



Beyond compliance Strategic choices on the conversion to IFRS

Volume II in the Deloitte series on conversion to IFRS
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Introduction

We at Deloitte believe that being efficient and effective is a matter of critical importance for Canadian entities undertaking the IFRS conversion process. There are multiple challenges to meeting these objectives: at the most fundamental level, interpreting the measurement, classification and disclosure principles of IFRS; at the human resources level, developing and retaining IFRS-competent individuals – from line and staff positions to the boardroom. Adding to these is the global economic crisis and its impact on obtaining the financial resources to execute conversion. A disciplined process, such as that outlined in our publication “Scoping the Effort,” focusing on significant issues and resolving them in a practical manner, should be at the heart of every conversion plan.

At the same time, converting to IFRS offers one-time opportunities for entities to realize on some strategic benefits. Strategic choices are those that influence the value of the entity by affecting users’ expectations of the entity’s future earnings, either by changing their amounts or their classification, or by modifying their recognition timing or by increasing their volatility. This volume, *“Beyond Compliance: Strategic choices on the conversion to IFRS”*, is our perspective on several topics that we believe may have compelling strategic consequences. These issues have been identified in the course of our current IFRS conversion work with Canadian entities, and through our global network where IFRS is a reality. The issues we have selected are not intended to be all-inclusive: in any entity, additional conversion issues may generate strategic consequences that have not been considered here.



The issues considered here all involve choices encountered in the conversion to IFRS, for which there are strategic consequences resulting from those choices. It is our view that these choices should be considered not only for their effects on the financial statements, but also for their wider strategic consequences.

Similar to the first volume in this series, *“Scoping the Effort”*, this volume focuses on more than the technical accounting issues involved in conversion. For more comprehensive guidance on technical issues, we are proud to have recently published *“iGAAP 2008: IFRS for Canada”*, a comprehensive document that provides advice on conversion from Canadian GAAP to IFRS. This book is available through CCH Canada at <http://www.cch.ca> in both hard copy and electronic versions.

This publication is intended to provide insights on certain significant issues so that they can be addressed in a timely manner. It is not intended to be a substitute for professional advice on these matters and we cannot accept any liability or responsibility for decisions made relying on this document. The responsibility for any decisions lies with the preparer who should consult their professional accountant. Nonetheless we believe that these issues should be considered in any comprehensive IFRS conversion plan.



1 Strategic choices in IFRS 1: identifying elections that may have a significant impact beyond the financial statements

IFRS 1, *First-time Adoption of International Financial Reporting Standards*, the standard that governs the first-time application of IFRS to financial statements, contains many specific directions, some prohibitions and numerous disclosure requirements. It also includes some mandatory and elective alternatives to the general rule that financial statements should be retrospectively restated for the application of all IFRS standards upon their initial adoption. These elections include such matters as: electing the initial date of application of business combination rules, thereby determining the date and manner of computation of goodwill; using the fair value of any specific item of property, plant and equipment as its “deemed historical cost”; electing to “zero-out” deferred actuarial gains and losses on defined benefit pension plans; and eliminating accumulated foreign currency gains and losses arising from the translation of self-sustaining operations. The amounts in play may be significant, and on transition may result in charging amounts to opening retained earnings that would otherwise flow through the income statement at some point in the future.

In addition, upon conversion, a specific provision of IAS 8 *Accounting Policies, Changes in Accounting Estimates, and Errors* permits an entity to electively change any accounting policy which it had previously applied under Canadian GAAP to any alternative policy that is compliant with IFRS without having to apply the preferability test for such changes that would otherwise be required. This represents a one-time opportunity for an entity to conform its policies with industry practices regardless of their preferability, as long as the policies comply with IFRS.

These options may be of significant practical value, as they may eliminate, for example, the need to retrospectively reconstruct balances of a foreign subsidiary’s cumulative translation account under IFRS, or reconstruct retrospectively determined actuarial gains and losses in an IFRS compliant manner. The intent of the International Accounting Standards Board (the “IASB”, the body that created IFRS standards) in providing the options is to reduce the cost of conversions – one-time cost-saving coupons as an incentive to adopt IFRS.

