFRS.
- The clearer view that lenders and investors get into the fair value of collateral (whether presented on the balance sheet or disclosed in the footnotes) may alter their evaluation of creditworthiness and may affect the terms of new debt instruments related to collateral values and covenants.

Information Technology: IFRS is expected to have wide-ranging effects at different levels of the IT systems architecture. The realignment of an institution’s information systems will pose a real challenge for IT (along with the rest of the organization). Virtually all applications and interfaces in the system architecture can be affected, from the upstream or source of data to the farthest end of the reporting tools. As such, time and resource needs may be significant.

As you plan changes to your IT systems, you will need to take into account external factors such as local and international regulations, financial consolidation of subsidiaries, stock markets, and external auditors. This business transformation should not be considered as a one-step project. It may be necessary to implement short-term initiatives strategically designed to institute an effective long-term solution for your institution.

Potential Technology Impacts

Upstream Source Systems and Transformation Layer	General Ledger and Financial Applications	Reporting Data Warehouse Planning and Calculation Engines	Downstream Reporting Capabilities
Differences in the accounting treatment between current accounting standards and IFRS will create a need for new input data.	Differences in the accounting treatment between current accounting standards and IFRS will likely drive changes to general ledger design, chart of accounts, as well as sub-ledgers and feeds.	IFRS has much more extensive disclosure requirements, requiring regular reporting and usage of financial data that may not be standardized in current data models.	The differences that arise in the accounting treatment between current accounting standards and IFRS will create a need for changes in reporting.
Data and transactions that are captured, stored and ultimately sent to the financial systems may not have all the needed attributes or qualities.	Multinational companies may ultimately realize a need to re-develop general ledger platforms or additional sets of books to ensure compliance with multiple financial reporting requirements.	Increased need for documented assumptions, sensitivity analyses; potential factors that could affect future development may expand the scope of information managed by financial systems.	Assumption changes from period to period can introduce significant volatility and require detailed support for derivation and rationale for changes, requiring design of additional reports.
Sub ledgers within the ERP may have additional functionality to support IFRS that is currently not being utilized but could be implemented.	Multi-ledger accounting functionality within newer releases of ERP’s may be considered for long-term solutions.	Reporting warehouse feeds to calculation engines may need to be adjusted in a standardized way to support reporting processes.	External reporting templates will likely require revisions to reflect IFRS requirements.
Transformation layer not likely to have been designed with IFRS in mind; data sender/ receiver structures may need to be adjusted.	Changes to IFRS will likely necessitate redesigned accounting, reporting, consolidation, and reconciliation processes, which may impact configurations of the financial applications.	Data governance functions and meta data repositories (potentially including data dictionary, ETL and business intelligence tools) may need to be adjusted to reflect revised data models.	Increased disclosures such as sensitivity tests and rollforwards may require additional ad hoc query capabilities.
Over time the potential for acquisitions of companies using IFRS will increase; altering source systems and Extract, Transform and Load (ETL) tools to provide all needed data elements will make integrations significantly more efficient.	Differences that arise in accounting treatment between current accounting standards and IFRS may create a need for new expense allocations and other calculations.	Current valuation systems may not have functionality to handle IFRS requirements.	

The European Experience

In July 2002, the European Parliament passed legislation requiring listed companies to convert to IFRS by 2005. The short timeframe and extensive reach of the directive had many companies scrambling to comply. Anecdotal reports from the field suggest that the conversion placed significant resource pressure – human and financial – on finance teams and their companies at large.

A more tangible measurement of the effort can be found by comparing European companies' 2004 (local GAAP) and 2005 (IFRS) financial statements. The latter averaged more than 50 percent longer than the former; in some instances, reports doubled in length. Much of the increase can be attributed to an increased level of disclosure in the financial statements in areas such as judgments made and assumptions used.

Certain accounting issues proved especially vexing during the transition, including asset impairments, financial instruments (under IAS 39), and lease accounting.

Among the lessons learned from the European experience were the following:

- **The effort was often underestimated.** The original perception that conversion was solely an accounting issue was replaced with a growing realization that the initiative was much larger and more complex.
- **Projects often lacked a holistic approach.** Because of the limited view cited above, companies frequently did not take the collateral effects into consideration, such as the effects on IT, HR, and tax.
- **A late start often resulted in escalation of costs.** Those few companies that anticipated conversion and took steps to prepare for it were in much better shape than those that did not. Companies that delayed their response paid a price for it, in terms of higher costs and greater diversion of resources.
- **Many companies did not achieve a “business as usual” state for IFRS reporting.** The highest quality financial data is obtained when companies fully integrate IFRS into their systems and processes. The compressed timeframes precluded this possibility; instead, first-year financials were often produced using extraordinary, labor-intensive, and unsustainable measures.
- **It's hard to get it right the first time.** Even under ideal circumstances of time, resources, and knowledge, a conversion process will often be difficult and error-prone.

Several European companies are only now starting to explore benefits from IFRS implementation. Due to multiple constraints, the first-year effort in the EU was focused more on “getting it done.” Potential benefits in terms of reducing complexity, increasing efficiency, decreasing costs, and improving transparency had to be deferred.

A Well-Organized Conversion

If your institution decides an accelerated IFRS conversion is desirable, here are a few suggestions for creating a well-organized conversion:

Leverage existing projects: If already going through — or recently completed — an ERP or finance transformation project, now may be the time to consider IFRS adoption. Recent versions of major ERP systems are designed to accommodate IFRS, which can be mapped in, usually with significant cost savings.

