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In this issue:

Changes ahead: An update on lease accounting

IFRS Summit 2010 focuses on convergence momentum

Exposure draft for insurance contracts

Why tax analysis can't wait for the SEC

SEC staff publishes progress report on work plan for global accounting standards

IFRS resources

IFRS contacts

www.deloitte.com/us/ifrs

Changes ahead: An update on lease accounting

Lease accounting continues to be a hot topic for U.S. companies. As covered in the last issue of this newsletter, in August 2010, the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (the Boards) issued a joint exposure draft (ED), Leases. The ED creates a new accounting model for both lessees and lessors and eliminates the concept of operating leases. The comment period on the proposed ED closed on December 15, 2010, and the Boards expect to issue a final standard by June 2011.

While waiting for the Boards to review the comments and issue a final standard, companies should begin thinking now about what this change will mean for them. In particular, many clients have expressed interest in how to tackle the many operational challenges — including system issues — which a transition to this new standard will cause.

What's changing?

The proposed lease model in the ED is expected to affect companies across various industries. For lessees, the new approach would eliminate the operating lease accounting model and replace it with a "right-of-use" model, in which a lessee would recognize an asset representing its right to use a leased item during the lease term as well as a liability for the lessee's obligation to pay rentals.

Lessors would either follow a derecognition model or a performance obligation model over the lease term, depending on their level of exposure to risks or benefits associated with the underlying asset during or after the lease term.

Why should companies care now?

Although the Boards may still change elements of the ED as proposed — particularly related to valuation, the consideration of optional lease extensions, and contingent rentals — certain aspects of the proposed model are likely to remain in the final accounting standard. In particular, the core concept of lessees recording all leases on the balance sheet as a "right-to-use" asset and the corresponding obligation to make lease rental payments is a key objective of the Boards that is likely to be incorporated into the final lease accounting rules.

Consequently, the impacts of the proposed model are likely to be felt throughout an organization. Identifying and evaluating those impacts can help with a smoother transition once a final standard is issued. Companies may wish to identify key impact areas now to understand how the new lease guidance may affect them, as well as to make informed decisions about how to manage both the transition and any internal changes necessary. Some potential impact areas include:

- Existing leases — both operating and capital/finance
- Information technology systems and processes
- Tax processes
- Operations

Key considerations

As companies evaluate the potential impacts of adopting a new lease standard, their attention will also likely turn to areas outside of the finance and accounting function. The following are some hypothetical questions on which to reflect as you look beyond the technical accounting changes required by the proposed model.

- **Systems** — are our current lease and other accounting systems able to capture all of the lease information needed in the computation of the amounts to be recorded on our balance sheet under this new guidance?
- **Financial statement impacts** — how will our financial statements change when all leases are included on the balance sheet as assets and liabilities?
- **Project plan** — what plans do we need, and at what level of detail should they be, for us to effectively evaluate the large volume and diverse types of leases?
- **Tax** — how will our tax accounting methods and deferred tax position be affected by the recognition of additional lease assets and liabilities on the balance sheet?
- **Investor education** — how will we educate stakeholders, including investors, analysts, and even regulators, about the changes that the new lease approach will have on our key performance measures?
- **Debt** — how will debt covenants be affected, and what does this mean for our existing and prospective debt agreements?
- **Nontraditional leases** — what other types of arrangements do companies need to analyze to determine how they may be affected under the proposed model (e.g., indefeasible rights of use, warehousing agreement, and power purchase agreements)?
- **Contracting** — what proactive steps can we take now in our contracting process to manage the impacts going forward and to potentially reduce our required transition efforts?
- **Commercial impacts** — how will bringing leases onto the balance sheet affect our (or our customers') lease-versus-buy analysis?

Tackling system issues

Many companies and clients are inquiring about how to handle technology issues for leases, and we have typically found that this involves two components:

- **Data gathering** — Many companies have a need for an immediately-available simple tool to facilitate global data gathering and preliminary lease calculations. This tool should be web-based and provide rigor and definition to the data gathering and preliminary analysis effort. Deloitte has developed a baseline tool for interested clients that can be tailored to meet a company's objectives.
- **Long-term system solutions** — Clients are also interested in long-term solutions, either through enhancements to their existing enterprise resource planning (ERP) systems or through separate leasing software. Deloitte has conducted research on particular packages that may be of interest to our clients, to assist with this requirement.