The effects of these options may also be strategically important: in some cases, they could lead to the recognition of additional tangible net worth on the balance sheet, which could provide greater borrowing capacity and enhance future cash flows. In other cases, such as the option to “zero-out” foreign currency translation balances, the effect is to transfer amounts from one reserve account in shareholders’ equity to retained earnings—a change that may have no significance for future cash flows. There may be tactical accounting considerations in making such elections: if an entity is considering disposing of its foreign operations, the balance of that account would be deemed realized upon the subsidiary’s disposition: a debit balance could reduce a gain or create or increase a loss. Eliminating that balance on conversion could avoid such consequences.

If external contractual relationships that affect cash flows depend on the balances of certain accounts, such as fixed asset balances that form the basis for borrowing limits, there may be direct cash flow consequences from accounting adjustments. Valuations based on cash flow expectations may also be affected by the manner in which the entity presents the results of operations, as well as by changes in business practices that are driven by the IFRS-determined financial statement consequences of a business policy. In these cases, conversion to IFRS may have strategic as well as accounting consequences.

2 IFRS policies and choices can affect reported cash flows

The process of adopting IFRS has been described by some as the substitution of one accrual accounting system for another, a change that has no impact on the entity's underlying cash transaction streams and thus does not affect the basic economics of the business. If true, the conversion to IFRS should have no impact on the valuation of the entity or its securities, both of which are presumably driven by its cash flows. Hence the adoption of IFRS would seem to be of little strategic consequence.

This assertion, however, is built on a series of assumptions that may not hold. First, it assumes that there are no cash consequences from the conversion itself (see Issue 4 for circumstances where this may not be true). Second, expectations of future cash flows are derived in part from the manner in which the financial statements present those cash flows. Upon conversion to IFRS, there are potentially several changes in the reported amounts of an entity's cash flows. These can arise from:

1. a change in the scope of the consolidated financial statements, such as adding (or eliminating) a newly consolidated subsidiary's cash flows to the operating, investing and financing flows of the entity's consolidated cash flow statement;
2. the reclassification of a transaction – such as when a transaction previously classified as an operating expenditure for a good or service is treated as an investing or financing transaction under IFRS; or
3. a reclassification of cash flows within the operating section of the cash flow statement that changes the perception of how the entity generates or uses cash.

Any changes in the amount, timing or classification of reported cash flows has the potential to change expectations of the timing, amounts and uncertainty related to the cash flows that drive the enterprise value of the entity.

The change to reporting under IFRS does not affect the cash flow generation of Rio Tinto's businesses and hence will not affect any commercial decisions.

Rio Tinto 2005 adoption of International Financial Reporting Standards
Salient points for year ended 31 December 2004
May 2005

The cash flows reported on IFRS financial statements may differ from those reported in Canadian GAAP statements for all the reasons described above. IFRS statements are more likely to consolidate entities that under Canadian GAAP are off-balance sheet, thereby portraying a different volume and composition of consolidated cash flows than under Canadian GAAP. IFRS may capitalize leases that were treated by lessees as operating leases under Canadian GAAP, reclassifying all or part of lease payments previously charged to operations as being repayment of capitalized lease obligations, i.e. as financing transactions rather than operating outflows. Under IFRS entities may also elect to reclassify the cash flows related to financing charges as elements of financing activities rather than as operating activities, changing the apparent sources of cash from operations. These may influence investors' perceptions of the magnitude of an entity's operating, investing or financing cash flows.

Changing the timing and measurement of accruals made in the financial statements may also change perceptions and expectations of underlying cash flows derived from non-GAAP measures. Proxy cash flow measures derived from the income statement, such as EBITDA, funds from operations and distributable cash may change simply because of accruals [See the examples in the box below and to the right]. To the extent such measures drive the value of the entity, adoption of IFRS and the choices made in doing so can change the valuation drivers of the entity. Even when there may not be any choices involved, these changes should be addressed for potential strategic consequences. Changes in IFRS may require changes in business strategies, not simply accounting policies.

...Abbey has adopted the fair value option under IAS 39 and substantially changes its hedging business model as a result... As Abbey's business model is now primarily structured to maximise use of the fair value option under IFRS, the Group decided to cease claiming any hedge accounting for US GAAP purposes, and de-designated all its hedges under U.S. GAAP from 1 January 2005 in order to reduce the administrative burden on the Group... In addition, the effects of applying hedge accounting under IFRS have been reversed.

