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IFRS Insights

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IFRS Newsletter for U.S. Companies

SEC Issues Proposed IFRS Roadmap

Long awaited

The Securities and Exchange Commission (SEC) issued its long-awaited proposed IFRS roadmap for public comment on November 14, 2008. While recent events related to the global financial turmoil may have delayed the SEC's issuing the roadmap, these current events also highlight the need for high-quality global accounting standards.

Indeed, over the weekend of November 15th, the leaders of the G-20 met in Washington D.C. to discuss the current financial crisis to develop an action plan to prevent recurrence. One undertaking that emerged from this meeting was that "the key global accounting standard bodies should work intensively toward the objective of creating a single high-quality global standard."

The roadmap emphasizes the importance of IFRS, noting that IFRS has the potential "to best provide the common platform on which companies can report and investors can compare financial information." Presented here is an update on the SEC's proposed roadmap, rule changes, and what it means for U.S. companies.

The Proposed Roadmap

The roadmap — for the potential use of IFRS by U.S. issuers — outlines milestones that, if achieved, could lead to mandatory transition to IFRS starting for fiscal years ending on or after December 15, 2014. It also provides an early adoption election for a limited number of U.S. issuers beginning in 2009.

The seven milestones are consistent with the milestones reported following the late August SEC meeting. These include: the continued improvement of IFRS, the accountability and funding of the International Accounting Standards Committee Foundation, the improvement in the ability to use interactive data for IFRS reporting (i.e., XBRL), and education and training of constituents. (See the sidebar, "IFRS Roadmap Milestones," for a brief summary.)

The roadmap is subject to a 90-day comment period once posted in the Federal Register — at which point, the SEC will be able to formally review responses from companies, investors, analysts, accounting professionals, and others. Based on this

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SEC Issues Proposed IFRS Roadmap (cont.)

Long awaited

time line, comments will be due in mid to late February. The SEC will consider comments received before voting on a final release, which it intends to publish in its Codification of Financial Reporting Policies.

IFRS Roadmap Milestones

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. Details on eligibility and filing requirements are described below.
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.

The roadmap outlines a phased-in approach to mandatory adoption of IFRS. Large accelerated filers would be required to use IFRS beginning for fiscal periods ending on or after December 15, 2014, followed by accelerated filers in 2015, and non-accelerated filers in 2016.

In 2011, the SEC would consider the progress made on these milestones before voting on a final rule for the mandatory use of IFRS by U.S. issuers. Once that decision is made, the SEC also may examine the possibility of opening up the option for eligibility to file in IFRS to a larger group of issuers.

As part of the transition to IFRS, the roadmap would provide a limited number of U.S. issuers the option to adopt IFRS before it is mandated. To be eligible for early adoption, an issuer would need to meet the following criteria:

- 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 Accounting Standards Board (IASB), are 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.

The roadmap provides some flexibility in determining the eligibility criteria and introduces judgment into the process. Those companies that can demonstrate they meet the eligibility criteria and obtain a "letter of no objection" from the commission staff would be able to use IFRS in financial statements in fiscal years ending on or after December 15, 2009. An overview follows:

Determining Eligibility: Under the proposed rule, a U.S. issuer would first need to ascertain its industry group by using either: the North American Industry Classification System (NAICS) code at the three-digit level, the Standard Industrial Classification (SIC) codes at the two-digit level, or the International Standard Industrial Classification (ISIC) codes at the "Division" level. Alternatively, the issuer could use a privately provided, published, and widely accepted industry classification scheme at a similar level of detail, such as the Industry Classification Benchmark (ICB) at the "Sector" level or the Global Industry Classification Standard (GICS) at the "Industry" level. For classifications of individual companies, the issuer must use a single published and widely accepted industry source.