Conduct a trial run: Implementation might be easier if starting with a single country or reporting entity. Use existing reporting requirements and local country IFRS requirements to your institution's advantage. For example, subsidiaries in countries adopting IFRS over the next three years may be good candidates for a trial run since IFRS-based reporting will be required there as of 2011. Learn from this initial conversion exercise, and apply the lessons learned to the global rollout down the road.

Consider shared services centers: IFRS provide a compelling reason to establish shared services centers to potentially consolidate dozens of local GAAPs down to a single reporting standard. Geographically dispersed finance offices could be drastically reduced or even eliminated in favor of a central finance function, strategically located to take advantage of tax incentives, payroll savings, and facilities cost reductions. In many cases, this concept is already aligned with the strategic direction banks and capital markets institutions have taken or are currently considering relative to their finance function.

Strengthen controls: Many banks and capital markets institutions have operations located across the globe. A decentralized structure can sometimes lead to reduced oversight and weakened controls. IFRS offers the opportunity to implement standardized frameworks and processes to enhance the overall control environment.

Refresh your institution's policies: Conversion to IFRS drives a need to revisit revenue recognition, impairment, share-based payments, cost capitalization, and other accounting policies. In other words, IFRS provides a refresh exercise for accounting policy implementation, with the aim of more accurate and timely financial reporting.



Time for Leadership

You are in an enviable position, because you possess knowledge that many others in your institution may not: the movement toward IFRS is inexorable; and the initiative involves multiple corporate functions, not solely finance.

You have a choice: either sit back and wait for it to happen (with all the attendant uncertainty and risk) or mobilize your company to attempt to maximize the benefits and minimize the obstacles.

In other words, it's time for leadership.

By starting now, you will likely spread out your costs, get the jump on your competition, and reel in scarce talent before it vanishes. You can improve your processes and systems. You can integrate with other initiatives, such as an ERP upgrade or a merger or acquisition. Most important, you can do it on your own terms, at a pace that suits your company and its circumstances.

There are major demands on financial and human resources at banks and capital markets institutions. An IFRS project cannot be a distraction from the primary activities of your business. It must be integrated, coordinated, and aligned. It should start soon with some preliminary questions and a carefully drawn roadmap; and it ends somewhere in the next decade when you report for the first time under a single unified standard. Whether the journey from here to there is rocky or smooth may be entirely up to you.



Appendix: Banks and Capital Markets Institutions Technical Accounting Issues Explained

Transfer of Financial Assets

IFRS (i.e., IAS 39) uses a multiple-step analysis that focuses primarily on transfer of risks and rewards of ownership, and may, secondarily, include an assessment of control over a transferred financial asset when determination based on risks and rewards is inconclusive. U.S. GAAP (i.e., Statement 140) uses a control-based model in which each party to a transfer of financial assets recognizes or continues to recognize the financial assets that it controls, and derecognizes assets when control is surrendered.

Further, the concept of a QSPE does not exist in IFRS. In many cases, derecognition of assets transferred to SPEs is only appropriate if a transaction meets the conditions to be considered a "pass-through arrangement." Under U.S. GAAP, because an SPE typically does not have the ability to freely pledge or exchange its assets, assets transferred to an SPE often will only achieve derecognition if the SPE is considered a QSPE.

Control Versus Risks and Rewards of Ownership

Pursuant to U.S. GAAP, Paragraph 9 of Statement 140 provides specific criteria that must be met for control over a financial asset to be considered surrendered and sale accounting (or derecognition treatment) to be appropriate. The conditions in paragraph 9 focus on whether an entity that transfers financial assets surrenders control over the financial assets and whether consideration other than beneficial interest in the financial assets is received in return. If control over a transferred financial asset is not surrendered, the entity must continue to recognize the financial asset and must recognize an associated secured borrowing equal to the consideration received.

Contrary to U.S. GAAP and as mentioned above, IFRS uses a multiple-step analysis that focuses primarily on transfer of risks and rewards of ownership. For example, if the contractual right to the cash flows of a financial asset is transferred, paragraph 20 of IAS 39 requires an entity to first consider whether substantially all the risks and rewards of ownership of that financial asset are transferred or retained in order to determine if derecognition of the transferred asset is appropriate. If substantially all the risks and rewards of ownership of a financial asset are transferred to a third party, derecognition of a financial asset is appropriate. However, if substantially all the risks and rewards of ownership of a financial asset are retained by the transferor, derecognition of the financial asset is not appropriate.

While derecognition under IAS 39 first requires consideration of the risks and rewards of ownership of the transferred financial asset, if substantially all the risks and rewards are neither transferred nor retained by the transferor, consideration must be given to whether the transferor continues to control the financial asset after the transfer. In such a case, derecognition of the entire transferred asset is only appropriate if control over the transferred financial asset is surrendered. If control is not surrendered, the transferor may derecognize the financial asset to the extent it does not have continuing involvement in the transferred asset.

If the contractual rights to the cash flows of a particular financial asset are retained, derecognition may still be appropriate if the entity enters into an offsetting contractual obligation to transfer the cash flows received from that asset to one or more third parties. This is often referred to as a "pass-through arrangement." Paragraph 19 of IAS 39 provides that an entity may derecognize an asset in which it retains

the contractual right to the asset's cash flows if certain conditions are met. If such conditions are met, an entity must derecognize the financial asset even though the contractual rights to the cash flows of the financial asset are retained.