ABBEE NATIONAL, 2005 Financial Statements

ROYAL AHOLD

U.S. Foodservice securitization program

At the outset of 2005, U.S. Foodservice and certain of its subsidiaries participated in separate accounts receivable securitization programs. On May 6, 2005 these two securitization programs were merged into one. Under the program U.S. Foodservice and certain of its subsidiaries sell, on a revolving basis, their eligible receivables to a wholly-owned, special purpose, bankruptcy remote subsidiary of U.S. Foodservice ("Receivables Company") which in turn, transfers its rights in the receivables to a special purpose entity (the "Master Trust") which then issues certificates, representing interests in the accounts receivable held in the name of the Master Trust, to third-party investors.

We consolidate the special purpose entity and the receivables have not been derecognized from our consolidated balance sheets... Under the terms of the accounts receivables programs, these proceeds are legally restricted to the Master Trust. As of January 1, 2006 and January 2, 2005, such restricted receivables collection proceeds held by Ahold amounted to USD 122 million (EUR 103 million) and USD 93 million (EUR 79 million), which are included in cash and cash equivalents in the balance sheets. The funds received from the Master Trust on a revolving basis have been used to redeem the short-term borrowings that have been recognized by the Receivables Company. Losses in the form of discounts on the sale of receivables, primarily representing interest, totaled USD 26 million (EUR 21 million) and USD 17 million (EUR 14 million) in 2005 and 2004, respectively, and are included in our consolidated statements of operations in interest expense.

Royal Ahold, 2005 Annual Report

3 Incorporating EBITDA, Operating Cash Flows and other “Non-GAAP measures” into IFRS conversion plans

Non-GAAP measures, such as “EBITDA” and “operating cash flows” are frequently used as alternative performance measures by many entities. These measures generally add back to reported earnings the non-cash charges for capital assets and goodwill, and in the case of EBITDA, charges for taxes and interest, but do not adjust for the cash effects caused by changes in working capital. It is argued that these measures are proxies for the long-run cash flows used by investors to value the entity or its assets, and are used in addition to GAAP measures.

In many established IFRS regimes – the U.K., the E.U., and Australia—non-GAAP measures are frequently disclosed in IFRS compliant financial statements, although the extent of use varies significantly as a matter of national practice. Examples include their disclosure as measures of segment performance in the operating segment note; subtotals, reconciliations, or separate analyses on the face of the income statement; or as a separate note to the financial statements. The inclusion of these measures in IFRS financial statements is arguably supported by IAS 1 *Presentation of Financial Statements*, which states that “an entity shall present additional line items, headings, and sub-totals in the statement of comprehensive income and the separate income statement (if presented) when such presentation is relevant to an understanding of the entity’s financial performance.” Anecdotal evidence provided by investors, analysts and financial executives indicates that non-GAAP measures – such as EBITDA and underlying earnings computed exclusive of non-recurring items—are relevant to their analyses, and are frequently requested by analysts.

...an entity shall present additional line items, headings, and sub-totals in the statement of comprehensive income and the separate income statement (if presented) when such presentation is relevant to an understanding of the entity’s financial performance...

IAS 1 Presentation of Financial Statement

In North America, the inclusion of non-GAAP performance measures in GAAP financial statements is essentially proscribed by a combination of factors, with regulatory policy, the lack of standards for assurance providers, and the entity’s potential liability for misleading information being major contributors. It is currently an open issue as to whether the use of such measures in financial statements will extend to North America: the recently proposed SEC roadmap to the adoption of IFRS in the U.S. would appear to contemplate their continued exclusion in that jurisdiction. The Canadian securities commissions have been silent to date on this issue. The acceptability of such disclosures to directors and auditors contemplating their legal liability is unknown.

Given their wide usage, it is likely that such measures provide information of some strategic value to investors. Assuming such practices are not prohibited by regulators, reporting such measures in IFRS financial statements may have strategic value. Because of the nature of the measures i.e. the exclusion of certain cash transactions and other items, entities that report such measures should exercise prudence: transparency, comparability, and consistency should govern their usage. If possible, entities should establish that financial analysts in fact employ such data, that measures are employed by the entity in



monitoring the results of operations or financial condition, and that the measures are carefully and consistently applied, i.e. they are well defined, unbiased in application and do not simply exclude unfavourable items or only include favourable results. Their use in financial covenants and in other contractual arrangements such as lease agreements would demonstrate their external utility. Reported amounts should be reconciled to the IFRS-compliant income statement, if they are not already embedded in the income statement.