The SEC estimates that under the two-digit SIC code method, at least 110 U.S. issuers in 34 industries would be currently eligible to use IFRS in accordance with the proposed criteria as of December 31, 2007. The overall number of eligible companies could be higher, however, because companies could use different industry classification systems to determine eligibility. In addition, currently noneligible industries may become eligible as foreign companies within those industries transition to IFRS. For example, assuming Brazil, Canada, Chile, and South Korea use IFRS (which is expected in the next couple of years), the number of eligible U.S. issuers using the SEC's method would increase to 160, representing approximately 23 percent of the market capitalization in the United States.

Letter of No Objection to use IFRS: According to the roadmap, issuers that are eligible to use IFRS would need to obtain a "letter of no objection" from the SEC's Division of Corporation Finance. U.S. issuers would submit to the SEC their analysis for eligibility. The SEC staff would then review the analysis and, if it does not object to the issuer's conclusion, would issue a letter of no objection that would permit the issuer to use IFRS in SEC filings. Receiving a no-objection letter would provide an issuer with the ability to begin filing financial statements using IFRS anytime during a three-year period from the date of the letter. However, an issuer that receives such a letter would not be obligated to use IFRS. An issuer's submission, along with the SEC staff's letter of no objection, would be made public on the SEC's Web site. The submission would not be made public if the SEC staff does not issue a letter of no objection.

For further information and details on the SEC's proposed IFRS roadmap and rule changes, see "Heads Up: SEC Issues Proposed IFRS Roadmap," November 17, 2008.

Making It Happen: Tax Matters

Share-based compensation plans and IFRS

When it comes to adopting IFRS, the challenges — and opportunities — extend well beyond accounting and financial reporting. A shift from U.S. GAAP to IFRS will have a significant impact on share-based compensation plans, requiring companies to carefully examine tax issues, including the potential change in pretax financial statement income and the impact on taxation.

As companies assess or prepare for a shift from U.S. GAAP to IFRS, key differences between the standards that affect tax issues related to share-based compensation plans will need to be understood. Consider the following areas:

- **Income tax accounting — Expect volatility in the income statement, balance sheet, and effective tax rate.** Under U.S. GAAP, the deferred tax asset (DTA) for a stock option is determined based on the option's fair value on the date the option is granted. Under IFRS, the deferred tax asset (DTA) is based on the tax deduction that would be available based on the current share price 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." What does this mean for financial reporting? Because the DTA for share-based payments under IFRS is remeasured at each reporting date, fluctuations in the fair value of the stock will result in an adjustment to the DTA that can cause volatility in the effective tax rate.

- **Valuation and expense amortization — Avoid unwanted surprises.** While book compensation expense for options under both IFRS and U.S. GAAP is calculated using a valuation model, the accounting for share-based payments with graded vesting will likely result in a different impact to pre-tax financial statement income under IFRS. . A tranche-by-tranche valuation generally results in a higher value for the later-vesting tranches (i.e. a long-term option is generally more valuable than a short-term award), and the later vesting tranches are more often forfeited than the earlier tranches.

- **Balance sheet classification — Liability awards and income statement volatility.** Under both IFRS and U.S. GAAP, a liability classified award is accounted for differently than an equity classified award in that a liability classified award must be recorded at its current fair value at each reporting date. The rules for determining the appropriate classification as a liability or equity award, however, differ between the two sets of standards. These differences stem from inherent differences in the classification models between the two sets of standards and certain exceptions that are allowed under U.S. GAAP that may not be allowed under IFRS. Share-based payment awards that are classified as liability awards will cause volatility in the financial statements as the expense recognized for the award over its vesting period must be recorded at its fair value at each reporting period end. With the difference in classification determination, companies should pay particular attention to the terms of the share-based payment awards issued and ensure they understand how the terms may impact the classification under the two sets of standards.

- **Payroll tax accounting — Prepare for new administrative requirements.** Under U.S. GAAP, companies recognize a payroll tax liability for share-based compensation when the liability arises — that is, when options are exercised. Under IFRS, companies will recognize an accrued liability for payroll taxes as the options vest. The implication for share-based compensation? Under IFRS, a company will accrue social security taxes (or similar tax obligations in foreign jurisdictions) related to share-based payments at each reporting date — a difference that may create significant process changes for some organizations.