These two system components can be implemented in a complementary manner, such that data gathered in a near-term solution can be effectively converted into a longer-term system solution.

Conclusion

While we are still months away from a new standard, there are many things that companies can and should be doing now to prepare. Please contact us if you would like further information or if you have questions about the tools and approaches mentioned above. Below are some additional resources from Deloitte to help during this transition.

- Leases: Lease accounting convergence brings a new view
- Heads Up: Proposed ASU Revamps Lease Accounting
- IFRS in Focus: IASB Issues Exposure Draft on Lease Accounting
- Archive of September 10 Dbriefs Webcast: FASB's Exposure Draft on Lease Accounting: A Closer Look at the Proposed Guidance

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IFRS Summit 2010 focuses on convergence momentum

Deloitte's third annual IFRS Summit was held on October 29 in New York City and was attended by more than 150 senior financial executives who heard about the incorporation of International Financial Reporting Standards (IFRS) into the U.S. public company financial reporting framework. An additional 160 people watched as part of a live video simulcast to Sao Paolo, Brazil. Featured speakers included International Accounting Standards Board (IASB) Chairman Sir David Tweedie and U.S. Financial Accounting Standards Board (FASB) Acting Chairman Leslie Seidman, who shared their perspectives on incorporation of IFRS, convergence efforts, and progress on the Securities and Exchange Commission's IFRS Work Plan.

We'll soon have video clips available on our website, so check out www.deloitte.com/us/ifrs in the coming weeks.

Hundreds gather in New York for IFRS Summit 2010

Journalist Robert Bruce (L) talks with IASB Chairman Sir David Tweedie (R)

Acting FASB Chairman Leslie Seidman (L) talks with Deloitte's Joel Osnoss (R)

Exposure draft for insurance contracts

After more than a decade of effort, in July 2010, the International Accounting Standards Board (IASB) issued its Exposure Draft (ED) on insurance contracts. Along the way, in 2004 the IASB issued IFRS 4, *Insurance Contracts*, a preliminary standard that enabled European insurers to comply with the European Union (EU) directive for all public entities in the EU to adopt IFRS. IFRS 4 defined an "insurance contract" and imposed certain minimal requirements, but did not attempt to change the underlying measurement of insurance liabilities from those used by insurers at the time. This resulted in a variety of local measurements for similar insurance contracts, hindering comparability.

In 2007, the IASB issued a comprehensive Discussion Paper (2007 DP) proposing an exit value approach to measuring insurance liabilities. The feedback on the 2007 DP indicated that there was no market for insurance liabilities, and that insurers primarily exited their contracts by fulfilling them, and thus a fulfillment value approach was considered better than an exit value approach. The principal difference was to substitute insurer-specific information in place of market-observed data wherever market information did not exist.

In 2008, the U.S. Financial Accounting Standards Board (FASB) joined the IASB's insurance contracts project, though accounting for insurance contracts was not originally included in the list of joint projects in the Memorandum of Understanding between the IASB and FASB (the Boards) or in the Norwalk Agreement. Over the course of 2009 and during the first half of 2010, the Boards held numerous joint meetings to discuss and resolve various issues relating to insurance contracts, culminating in the IASB issuing its ED.

At the time, it was hoped that the FASB also would issue an exposure draft, but the FASB instead chose to issue its "preliminary views" in a discussion paper (FASB DP), wrapped around the IASB's ED, with a series of questions relating to matters covered by the ED.