TESCO 2008 Annual Report

Non-GAAP measure: underlying profit before tax

	notes	2008 £m	2007 £m
Profit before tax (excluding discontinued operation)		2,803	2,654
Adjustments for:			
IAS 32 and IAS 39 'Financial Instruments' – fair value remeasurements	5	(49)	4
IAS 19 Income Statement charge for pensions	24	414	432
'Normal' cash contributions for pensions	24	(340)	(321)
IAS 17 'Leases' – impact of annual uplifts in rent and rent-free periods	1	18	–
Exceptional items:			
Pensions adjustment – Finance Act 2006	24	–	(258)
Impairment of the Gerrards Cross site	1	–	35
Underlying profit before tax	1	2,846	2,545

Use of non-GAAP profit measures – underlying profit before tax

The Directors believe that underlying profit before tax and underlying diluted earnings per share measures provide additional useful information for shareholders on underlying trends and performance. These measures are used for internal performance analysis. Underlying profit is not defined by IFRS and therefore may not be directly comparable with other companies' adjusted profit measures. It is not intended to be a substitute for, or superior to IFRS measurements of profit.

RIO TINTO

- To enhance understanding of the performance of Rio Tinto's businesses an alternative earnings measure, Underlying Earnings, will be presented in addition to Net Earnings.
- IFRS Underlying Earnings for 2004 were \$2,272 million which compares with \$2,221 million for UK GAAP Adjusted Earnings (which included the amortisation of goodwill).

May 2005

4 The benefits of using fair value as the deemed cost of property, plant and equipment on transition

On first-time transition to IFRS, IFRS 1 permits an entity to use fair value as the deemed cost of any item of property, plant and equipment. This option simultaneously creates opportunity for benefit and anxiety about its use. The opportunity for benefit arises from the fact that many assets carried at historical cost under Canadian GAAP may be significantly undervalued, even in recessionary times: increasing their carrying value to fair value may generate costless additional borrowing capacity, and thereby change the entity's cash flows. The anxiety may arise from a sense of questionable motive: writing up assets to fair value seems so inconsistent with legacy Canadian GAAP (and the Canadian financial reporting psyche) that discomfort ensues.

There are many reasons why assets may be carried at significantly less than their fair value: for instance, the asset may have been acquired decades ago, such as land; it may have been acquired from related parties and recorded under GAAP at its predecessor's carrying value, even though the fair value of the consideration was significantly higher; or it may have been acquired by transfer from a government or government entity where it was carried at nominal or no value upon the transferor's books. The adjusting entry to use fair value as the deemed cost would be simply a debit to the specific asset within the property, plant and equipment account and a corresponding credit to shareholders' equity in the opening balance sheet. The new "deemed cost" would be the new cost basis for subsequent impairment testing and depreciation expense for depreciable assets.

The benefits of making adjustments from cost to fair value range from the abstract to the highly practical. At the conceptual level, it provides more realistic measures of the value of the assets consumed, which may be highly relevant for determining the entity's "distributable cash" providing depreciation using recent fair values, not historical costs. On the practical side, the asset's fair value may be easier and less costly to determine than its

GRANGER ROLF

IFRS 1, First time adoption of International Financial Reporting Standards, has been applied. The key principle in IFRS 1 is full retrospective application of all IFRSs in force at the reporting date (31 December 2005), as if IFRS had always been applied. IFRS 1 contains both mandatory and voluntary exceptions from this principle.

ASA Group 2005 Financial Statement

Granger Rolf has applied the following exceptions, in accordance with IFRS 1:

- To measure items of property, plant and equipment at the date of transition to IFRSs at its fair value and use that fair value as its deemed cost at that date. Book values under Norwegian GAAP (NGAAP) are thereby replaced by fair values. This alternative was applied to drilling rigs and all other items of property, plant and equipment where stated in IFRS at book values identical to NGAAP values.

reconstructed cost under IFRS, for which adequate records may not exist. There are also the strategic benefits of increasing an entity's reported tangible net worth, which may have a beneficial impact on financial flexibility, as noted above, particularly if covenant compliance is narrow or if the carrying values of other assets are found to be impaired as the result of the first-time application of IFRS impairment tests. An election on transition that could address potential covenant violations and not accelerate debt repayments would have a direct impact on the entity's cash flows.

AIR FRANCE

Main selected options

Over and above its legal obligation, Air France-KLM has sought to take advantage of the transition to IFRS in terms of the framework which it offers for measuring the Group's economic performance and the opportunity to enhance the quality of its financial information and communication.