The complexity of these issues requires sufficient lead time for analysis, as well as careful coordination among tax, human resources, finance, and other functions to understand the implications and determine the most appropriate courses of action.

Steps to take now

Executives in human resources, tax, and finance will need to look closely at the share-based payment implications of an IFRS conversion. This assessment will require a coordinated assessment of the impact on financial reporting, potential modifications of existing equity compensation programs, and systems modifications that will be necessary to accommodate the new recordkeeping requirements. An analysis should include the following steps:

- Understand the potential impact of an IFRS conversion on the DTA and the effective tax rate.
- Estimate the transitional and post-adoption financial statement effect of conversion on amortization expense for share-based payments.
- Review the rules and processes required to support share-based compensation tax deductions in each country, including recharge reimbursements and transfer pricing implications.
- Assess financial system implications, including the reporting and recordkeeping systems of the share-based compensation plan administrator.
- Develop new processes and controls for the accrual of payroll tax liabilities for both domestic and cross-border employees.
- Conduct IFRS training for human resource, tax, and financial executives to prepare for the road ahead.

For more information on tax and IFRS, access these recent whitepapers from Deloitte Tax: "Share-based compensation plans and IFRS: Tax implications for financial reporting, systems, and plan design," "Global Tax Implications of IFRS: Key issues to consider now" and "IFRS for U.S. Companies: Tax implications of an accelerating global trend."

Technical Corner: IAS 17

Accounting for Leases

Lease accounting is complex and can have a significant impact on an entity's financial statements. Since IAS 17, "Accounting for Leases" focuses on the substance of a transaction rather than its form, it is an illustration of how the principle-based framework IFRS) differs from the rule-based approach (U.S. GAAP).

The "finance" and "operating" lease classifications in IAS 17 resemble their "capital" and "operating" lease counterparts described in SFAS 13, "Accounting for Leases." However, making the determination of classification under IAS 17 focuses on the transfer of risks and rewards of ownership and entails exercising more judgment. And SFAS 13 simply focuses on whether or not the lease meets one or more of the following criteria: 1) lease transfers ownership of the property to the lessee by the end of the lease term; 2) lease contains a bargain purchase option; 3) lease term equals 75% or more of economic life of leased property; and 4) present value of minimum lease payments equals 90% or more of leased asset's fair value.

In addition to not having these "bright-line" measurements, several other differences between IAS 17 and SFAS 13 to note include:

- **Scope** — With certain exceptions, IAS 17 applies to leases involving all assets, while SFAS 13 applies leases involving property, plant, and equipment.
- **Land and buildings** — IAS 17 considers these two separate items, except if the land element is not material. Whereas, under U.S. GAAP, land and buildings are generally accounted for as a single unit, unless land represents more than 25% of the total fair value of the leased property.
- **Present value of minimum lease payments** — Under IFRS, minimum leases payments are generally discounted using the lease's implicit rate. Similarly, U.S.GAAP requires lessors to discount minimum lease payments using the implicit rate. However, lessees under U.S. GAAP use the incremental borrowing rate to discount, unless the implicit rate is known and is lower.
- **Sale and leaseback transaction** — IFRS requires any gains or losses resulting from the leaseback of a finance lease be deferred and amortized over the lease term while for U.S. GAAP it depends on the seller's retained interest in the asset.

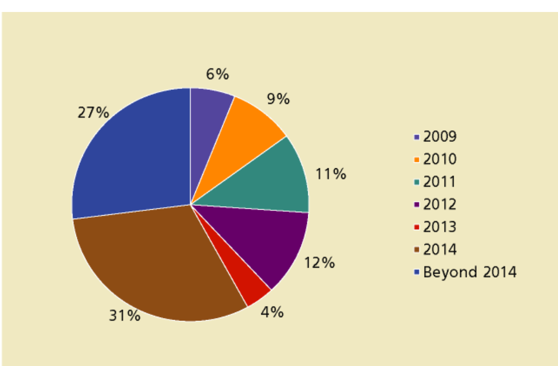
As a result of these fundamental differences, entities should begin to take an inventory of key quantitative and qualitative characteristics within each leasing arrangement to identify factors that could potentially indicate risk or ownership transfer, and could result in a different classification and/or accounting under IFRS.