Transfers to a QSPE

IAS 39 does not include the concept of a QSPE. If a transferor transfers financial assets to an SPE that it establishes, the transferor often will be required to consolidate that SPE in accordance with SIC-12, Consolidation – Special Purpose Entities. With regard to derecognition, paragraph 15 of IAS 39 requires an entity first to consolidate all subsidiaries in accordance with IAS 27, *Consolidated and Separate Financial Statements*, and SIC-12 and then apply the derecognition provision of IAS 39 to the consolidated entity.

Under U.S. GAAP, a transferor that transfers assets to an SPE that does not have the ability to freely pledge or exchange the transferred asset can still derecognize the transferred asset if the transferee SPE meets the definition of a QSPE (as provided in paragraph 35 of Statement 140) provided the underlying beneficial interest holders in the QSPE have the ability to freely pledge or exchange their beneficial interest and the other conditions for derecognition in paragraph 9 are met. In other words, the transferor can “look through” a QSPE and consider whether the underlying beneficial interest holders in the QSPE have the ability to pledge or exchange their beneficial interests. Under U.S. GAAP, a transferor of assets to an entity that meets the definition of a QSPE is not permitted to consolidate that entity.²

Financial Statement Effect

The adoption of IFRS' multiple-step derecognition model and the elimination of the QSPE could lead to transfers of financial assets failing the derecognition criteria and those financial assets continuing to be recognized on the balance sheet. The following provides an example of the financial statement effects.

Bank A, a U.S. bank, owns – through its UK subsidiary – one million shares of Company B's common stock and accounts for them as available-for-sale securities both under FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (Statement 115) and IAS 39, *Financial Instruments: Recognition and Measurement* (IAS 39). Bank A enters into an agreement to sell its investment in Company B to European bank, Bank F. At the time of the sale, Bank A also enters into a net-cash-settled total return swap agreement with Bank F, which effectively transfers to Bank A all of the risks and rewards of owning Company B shares. The transfer is deemed to meet all the criteria in paragraph 9 of Statement 140 because i) the transferred assets have been legally isolated from Bank A, ii) Bank F has the right to exchange the assets, and iii) Bank A does not maintain effective control over the transferred assets. Under Statement 140, Bank A should derecognize its investment in Company B upon the transfer and recognize the related gain or loss in earnings. However, under IAS 39, Bank A cannot derecognize its investment in Company B because the risk and rewards of owning Company B's common stock have been substantially retained by Bank A through the net-cash-settled total return swap entered into with Bank F. Under IAS 39, Bank A shall continue to recognize its investment in Company B's common stock and shall recognize a financial liability for the consideration received.

Convergence Update

The IASB and the FASB initiated in 2005 a project to develop a new approach to derecognition under the Roadmap of Convergence between U.S. GAAP and IFRS. The initial phase of the project focuses on financial assets. In July 2008, the IASB moved the project from its research agenda to its active agenda.³

Available for Sale (AFS) Securities and Impairment Recognition Other-Than-Temporary Impairment Compared to a Recognized Loss Event

Under U.S. GAAP (i.e., Statement 115), an entity recognizes an impairment loss on an AFS security if a decline in fair value below amortized cost is other than temporary. Paragraph 16 of Statement 115 provides that an investment in a debt security is considered other-than-temporarily impaired if it is probable that the investor will not be able to collect all amounts due on the security. SEC Staff Accounting Bulletin Topic 5.M, *Other Than Temporary Impairment of Certain Investments in Debt and Equity Securities*, clarifies that an other-than-temporary impairment is required if it is probable that an entity will not be able to realize an amount equal to or greater than the carrying value of the investment. Under U.S. GAAP, several sources provide interpretive guidance on when a security is considered other-than-temporarily impaired. Regardless of which source of impairment guidance is applicable for a particular security, under U.S. GAAP, an other-than-temporary impairment must be recognized if it is probable that the investor will not (1) collect all amounts contractually due on a debt security or (2) recover an amount equal to or greater than the carrying value of the security.

IFRS (i.e., IAS 39) does not focus on whether it is probable that all amounts due will be collected or whether an amount equal to or greater than carrying value will be realized. Instead, paragraph 59 of IAS 39 indicates that a financial asset is considered impaired and an impairment loss is recognized “if, and only if, there is objective evidence of impairment as a result of one or more [triggering] events...” (i.e., loss events). Paragraph 59 of IAS 39 provides various examples of objective evidence supporting the occurrence of a loss event for use in determining whether impairment has occurred, including the following:

1. Significant financial difficulty of the issuer or obligor;
2. A breach of contract, such as a default or delinquency in interest or principal payments;
3. The lender, for economic or legal reasons relating to the borrower's financial difficulty, granted to the borrower a concession that the lender would not otherwise consider;
4. An increasing probability that the borrower will enter bankruptcy or other financial reorganization;
5. The disappearance of an active market for that financial asset because of financial difficulties; or
6. Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets.

In addition to the above events, paragraph 61 of IAS 39 provides the following examples of objective evidence that indicates that the cost of an investment in an equity instrument may not be recovered and an impairment loss should be recognized when:

- A significant change “in the technological, market, economic or legal environment in which the issuer operates...” that has an adverse effect or
- “A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost...”