In this context, Air France-KLM has chosen to adopt the following options in the presentation of its financial statements under IFRS:

- No retrospective restatement of acquisitions undertaken before 1st April 2004.
- Valuation of the Air France fleet at fair market value on the date of transition. In the context of the acquisition of the KLM group, where the KLM fleet was valued at its market value at the time of acquisition, the Group has elected to value the Air France fleet at its market value at the date of the transition to IFRS. This will have the benefit of the harmonizing the value of both fleets in the consolidated balance sheet, and, going forward, will allow the economic performance of both airlines to be measured on a comparable basis.

June 2005

The determination of the fair value of an asset or group of assets may be simple, or it may incorporate wide-scale determinations. The fair value of a readily-marketable asset for which there is an active market is one end of the spectrum. At the other end of the spectrum are "network assets," where no particular physical asset (other than a very large aggregation) generates cash flows independently of any other. Examples of such networks abound: telecommunications systems, railways, the branch network of financial institutions, and chain stores that are supplied through common distribution centres may all be network-based assets.

Fair values of such productive assets are generally estimated, not directly observed. In determining fair value, the cash flows would include the synergies of network operation but also the expected consequences of technological change embodied in capital investments. An understanding of the relationships between an industry's revenue and cost structures, technology and finances is required to determine the relevant fair value, which is the price at which an arm's length transaction could occur, could be attributed to the specific assets. Entities that use such fair value measures may have a competitive advantage: their use deserves serious consideration. Entities should also assess the additional effort and cost potentially required to obtain reliable fair value.

5 Employee compensation including defined benefit pension plans: important options on conversion – and after

One of the key drivers of the design of employee compensation schemes is the reflection of the cost of and liabilities for such schemes on the entity's financial statements. The recognition, measurement and classification of employee compensation expense and obligations in IFRS financial statements may differ substantially from the manner in which it is reported under Canadian GAAP. For example, under Canadian GAAP, the past service costs resulting from the plan initiation or amendment are not recognized fully in income in the period in which the initiation or amendment takes place. Rather, the past service costs are amortized over the service periods in which the entity expects to realize the economic benefit. It is usually acceptable to amortize past service costs on a straight-line basis over the average remaining service period of active employees expected to receive benefits under the plan up to the full eligibility date.[3461.082] Under IFRS, amendments to defined benefit plans that vest immediately are recorded as expenses when enacted ; otherwise they are amortized on a straight line basis to the date of vesting.[IAS 19(96)]

The costs of stock compensation plans with graded vesting schemes are recognized on an accelerated basis under IFRS. Certain employee share ownership trusts not consolidated under Canadian GAAP may be consolidated under IFRS. The shares issued to such trusts would not be reflected as issued capital in the consolidated statements of the sponsor, but rather may be reflected as a credit to a reserve account. The shares would also not be considered as issued for the computation of earnings per share. IFRS reporting entities also commonly reclassify elements of defined benefit pension plan expense – such as the unwinding of the discount on the plan liability and the return on plan investments – as financing income and expenses rather than as operating costs. Such re-classifications change the perceptions of the costs of benefits attributable to the current period's operations as opposed to the income and expense arising from the assets and liabilities of the pension plan.

On conversion to IFRS, an entity may also elect to eliminate any unamortized balance of actuarial gains and losses in defined benefit plans at the date of conversion. Avoiding the future expenses from any such deferred losses is a powerful incentive for making this election. The opening IFRS balance sheet presentation of defined benefit pension plans by a sponsoring entity may then be simply a liability equal to the excess of the plan's actuarial obligations over the fair value of the plan assets as at the date of the balance sheet (or an asset to the extent there is a useable surplus of assets over the actuarial obligations). The decision to "zero-out" deferred actuarial gains and losses would seem to be a simple one, particularly if an entity has deferred actuarial losses that would otherwise depress future earnings and it would require extensive actuarial calculations to determine the amount to defer. However, there would be no direct change in the cash flow consequences.