IFRS Pulse Survey

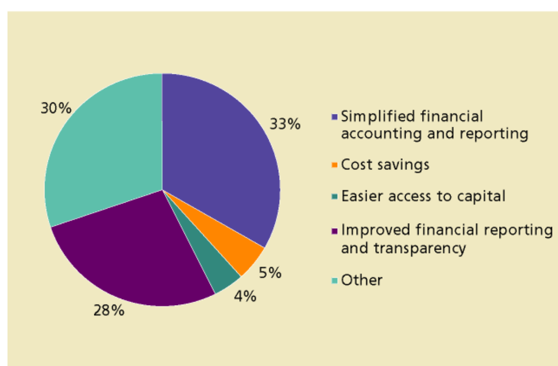
Preview of Results

The IFRS Solution Center recently launched a survey series aimed at gathering relevant marketplace information to help keep companies current on the latest IFRS trends. Over 200 financial executives responded. Here we highlight some of the results.[1] Interestingly, forty-two percent of respondents, if given the choice, would implement IFRS sooner than the SEC would mandate.

If permitted by the SEC, when would your company consider adopting IFRS?



What do you perceive as the most significant benefit to adopting IFRS for your company?

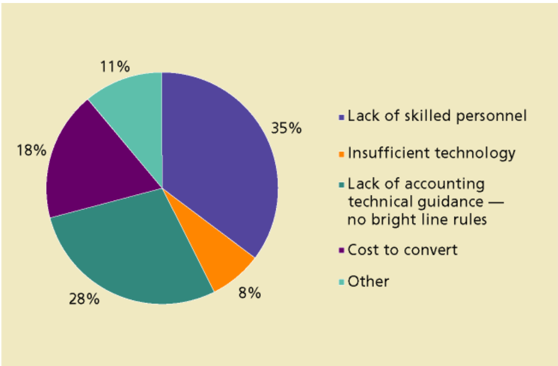


[1] The November Deloitte survey had over 200 respondents, which included financial professionals, CFOs and finance managers. The survey results presented herein are solely the thoughts and opinions of the survey participants and are not necessary representative of the full population of companies. However, we believe the results do provide valuable insight regarding the opinions and concerns of financial professionals in general as the results are consistent with the experience of Deloitte & Touche practitioners who have worked on related engagements with numerous companies. The goal of the November IFRS survey was to gauge relevant marketplace information on the latest IFRS trends.

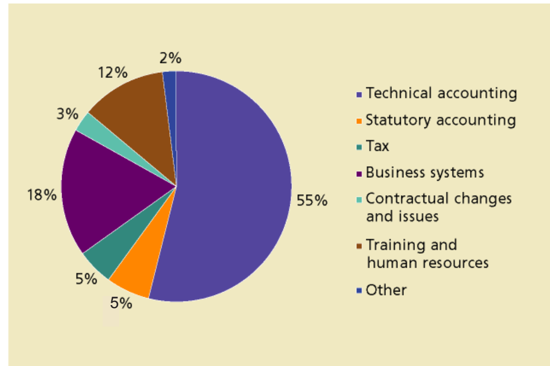
IFRS Pulse Survey (cont.)

Preview of Results

What do you perceive as the most significant challenge to adopting IFRS for your company?



Which area do you perceive as being most impacted by the conversion to IFRS for your company?



Upcoming IFRS Events

IFRS Two-Day Executive Training – December 15 & 16, 2008 - Deloitte offers a two-day IFRS executive training program to learn about key accounting issues and practical considerations related to IFRS implementation. CPE credit.

IFRS and Internal Audit - December 2, 2008 - Deloitte and The Institute of Internal Auditors (IIA) are pleased to present this webinar on IFRS for Internal Audit – People, Process, Technology, Governance and Controls. Gather insight into key focus areas for internal audit, including people, process technology, governance & controls. Register now.

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