The IASB ED carries forward the definition of an insurance contract from IFRS 4 and proposes a three-building-block-approach to measuring insurance contract liabilities. The proposed model would apply to all insurance contracts, including life, property and casualty, and health, and also would apply to both primary insurers and reinsurers:

- The first building block consists of projecting probability-weighted, unbiased future contract cash flows from the inception of an insurance contract to its contract boundary, including cash flows relating to "incremental" acquisition costs.
- The second building block consists of discounting those cash flows to reflect the time value of money using a discount rate that reflects the characteristics of the liability, which was proposed to be the risk-free rate adjusted for illiquidity.
- The third building block consists of establishing a margin for risk and a residual margin to prevent a day one gain. The residual margin arises as a result of calibrating the liability to the customer consideration, namely total premiums receivable from the customer.

The ED also stipulates certain acceptable methods to amortize the risk margin and that the residual margin shall be amortized into earnings over the coverage period. The measurement model follows a balance sheet approach, requiring re-measurement at each balance sheet date, based on current best estimates at the time, with changes in the liability being reported in earnings.

The FASB raised a fundamental question in the FASB DP: is it necessary to issue a completely new standard to replace existing Generally Accepted Accounting Principles (GAAP) that have been in place in the U.S. for many years, and which are well understood by issuers and readers of financial statements? Among other matters, the FASB also questioned whether a two-margin approach was appropriate, or whether it was better to have a single composite margin which would be amortized into earnings over the coverage and claims settlement period based on a set formula, a different basis than proposed by the IASB for the risk and residual margins.

The deadline for comment letters for both the IASB ED and the FASB DP has now expired. The Boards received a total of 302 letters from preparers, accounting firms, trade organizations, and analysts. Both Boards also implemented an outreach program, which included holding roundtables in Norwalk, CT, London, and Tokyo during December 2010, and meetings or conference calls with those that wished to share their views. Preliminary feedback from the comment letters and the roundtables is as follows:

Volatility of earnings and the discount rate — The ED proposes that the assumptions underlying cash flows and the discount rate be reset to current amounts at each balance sheet date, with changes in the liability being reflected in earnings. The most significant assumption that affects the value of the liability is considered to be the discount rate. Comments have been made that there will be significant volatility in reported earnings as the observed discount rate is reset in each period, particularly for life insurers or general insurers who have long duration liabilities. Further, respondents have indicated that it is difficult to determine the illiquidity adjustment that must be made to the risk free rate, and questioned the theoretical basis for adjusting for illiquidity. Further comments suggest that the proposed discount rate is inconsistent with the discount rates used for assets and pricing, and could cause day one losses to be reported.

Acquisition costs — Most respondents stated that the use of "incremental acquisition costs" is too restrictive, and they prefer the definition in FASB ASU 2010-16 (EITF 09-G). EITF 09-G aligns the insurance deferred acquisition cost model to the loan origination deferred cost model in FASB ASU 310-20 (SFAS No. 91). Under that standard, deferrable costs are those that relate directly from and are essential to contract acquisition, and are costs that would not have been incurred had the contract acquisition not occurred.

Transition provisions — The proposed transition provisions would require insurance liabilities to be set to the values indicated by the three-building-block-model in the ED, and all other insurance-related balances, such as deferred acquisition costs, insurance related intangible assets, and unearned premiums on the balance sheet at the transition date to be written off, with the net change being adjusted in opening equity. Depending on the length of any look back period, it may also be difficult to estimate the remaining unamortized residual margin at transition, or be precluded from reporting amounts arising before the look back. Respondents have indicated that this could reduce, perhaps significantly, the emergence of future profits from in force business, and would result in inconsistent treatment of in force and new business. Respondents further commented that the transition provisions needed to be aligned with those in IFRS 9, *Financial Instruments*.

Presentation and disclosure — There was a widespread view that a measure of volumes, such as premiums, was relevant to users, and thus should be included. There were concerns expressed that the extent of proposed disclosure was too excessive, could cause difficulties and delays in implementation, and could potentially result in proprietary information being disclosed.

Other — In addition, numerous comments were received on the margins, reinsurance, the modified approach proposed for short duration contracts and the unbundling of contracts that had insurance as well as non-insurance features.

Conclusion

As the feedback from the comment letters and roundtables is considered, the ED proposals will undoubtedly be modified before being issued in final form. At this time it is difficult to forecast the extent of any changes. We still expect the IASB to issue a final standard in June 2011, though it is by no means certain that the FASB will follow suit. Below are some additional resources from Deloitte.