Reversing Recognized Impairments

Under U.S. GAAP, once an investment in a security is considered other-than-temporarily impaired, the new cost basis of the previously impaired security cannot be adjusted for subsequent recoveries in the value of the security.

Under IFRS, paragraph 65 of IAS 39 provides that for investments in debt securities classified as AFS, a previously recognized impairment loss may be reversed through earnings if, in a subsequent period, the amount of the impairment loss decreases and the decrease can be objectively related to an event occurring after the impairment was recognized (e.g., an improvement in credit rating). A recovery of an impairment loss is reversed by crediting earnings and debiting the carrying amount to the investment. Like U.S. GAAP, impairments on investments in equity instruments that are classified as AFS cannot be reversed.

Financial Statement Effect

The timing of the recognition and reversal of an impairment loss for AFS securities can affect net income and/or equity. The result on regulatory capital could be similar to that of loan impairments, as previously discussed.

Convergence Update

The IASB⁷ current projects on financial instruments do not give a clear indication of addressing topics related to impairment of available-for-sale securities.

Fair Value of Financial Instruments⁴

In general, U.S. GAAP (i.e., Statement 157) provides more comprehensive guidance on fair value measurements than IFRS does. Unlike U.S. GAAP, IFRS does not currently have one comprehensive fair value measurement standard. Rather, fair value measurement guidance in IFRS is spread throughout various accounting standards; however, most financial assets and financial liabilities are within the scope of IAS 39 and IAS 39's fair value measurement guidance is applicable to all assets and liabilities within its scope and the scope of IFRS 7 and IAS 32.

Fair Value at Initial Recognition (Inception)

Inception gains and losses occur when a reporting entity enters into a transaction at a price other than the one that it initially recognizes in its financial statements as the transaction's fair value.

Under U.S. GAAP, the use of the exit price is required for all fair value measurements, both at initial recognition and in subsequent measurements. When an exit price is used to determine fair value, the fair value of an asset or liability at inception may be an amount other than the transaction price (entry price). This could occur, for example, because the exit price is based on a market different from that of the entry price. Paragraph 17 of Statement 157 includes a list of other circumstances in which the transaction price may not represent fair value at initial recognition. However, paragraph 17 does note that "[i]n many cases, the transaction price will equal the exit price and, therefore, represent the fair value of the asset or liability at initial recognition."

IAS 39 requires an entity to determine fair value on the basis of the asset's or liability's exit price, except at initial recognition. Paragraph AG64 of IAS 39 states, in part, "The fair value of a financial instrument on initial recognition is normally the transaction price . . ." Paragraph AG 76 elaborates on this point by requiring the use of the transaction price for fair value at initial recognition "unless the fair value of that instrument is evidenced by comparison with other observable current market transactions in the same instrument (i.e., without modification or repackaging) or based on a valuation technique whose variables include only data from observable markets." This concept is similar to the inception gain or loss guidance that previously existed in EITF Issue No 02-3, *Issues Involved in Accounting for Derivatives Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities*, which was superseded by Statement 157.

Valuation Techniques: Mid-Market Pricing Versus Bid-Ask Pricing

IFRS and U.S. GAAP differ when determining the expedients for fair value measurement used in valuation techniques. Under U.S. GAAP, an entity must use the price within the bid-ask spread that is most representative of fair value in the circumstances. However, it does permit an entity to use mid-market pricing as a practical expedient (Statement 157, paragraph 31).

Paragraph AG72 of IAS 39 allows the use of mid-market pricing **only** when determining risk fair value for offsetting risk positions. In all other circumstances, the guidance assumes the use of the bid price for assets and the ask price for liabilities.

Fair Value Hierarchy

Statement 157 established a fair value hierarchy. The hierarchy classifies valuation technique inputs into the following three broad levels:

- Level 1 – Inputs based on quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 – Inputs based on observable market information.
- Level 3 – Inputs based on unobservable information.

This hierarchy was established to develop increased consistency and comparability within and between reporting entities. Paragraph 21 of Statement 157 requires entities to use valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs.

IAS 39 classifies fair value measurements into two broad⁵ categories:

- Quoted prices in active markets; and
- Fair values determined by using valuation techniques (i.e., in the absence of an active market).

IAS 39 requires reporting entities to use quoted prices in active markets when available. Paragraph AG71 of IAS 39 states, "The existence of published price quotations in an active market is the best evidence of fair value and when they exist they are used to measure the financial asset or financial liability." The IAS 39 requirement is similar to the requirement in paragraph 24 of Statement 157, which states, "A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available. . .". In the event that an active market does not exist, Paragraph AG75 of IAS 39 requires that if a valuation technique is used, the valuation technique should make maximum use of market inputs and rely as little as possible on entity-specific inputs.

Financial Statement Effect

On adoption of IFRS, the measurement of the fair value of certain financial assets and financial liabilities could differ and could affect net income and/or equity depending on the classification of the financial instrument (e.g., trading, fair value through P&L, or available for sale).