A longer-term accounting policy choice, which is not available under Canadian GAAP, is whether the entity should adopt a policy of deferring actuarial gains and losses, or recognize the amounts in income as they occur. This decision is independent of the decision to “zero-out” balances on conversion. The immediate recognition of such amounts will undoubtedly add volatility to compensation expenses. However, the deferral of actuarial gains and losses – particularly if losses accumulate year over year – may result in a significant expense overhang. Neither accounting policy changes the cash costs of the plan. But the choice may have strategic consequences: the decision amounts to a trade-off between expense volatility and the potential accumulation of large deferred expenses. As cash flows are not changed, it conceptually should not have an impact on the entity’s cost of capital, but the increased income volatility may.

The structure of share-based compensation schemes may also need to be re-examined given their consequences under IFRS. Graded-vesting share-based schemes may be less preferable than cliff vesting schemes, considering IFRS front-end loads their expense in income. As noted, employee share ownership schemes may also result in differing EPS and other per share measures. Strategically designed compensation plans should consider the impact of these effects in determining the optimal package.

BHP Billiton

2006 Financial Statements

Year ended 30 June 2006	South Africa US\$M	US US\$M	Canada US\$M	Suriname US\$M	Total US\$M
Current service cost	3	5	–	–	8
Interest cost	10	7	2	1	20
Past service cost	(1)	–	–	–	(1)
Losses/(gains) on settlements/curtailments	–	–	–	–	–
Total expense	12	12	2	1	27
Recognised in employee benefits expense	2	5	–	–	7
Recognised in net finance costs	10	7	2	1	20

Year ended 30 June 2006	Australia US\$M	Canada US\$M	US US\$M	Europe US\$M	South Africa US\$M	South America US\$M	Total US\$M
Present value of funded defined benefit liability	437	132	477	362	213	79	1,700
Present value unfunded defined benefit obligation	4	23	32	–	–	–	59
(Fair value of defined benefit scheme assets)	(414)	(151)	(396)	(283)	(250)	(91)	(1,585)
(Surplus)/deficit	27	4	113	79	(37)	(12)	174
Unrecognised surplus	–	28	–	–	11	14	53
Adjustment for employer contributions tax	4	–	–	–	–	–	4
Net liability recognised in the balance sheet	31	32	113	79	(26)	2	231

6 Negotiating or re-negotiating bank covenants and other GAAP-related agreements on conversion to IFRS: strategic considerations

Covenants in loan agreements or other contractual relationships, such as profit participation agreements or compensation arrangements, frequently refer to financial statement amounts as being “prepared in accordance with GAAP, consistently applied.” Common covenants include tangible net worth tests, referring to the carrying value of property, plant and equipment; funded debt limitations referring to the book value of certain debts; cash flow adequacy tests computed by comparing interest and finance charges to EBITDA or similar non-GAAP measures based on earnings; and liquidity measures computed as working capital ratios utilizing the ratios of the book values of receivables and inventories to payables and other short-term liability accounts. It is also common to stipulate that if the entity’s accounting policies change for any reason, any change to such references may result in the renegotiation of the covenants.

In this context the adoption of IFRS is a simultaneous change in a substantial number of accounting policies. There will likely be changes to covenants that reference GAAP or other financial statement elements requiring the negotiation or re-negotiation of agreements. The general presumption is that existing GAAP references will be replaced with references to amounts determined in accordance with IFRS. These components may not be identical, however, to those they replace. For example, the conversion to IFRS may change the components of finance charges and finance income, the recognition and measurement of property, plant and equipment, as the result of fair valuation or impairment, the classification

of sources of finance as liabilities rather than equity, and the scope of the consolidated statements (assuming the covenant relates to a consolidating entity). All of these may affect the measures commonly referred to in covenants.

There are several strategies to managing the changeover to IFRS and the renegotiation of covenants (these observations also apply to the negotiation of covenants in new lending agreements that span the changeover date). One approach is to treat the renegotiation of such contracts as an additional step in the IFRS conversion process, to be undertaken after decisions are made on the adoption of various IFRS compliant accounting principles. Compliance with covenants would be determined after alternative IFRS policies have been contemplated and determined. This approach simplifies the IFRS conversion process, but may have cash-flow consequences if the IFRS statements portray a riskier entity and there are increases in the cost of borrowing, or the covenants are not satisfied under IFRS and the debt needs to be repaid.

An alternative approach is to view IFRS conversion as a strategic activity, carried out with a focus on maximizing positive cash inflows or minimizing cash outflows. The steps would be:

1. determine the financial statement consequences of IFRS conversion, including modelling the effects of choices available to the entity, but making no definitive selection;
2. forecast relevant balances in converted financial

The [Workspace Group] property group has a deferred tax liability of 50m pounds, which under IFRS will reduce the company’s net worth by the equivalent sum, triggering the ‘net worth’ covenant on its 150m pound loan facility with NatWest.