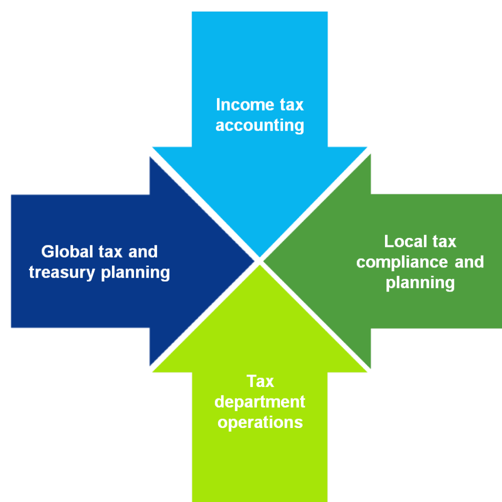
- Heads Up: IASB Issues Exposure Draft on Insurance Contracts
- Heads Up: FASB issues Discussion Paper on Insurance Contracts

Why tax analysis can't wait for the SEC

The SEC has continued its evaluation of the United States' move toward a single set of high-quality globally accepted accounting standards as outlined in its February 2010 "Work Plan." While the October 29, 2010, SEC status report provided insights into the depth and the details of the analysis it has undertaken, the report also reemphasized the SEC's commitment in moving toward a single set of global accounting standards, for which they have identified International Financial Reporting Standards (IFRS) as the most likely option. This thorough and methodical approach has led many U.S. companies to adjust their prioritization of IFRS evaluation efforts. The tax issues that may arise in the adoption of IFRS for statutory reporting of multinational companies, however, are particularly critical and, in some instances, may be time sensitive.

From a tax perspective, there are many areas affected by a potential change to IFRS. The differences between the income tax accounting standards, ASC 740 and IAS 12, would be the most obvious issue. However, multinational organizations may experience significant implications with respect to global tax planning, local country cash taxes, and tax department operations. While the evaluation of each area is critical to an IFRS assessment and conversion, the organization may experience the impact of some of these issues well before a U.S. parent adopts IFRS. Namely, the impacts that are driven by a change to IFRS in the statutory books of some foreign jurisdictions in which a multinational operates may be felt long before the SEC ultimately makes a decision on the use of IFRS by U.S. public companies.

Tax components of IFRS conversion



As shown in the graphic on the left, there are four tax components to IFRS conversion:

- **Income tax accounting**: There is currently a limited scope project on IAS 12 Income Taxes. This project is aimed at making several adjustments to the current international standard; however, significant differences between U.S. Generally Accepted Accounting Principles (GAAP) and IFRS will remain. While the broader IFRS/U.S. GAAP convergence effort around income taxes has been abandoned, in September 2010 top U.S. and international accounting officials agreed that the existing standards on accounting for income tax should be revised after the current ongoing accounting convergence projects are completed.
- **Local tax compliance:** Each pre-tax accounting change that a company makes potentially has an impact on tax accounting methods, book tax differences, and cash taxes to the extent the data is used for tax filings.
- **Global tax and treasury planning:** This is often impacted by the local country statutory books. Many jurisdictions around the world are currently moving the basis for statutory reporting toward IFRS through conversion or convergence. This shift may have a significant impact, including: thin capitalization, cash repatriation, and transfer pricing. It is important to note that these changes are happening in countries around the world irrespective of the potential U.S. move toward IFRS for public filers.
- **Tax department operations:** IFRS impacts the people, processes, and systems within the tax department. IFRS may provide an opportunity for the department to be involved in an enterprise-wide finance transformation type project that can improve automation and efficiency in the tax function. These projects often have a significant lead time and may be contemplated or ongoing in organizations today. It is critical that these enterprise-wide initiatives be IFRS-ready and tax-enabled.