Convergence Update

The IASB⁶ has undertaken a project to develop and issue an IFRS on fair value measurement guidance. The project is part of the Memorandum of Understanding between the IASB and the FASB, which sets out a roadmap of convergence between the IFRS and U.S. GAAP. The IASB's stated objective in its fair value project is to establish a single standard that provides uniform fair value measurements, clarifies the definition of fair value, and enhances disclosures about fair value. Such objectives appear to be consistent with Statement 157, although the IASB has stated that the new

standard might differ in its requirements and wording. Guidance is expected to be issued in 2010 to address the differences highlighted above.

Hedge Accounting

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (Statement 133), as amended, is the primary source of guidance on derivative instruments and hedge accounting. Other sources of hedge accounting guidance in U.S. GAAP include the Statement 133 Implementation Issues (DIG Issues).

Under IFRS, IAS 39 is the primary source of guidance on derivative instruments and hedge accounting. Other hedge accounting guidance in IFRS includes the illustrative examples in Appendix A of IAS 39 and Section F of "Guidance on Implementing IAS 39, Financial Instruments Recognition and Measurement."

Both U.S. GAAP and IFRS have general requirements for hedge accounting as well as requirements for specific types of hedging relationships (i.e., a fair value hedge or a cash flow hedge, including foreign currency hedges, or a hedge of a net investment in a foreign operation). There are numerous hedging differences between U.S. GAAP and IFRS. For example, U.S. GAAP, particularly the DIG issues, provide significantly more detailed guidance than IFRS do on issues that are sometimes highly technical and not broad-based. With that being said, there are two notable differences: 1) portfolio hedge of interest rate risk and 2) short-cut method.

Portfolio Hedge of Interest Rate Risk

Both IFRS (paragraph 78 of IAS 39) and U.S. GAAP (paragraph 21(a) (1) of Statement 133) permit an entity to designate a portfolio of similar assets and liabilities as a hedged item as long as the individual assets and liabilities within that portfolio share the risk exposure for which they are being hedged. Paragraph 21(a)(1) of Statement 133 provides quantitative guidance on how to determine whether assets or liabilities within a portfolio are similar; IAS 39 does not provide similar guidance.

Paragraphs 81A, 89A, and AG114–AG131 of IAS 39 provide a special hedge accounting method for "a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities." This method allows the hedged item to be designated as an amount of a currency (e.g., an amount of U.S. dollars or euros) instead of as individual assets or liabilities. However, this amount must be an amount of assets or an amount of liabilities; an entity is not permitted to designate a net amount. U.S. GAAP does not allow a currency amount to be designated as the hedged item in a fair value hedge of a portfolio of similar assets or liabilities.

Shortcut Method

IFRS does not permit the use of the shortcut method for assessing hedge effectiveness. Under paragraph AG106 of IAS 39, effectiveness must be assessed whenever the entity prepares its interim or annual financial statements.

Under U.S. GAAP, the use of a shortcut method for assessing effectiveness is permitted as long as specific criteria are met in the hedging relationship. Paragraph 68 of Statement 133 lists the specific eligibility requirements for applying the shortcut method. When an entity is eligible for, and applies, the shortcut method, it assumes that the hedging relationship has no ineffectiveness. A number of DIG Issues also interpret how to apply the shortcut method.

Financial Statement Effect

On adoption of IFRS, hedging criteria can result in a different (whether greater or fewer) number of financial instruments qualifying for hedge accounting. Accordingly, there will be resulting effects on net income and/or equity.

Convergence Update

In June 2008, the FASB issued a proposed statement, or exposure draft, "Accounting for Hedging Activities – an amendment of FASB Statement No. 133." There are preliminary indications that the FASB may combine its hedging project with the broader, longer-term, joint effort with the IASB – entitled, "Reducing Complexity in Reporting Financial Instruments." The FASB issued an invitation to comment on this effort in March 2008 – and comments were due in September 2008.

Offsetting of Financial Instruments

U.S. GAAP, primarily FASB Interpretation No. 39 (Interpretation 39) and FASB Interpretation No. 41 (Interpretation 41) and IFRS, primarily International Accounting Standards No. 32, (IAS 32), are similar in many respects. For example, both sets of accounting principles provide that a right of offset generally exists when a reporting entity's right of offset is legally enforceable *and* the reporting entity intends to settle net. However, despite the similarities, there are key differences.

Offsetting Election

Under U.S. GAAP, reporting entities are permitted but not required to offset financial assets and liabilities when certain conditions are met (Interpretation 39, paragraph 5). The guidance under Interpretation 39 results in an accounting policy choice that must be applied consistently. However, according to IAS 32, when the conditions are met, the reporting entity is required to offset the relevant financial assets and liabilities (IAS 32, paragraph 42). As a result of this difference, an entity reporting under both set of accounting frameworks may present financial assets and liabilities differently. For example, under U.S. GAAP an entity may elect not to offset qualifying assets and liabilities with a given counterparty; however, IFRS would require the assets and liabilities to be presented net.

Intent to Offset

There are exceptions to the "intent to set off" criterion provided by U.S. GAAP for certain contractual relationships under master netting agreements. Interpretation 39, under paragraph 10, states that without regard to the "intent to set off" criterion under its paragraph 5(c), a reporting entity may offset fair value amounts recognized for derivative instruments and fair value amounts recognized for the right to reclaim cash collateral or the obligation to return cash collateral arising from derivative instruments recognized at fair value executed with the same counterparty under a master netting agreement. Similarly, paragraph 3 of Interpretation 41 provides an exception for certain amounts recognized as payable under repurchase agreements or receivable under reverse repurchase agreements executed with the same counterparty under a master netting agreement. IFRS does not provide any exceptions to the "intent to set off" criterion.