Workspace’s finance director, Mark Taylor, says he has made NatWest aware of the issue. He says: “When we first raised this with our bankers last year, I said, ‘has anyone in your team started looking at the impact of IFRS?’ **They said no.**”

Finance Week, Centaur Media PLC, February 2005

statements and their effects on covenants in the various circumstances which may prevail; and

3. armed with a knowledge of the consequences of IFRS conversion options, commence negotiations with a deadline that provides sufficient time for successful completion of negotiations prior to conversion.

If the converted financial statements as of the relevant dates are unpredictable, management may wish to defer negotiations until options such as revaluing property, plant and equipment (and possibly other elections) are known with sufficient certainty. This may not be until after January 2010 or later in that year. The simultaneous assessment of borrowing arrangements and IFRS choices may change the result of both for the better.

APN European Retail Property Group

As a result of the revaluation of AEZ's property portfolio and the change in value of AEZ's hedging contracts, APN expects that there will be breaches of several financial covenants to which AEZ is subject with its financiers. The financial covenants which are expected to be breached are summarized as follows:

Facility	Bank	Amount outstanding (A\$ m)	Covenant	Expected covenant level	Required covenant level	Test date	Specific remedy regime	ICR ¹ Actual	ICR Covenant
Spanish senior debt facility	RBS	250.0	Spanish Portfolio Loan to Valuation Ratio	83.2%	68.0%	28 Feb 09	Yes	2.3	1.8
Roller (Germany) senior debt facility	RBS	100.2	Roller Loan to Valuation Ratio	60.4%	60.0%	28 Feb 09	Yes	4.0	1.9
Working Capital Facility	RBS	48.1	AEZ Fund Net Equity Amount	€132.0m	€225.0m	28 Feb 09	Yes	2.2	1.8
			AEZ Assets to Liabilities Ratio	81.0%	75.0%		No		
Hedging Agreements	Deutsche Bank	Not Applicable	AEZ Debt to Total Assets Ratio	62.8%	60.0%	31 March 2009	Not Applicable	n/a	n/a

¹ Interest Coverage Ratio
February 2009

7 Not a stable platform: future changes in IFRS and how these may affect your conversion and communications plans

Reference is frequently made to the costs incurred and benefits experienced by entities in the European Union ("EU") on conversion to IFRS, with the implication that similar costs and benefits (and changeover strategies) may be relevant in Canada. The timeline for the conversion of Canadian GAAP to IFRS appears similar in many respects to the timelines for conversion adopted in other countries, such as the EU. However, a significant difference between those two timelines is the fact that the EU's timeline was accompanied by an agreement by the IASB to provide a stable platform of IFRS. The IASB abstained from introducing new accounting standards into IFRS for the two year period leading up to the EU changeover date. This stable platform agreement also included an option that permitted first-time adopting entities to forgo restatement of the initial application of financial instruments standards, including IAS 39 *Financial Instruments: Recognition and Measurement* that was implemented in the changeover year.

The Canadian conversion process does not involve such stable platform protocols, and in fact may feature the reverse—the incorporation of new IFRS standards in the changeover period including such matters as income taxes and consolidation, including the treatment of special purpose entities. New IFRS-convergent standards are likely to be incorporated into Canadian GAAP before the IFRS conversion date. One of these—the likely elimination of proportional consolidation of jointly-controlled entities—may have significant repercussions for the financial statements of the large number of Canadian entities in the natural resource sector that extensively employ jointly controlled entities as operating vehicles. There are other "wild card" projects as well—the Canadian Accounting Standards Board's website should be consulted for an up-to-date list of these projects [see www.acsbcanada.org].

Assuming the IASB adheres to its normal policy of providing at least one year's lead time before mandating the application of new accounting policies, the list of IFRS standards applicable on December 31, 2011 should be known on or about January 1, 2011. This uncertainty has consequences not only for planning the conversion process, but also for the communication of information about the consequences of the adoption of IFRSs for its financial statements to users prior to the conversion date. It would be preferable for an entity to publish only one set of expectations to the user community rather than to publish a series of changing targets that are subject to further adjustment as IFRS standards evolve. In light of these circumstances, several entities are currently disclosing no quantitative data and stating that the consequences of changes in IFRS standards prior to the conversion date could be material: this is unlikely to change before 2010.