While much of the world has converted to IFRS for publicly-traded companies, many jurisdictions are in the process of evaluating or are converting to IFRS for local country statutory reporting. Jurisdictions such as China, Korea, Mexico, Brazil (2010 conversion), and the UK are moving toward IFRS through conversion or convergence of the local standards. Other countries, such as Italy and the Netherlands, allow, or are considering allowing, IFRS on an optional basis for local country statutory reporting.

While the primary move to IFRS for public companies in the major economic centers is substantially complete around the world, with the exception of the U.S. and Japan, the secondary move to IFRS for statutory reporting is just under way in many key jurisdictions. This movement in statutory reporting is critical from a tax perspective as the local country statutory books are often the starting point for tax compliance, cash repatriation calculations, limitations on interest deductions for affiliated party loans under thin capitalization rules, and transfer pricing, to name a few. These critical areas of tax could be impacted in each jurisdiction in a different manner and on a different timeline based upon the way in which the current basis for statutory reporting differs from IFRS, as well as how and when the country moves to IFRS.

The tax impacts associated with a change in statutory reporting may provide opportunities or present challenges with significant consequences to an organization. Thus, advance planning is essential to understand the ramifications and avoid surprises.

A few examples of the implication of the movement to IFRS in the UK are summarized below:

- **Distributable reserves and intercompany loans:** Many UK public companies have experienced an overall decrease in distributable reserves on the conversion to IFRS, for example, as a result in many cases of a substantial increase in pension liabilities. Distributable reserves in the UK are generally based on the statutory accounts. An overall reduction in net equity may also limit deductions for interest payments made on loans from related parties.
- **Cash tax:** For the amortization of goodwill and intangibles, UK tax follows statutory accounts or is recovered on a 4% irrevocable straight line method if a timely election was made within two years of the acquisition date. Since there is specific reference to the statutory accounts under UK tax law, a change in statutory reporting may impact the cash tax liability.
- **Amortization:** UK GAAP generally provides for mandatory amortization over a maximum useful life of 20 years. However:
  - No amortization is permitted under IFRS for goodwill, but the balance of intangible assets are subject to an impairment model.
  - Under IFRS for Small and Medium Sized Entities (a possible option in the UK for statutory reporting), acquired intangibles/goodwill must be amortized. The default useful life is ten years.

Conclusion

These are just a few examples of how the tax function may be impacted by changes in statutory accounting well before the SEC concludes on the use of IFRS for U.S. public companies. For jurisdictions with statutory reporting, it is important to:

- Determine if statutory reporting will be changing in significant tax jurisdictions (through conversion or convergence)
- Determine if local country statutory reporting is the basis for tax filings
- Evaluate any global tax and treasury implications associated with changing statutory accounting standards including:
  - Cash repatriation
  - Thin capitalization
  - Transfer pricing
  - Tax return compliance matters
- Plan for the changing standards and be prepared for the challenges and the opportunities

It is critical that tax departments monitor all four areas of an IFRS tax conversion — income tax accounting differences, tax compliance, global tax planning, and tax department operations — in order to avoid unintended consequences and plan for potential opportunities.

SEC staff publishes progress report on work plan for global accounting standards

On October 29, 2010, the U.S. Securities and Exchange Commission (SEC) provided an update on its proposed transition to International Financial Reporting Standards (IFRS) since ordering a Work Plan related to global accounting standards in February 2010. This first progress report provided an overview of the SEC's IFRS activities to date, summarized certain aspects of the input received on the proposed IFRS roadmap, and outlined next steps for the SEC's consideration for the use of IFRS by U.S. issuers. The SEC staff expects to continue to report periodically on the status of the Work Plan in 2011.

To learn more about how the SEC is addressing IFRS, access our recent Heads Up article that summarizes the SEC's actions or our publication IFRS: An update for boards and audit committees which was updated in October 2010. We will also provide updates in future editions of IFRS Insights.

IFRS resources

If you are looking to learn more about IFRS and need some CPE credits, join us for two days of IFRS executive training in Atlanta, GA on March 22-23, 2011, or in San Jose, CA on May 17-18, 2011. Check our website for more details and registration information. If you are unable to attend, please consider our IFRS e-learning program that also provides CPE credit.

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