Offsetting Third-Party Debtor Against a Different Creditor

Under IFRS IAS 32 (paragraph 45), in unusual circumstances a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided there is an agreement between the three parties that clearly establishes the debtor's right of set-off. It further provides that because the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another and the laws applicable to the relationships

between the parties need to be considered. U.S. GAAP does not have similar guidance and does not permit offsetting amounts due from a third party against amounts due to a different creditor. Paragraph 5 of Interpretation 39 explicitly requires that the right of setoff exist between “each of two parties.” Thus, an entity applying U.S. GAAP is not permitted to set off amounts owed by a third-party debtor against an amount owed to a different creditor.

Financial Statement Effect: On adoption of IFRS, certain financial assets and liabilities may need to be shown net or gross in the balance sheet or vice versa, resulting in increases and/or decreases in total assets and total liabilities. The following provides an example of the differences in master netting agreements.

Bank X, an investment bank, enters into several swap transactions with different reset dates to manage the interest rate risk arising from its corporate loans portfolio. Although these transactions are with a range of other banks as counterparties, Bank X’s systems aggregate all exposures on a daily basis to enable them to recognize the net profit or loss due to the change in fair value of all open (i.e., unexpired) contracts. Certain contracts have a positive fair value while others have a negative fair value (i.e., are in a loss position). ISDA Master Netting Agreements are in place with some, but not all of these counterparties. Bank X does not net settle across swap positions with counterparties on reset dates. Bank X does not meet the IFRS criteria for offsetting financial assets and liabilities related to its swap positions. It does not settle on a net basis and, due to the mismatch in reset dates across its swaps book, cannot demonstrate the simultaneous settlement of swap cash flows. Additionally, the ISDA Master Netting Agreements are not, in themselves, sufficient to provide the Bank with the legal right to set off its settlement cash flows across contracts except in the conditional event of default or termination by one of the parties.

As a result of the exemptions provided by Interpretation 39, these derivatives could be netted under U.S. GAAP, but not under IFRS.

Convergence Update

The IASB’s current projects regarding financial instruments do not directly address the differences in the offsetting of financial instruments (i.e., netting of assets and liabilities). The IASB and FASB have undertaken a joint project to establish a common standard for presentation of information in the financial statements. Phase B of the project, which addresses fundamental issues such as consistent principles for aggregating information in each financial statement, has been initiated and a discussion paper was issued on October 16, 2008. The discussion paper is open for comment until April 14, 2009.

Loan Impairment

Under U.S. GAAP, the primary guidance for the recognition of impairment of loans accounted for on an amortized cost basis is FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan – an amendment of FASB Statements No. 5 and 15* (Statement 114), and FASB Statement No. 5, *Accounting for Contingencies* (Statement 5). IFRS impairment guidance for such loans is found in IAS 39, *Financial Instruments: Recognition and Measurement* (IAS 39).

Impairment Evidence Compared to Loss Event

Similar to IAS 39, U.S. GAAP employs different accounting methods depending on whether impairment is evaluated on a single asset or on a group of similar assets. An entity assesses larger loans regularly for evidence of impairment on an item-by-item basis (Statement 114). If the entity concludes that an individual loan is impaired, it generally

measures the amount of impairment in a similar way as in IAS 39. Additionally, an entity is required to assess homogeneous groups of loans collectively for impairment in accordance with Statement 5. Unlike IAS 39, Statement 5 does not require expected cash flows to be discounted in measuring impairment for groups of loans. Compared with IAS 39, U.S. GAAP contains less prescriptive guidance about how to measure the impairment of groups of loans. SEC and U.S. bank regulators have emphasized that arriving at an appropriate allowance involves a high degree of judgment and results in a range of estimated losses (EITF D-80). Banks should continue to maintain prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses. The overall allowance should appropriately reflect a margin for imprecision inherent in most estimates of expected credit losses.

Under U.S. GAAP, a loan is considered impaired if it is probable that the creditor will be unable to collect all amounts due according to the contractual terms (paragraph 8 of Statement 114), where probable means “likely to occur” (paragraph 3 of Statement 5).

Under IFRS, rather than focus on whether it is probable that all amounts due will be collected, an entity must determine whether there is objective evidence that impairment exists (paragraph 58 of IAS 39). A financial asset is impaired if there is objective evidence of impairment as a result of one or more events that occurred after initial recognition of the asset (“a loss event”). A loss event must have an effect on future cash flows that can be reliably estimated. Paragraph 59 of IAS 39 provides the following examples of loss events:

- Significant financial difficulty of the issuer or obligor;
- A breach of contract, such as a default or delinquency in interest or principal payments;
- The lender, for economic or legal reasons relating to the borrower’s financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- It is becoming probable that the borrower will enter bankruptcy or other financial reorganization;
- The disappearance of an active market for that financial asset because of financial difficulties; or
- Observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets.

IAS 39 includes additional guidance – guidance not included within U.S. GAAP – for evaluating and measuring impairment of a portfolio of financial assets. This guidance addresses issues such as:

- How to group financial assets for purposes of a collective evaluation of impairment (paragraphs 64, AG87, and BC122-BC123 of IAS 39). Financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors’ ability to pay all amounts due (e.g., on the basis of a credit risk evaluation or grading process). If an entity does not have a group of assets with similar risk characteristics, it does not make a collective evaluation of impairment.
- How to estimate future cash flows in a group of financial assets that are collectively evaluated for impairment (paragraphs AG89-AG91 and BC124 of IAS 39). Future cash flows are estimated based on historical loss experience for assets with credit risk characteristics similar to those in the group adjusted on the basis of current observable data. Entities that have no or insufficient loss experience use peer-group experience for comparable groups of financial assets.

- The use of formula-based approaches or statistical methods (paragraphs AG92 of IAS 39). The approach or method used incorporates the effect of the time value of money and considers the cash flows for all of the remaining life of an asset (not only the next year).

Financial Statement Effect

The adoption of IFRS may result in differing loan loss analyses and provisions for loan losses/credit reserves.

Risk Disclosures

IFRS 7 requires disclosure of (a) the significance of financial instruments for an entity's financial position and performance; and (b) qualitative and quantitative information about exposure to risks arising from financial instruments, including specified minimum disclosures about credit risk, liquidity risk, and market risk. The qualitative disclosures describe management's objectives, policies, and processes for managing those risks. The quantitative disclosures provide information about the extent to which an entity is exposed to risk, based on information provided internally to the entity's key management personnel.

The qualitative and quantitative information about exposure to risks arising from financial instruments was developed so as to meet the Basel Committee disclosure guidance for banks (so called "Pillar III" of Basel II) to allow banks to prepare a single set of coordinated disclosures about financial risk. (Note: Only a subset of the largest U.S. banking organizations are required to implement Basel II, as outlined in the final rules published in late 2007.)

Disclosure requirements relating to the significance of financial instruments for an entity's financial position and performance can be found in a number of FASB standards (e.g., Statement 157, Statement 133, Statement 115, Statement 114, and Statement 118). Three disclosures with varying treatment between U.S. GAAP and IFRS include the disclosures required by paragraphs 27(c) and 28 of IFRS 7 are (1) a sensitivity analysis of unobservable assumptions for those fair value measurements that were determined using a valuation technique, (2) the accounting policy for recognizing inception gains and losses, and (3) a reconciliation of the change in the period in the aggregate difference yet to be recognized for inception gains and losses. U.S. GAAP does not require similar disclosures.

Disclosure requirements relating to qualitative and quantitative information about exposure to risks arising from credit risk, liquidity risk, and market risk is primarily found in SEC guidance. For example, market risk disclosure guidance is found in SEC Regulation S-K, Item 305, Quantitative and Qualitative Disclosure About Market Risk, and liquidity risk disclosure guidance is found in Item 301 Management Discussion and Analysis of Financial Condition and Results of Operations, and in the Securities Act Industry Guide 3, Statistical Disclosure by Bank Holding Company. Additionally, credit risk disclosure requirements and suggested market risk disclosure can also be found in paragraphs 15A, 15C, and 15D of Statement 107.

Qualitative Disclosures

Paragraphs 31 and 32 of IFRS 7 require an entity to disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the reporting date. These risks typically include, but are not limited to, credit risk, liquidity risk, and market risk. The disclosure should be prepared based on management's view of the entity's risks arising from financial instruments.

Credit Risk

IFRS 7 requires an entity to disclose the following information related to credit risk (by class of financial instrument):

- The amount that best represents its maximum exposure to credit risk at the reporting date without taking into account any collateral held or other credit enhancements;
- A description of collateral held as security and other credit enhancements;
- Information about the credit quality of financial assets that are neither due nor impaired, and
- The carrying amount of financial assets that would otherwise be past due or impaired whose terms have been renegotiated.

Liquidity Risk

IFRS 7 requires that entities disclose the following information related to liquidity risk:

- A maturity analysis for financial liabilities that shows the remaining contractual maturities, and
- A description of how it manages the liquidity risk inherent in the above.

Market Risk

IFRS 7 requires that entities disclose the following information related to market risk:

- A sensitivity analysis for each type of market risk to which the entity is exposed at the reporting date, showing how profit or loss and equity would have been affected by changes in the relevant risk variable that were reasonably possible at that date;
- The methods and assumptions used in the preparing the sensitivity analysis; and
- Changes from the previous period in the methods and assumptions used, and the reasons for such changes.

(If an entity prepares a sensitivity analysis, such as value-at-risk, which reflects interdependencies between risk variables and the entity uses that analysis to manage financial risks, the entity may use that sensitivity analysis in place of the above.)

Unlike IFRS 7, SEC guidance and/or U.S. GAAP contains qualitative risk disclosure guidance in a number of rules/standards, including Statement 107, Statement 114, Statement 140, Statement 161, and SEC Regulation S-K Items 303 and 305. Overall, the risk disclosures required under IFRS 7 above are similar to those required under U.S. GAAP and SEC guidance; however, some of the disclosures may be presented within the financial statements of the entity or within the Management Discussion & Analysis section of an SEC registrant's annual and quarterly reports. Under IFRS, these disclosures are either provided in the financial statements or incorporated by clear cross-reference from the financial statements to some other statement and such a report must be available to users on the same terms as the financial statements and be available at the same time. Under IFRS, disclosures relating to risks arising from financial instruments will now form part of the audited financial statements and will be under greater scrutiny and require an appropriate audit trail/documentation and level of review by external auditors. Therefore, the adoption of IFRS 7 provides SEC registrants and/or U.S. GAAP reporters an opportunity to revisit their qualitative disclosures and provide more cohesive and comprehensive information to the financial statement users.

Convergence Update

As previously mentioned, the IASB published for public comment on October 15, 2008, proposals to improve the information available to investors and others about fair value measurements of financial instruments and liquidity risk. The exposure draft, *Improving Disclosures about Financial Instruments (proposed amendments to IFRS 7)*, is open for public comment until December 15, 2008.

Technical accounting and financial reporting differences will be numerous and challenging, but an IFRS conversion is not only an exercise in reshuffling the chart of accounts or addressing technical accounting and financial reporting matters. In fact, your institution is likely to spend a significant amount of time addressing concerns regarding matters other than accounting and financial reporting.

Endnotes

- ¹ The IASB recently issued an Exposure Draft, *Improving Disclosures about Financial Instruments (Proposed amendments to IFRS 7)*. The proposed amendments would affect the fair value and liquidity risk disclosures in accordance with IFRS 7 *Financial Instruments: Disclosures*. The proposals would:
 - Introduce a three-level hierarchy when disclosing fair values (comparable to the U.S. GAAP hierarchy)
 - Require reconciliations of balances for fair values using unobservable market inputs
 - Require reconciliations of movements between the levels (including reasons)
- ² On September 15, 2008, the FASB issued three separate, but related, exposure drafts (EDs) – one of which is a FASB Staff Position (FSP) - that would amend Statement 140 and Interpretation 46(R), by eliminating the concept of a QSPE from Statement 140, delete the related scope exceptions from Interpretation 46(R), and require additional disclosures about transfers of financial assets. As proposed in the EDs, the FASB statements would be effective at the beginning of each reporting entity's first fiscal year that begins after November 15, 2009. The effective date for the proposed FSP would be the first reporting period (interim and annual) that ends after issuance of the FSP for public entities. The Board expects that this FSP would be issued in the fourth quarter of 2008 which means that it would be effective for financial statements issued as of December 31, 2008, for calendar year end, public entities.
- ³ It is anticipated that the IASB will issue an exposure draft to amend IAS 27 and SIC-12 in November 2008 with a comment period that likely will last 120 days.
- ⁴ On October 10, 2008, the FASB issued FASB Staff Position 157-3 (FSP 157-3). FSP 157-3 clarifies the application of Statement 157 in a market that is not active. For additional information, please see Deloitte's Head's Up publication, "What Is Fair in This Market?"
- ⁵ As previously mentioned, the IASB recently published an exposure draft that proposed three categories of fair value measurement which are generally consistent with U.S. GAAP.
- ⁶ In response to the recommendations of the Financial Stability Forum in its report entitled, "Enhancing Market and Institutional Resilience," the IASB formed an expert advisory panel. The IASB consulted with members of this panel to identify practices that experts use for measuring and disclosing financial instruments when markets are no longer active.
- ⁷ *American Banker*, Bank and Thrift Holding Companies with the Most Assets on Dec. 31, 2006.
- ⁸ *National Mortgage News*, Largest Home Mortgage Originators in 2006.
- ⁹ *Card Source One*, Credit Card Issuers Ranked by Receivables 2005.
- ¹⁰ *Securities Industry Association 2006-2007 Directory*.
- ¹¹ *Fortune*, April 2007.

Resources

Deloitte has extensive IFRS experience serving banks and capital markets institutions. With thousands of IFRS-experienced professionals in our global network, we provide a comprehensive array of services related to IFRS and, as a multidisciplinary organization, are positioned to assist companies in addressing a wide range of IFRS issues.

Deloitte offers companies assistance with:

- Evaluating the potential effects of IFRS
- Assessing readiness for IFRS conversions
- Implementing IFRS conversions, providing support with technical research, project management, and training
- Addressing the implications of IFRS in such areas as tax, finance operations, technology, and valuation

Deloitte's Banking and Securities Practice:

As a recognized leader in providing audit, tax, consulting and financial advisory services to the banking and capital markets industry, our clients include full-service broker-dealers, retail and online brokerage companies; national and regional boutique firms; investment banks; electronic communications networks and exchanges; commercial, community, mortgage and foreign banks; thrifts; finance companies; and credit unions in the United States and around the world. Our multi-disciplinary approach allows us to provide regional, national and global services to our clients. Our banking and capital markets practice is recognized for bringing together teams with diverse experience and knowledge to provide customized solutions for all clients.

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The Deloitte U.S. Firms serve:

- All of the top 25 banks in the United States⁷
- 60 percent of the top 20 mortgage servicers and 75 percent of the top 20 mortgage originators⁸
- Eight of the 10 largest credit card issuers⁹ and two of the world's leading full-service payment networks
- More than 95 percent of the top 25 full-service securities firms¹⁰
- All but two of the 17 securities firms listed on the 2007 Fortune 1000 – and audit six¹¹

Deloitte's Online Resources

For a wealth of online resources related to IFRS, visit www.deloitte.com/us/ifrs or www.iasplus.com. Available materials include newsletters, whitepapers, pocket guides, timelines, webcasts, podcasts, and more.

International Accounting Resources

The International Accounting Standards Board (IASB) provides additional guidance. Visit the IFRS section of www.iasb.org for additional details and copies of the standards.

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