When other uncertainties about the conversion process are considered (see, for example, the use of fair values as of January 1, 2010 effectively prohibits the preparation of fair value data prior to that date), the likelihood of early completion of the changeover process diminishes. Likewise, the likelihood of any early disclosure of quantitative information diminishes. A communication approach that addresses these issues is considered in Issue 9. Such uncertainty will affect the approach an entity may adopt to deadlines as well, considering that changes in IFRS may change not only the content but the strategic consequences that follow from the converted financial statements.

BOMBARDIER INC.

International Financial Reporting Standards

In February 2008, the AcSB confirmed that Canadian GAAP for publicly accountable enterprises will be converged with IFRS effective in calendar year 2011, with early adoption allowed starting in calendar year 2009. IFRS uses a conceptual framework similar to Canadian GAAP, but there are significant differences on recognition, measurement and disclosures. In the period leading up to the changeover, the AcSB will continue to issue accounting standards that are converged with IFRS, thus mitigating the impact of adopting IFRS at the changeover date. The International Accounting Standard Board (IASB) will also continue to issue new accounting standards during the conversion period, and as a result, the final impact of IFRS on the Corporation's consolidated financial statements will only be measured once all the IFRS applicable at the conversion date are known.

For the Corporation, the changeover to IFRS will be required for interim and annual financial statements beginning on February 1, 2011. As a result, the Corporation has developed a plan to convert its Consolidated Financial Statements to IFRS. The Corporation has also set up IFRS dedicated teams at all levels of the organization. The Corporation has provided training to key employees and is monitoring the impact of the transition on its business practices, systems and internal controls over financial reporting.

A detailed analysis of the differences between IFRS and the Corporations' accounting policies as well as an assessment of the impact of various alternatives are in progress. Changes in accounting policies are likely and may materially impact the Corporation's Consolidated Financial Statements.

Bombardier

Quarterly Report, three months ended October 31, 2008

8 Approaching the disclosure of the cost of capital and key management compensation: the choices and their messages

IFRS disclosure requirements include elements that are beyond the scope of matters that are normally included in financial statements prepared in accordance with Canadian GAAP. Two examples of such disclosures are the disclosure of discount rates based on the entity's cost of capital that are used to value impaired assets valued under the value-in-use method, and the disclosure of the compensation of key management personnel.

IFRS requires an entity using the value-in-use methodology to measure impairment of assets to disclose, among other things, the discount rates used to determine value in use – “the weighted average cost of capital for the operations using the asset in question.” The disclosure is unique in several ways. First, it is generally not an observable economic parameter, but is internally-estimated. It is in fact usually estimated as an after-tax rate of return, although the discount rate specified by IFRS is the before-tax rate.

In North America, disclosure of compensation levels is required in proxy statements by regulation, but not in the financial statements. Unlike the proxy disclosure, the IFRS financial statement disclosure does not stipulate the measure to be used for that compensation. This is not a trivial omission as regulators have struggled at length to determine whether among other things stock option compensation should be reflected at the fair value of the grant at the grant date, or the fair value thereafter. It is a conundrum: if the fair values of options are continuously adjusted and the values fall, this may result in negative compensation, an illogical outcome; if the grant date value

is used, no recognition is given to subsequent enrichment. Evidence shows that current compliance with these two disclosure requirements in IFRS-compliant financial statements does not always produce precise information. Frequently cost of capital rates are disclosed as wide ranges (e.g. “pre-tax: 8%-24%..., post-tax: 5%-20%”). Similarly disclosure of compensation practices may span several pages of the financial statements, with details of the valuation parameters of each option grant. The user is required to read through mountains of information to obtain an understanding of compensation.

The objective of the IFRS disclosure requirements in both cases is to provide transparent communication of potentially sensitive information. In the case of the cost of capital, disclosing the rate of return may identify whether the entity used a low discount rate to raise an impaired asset's carrying value, or used a high rate to provide for unrealistically high future yields. Disclosure serves as a control over such risks in the use of internal estimates. In the case of compensation, the issue is the disclosure of a fundamentally non-arm's length transaction that may be subject to abuse.

The choice faced by preparers is to provide measures of rates of return and compensation that accomplish these objectives, or ones that merely comply but do not meet the objective of the disclosure. The forthright disclosure of such data would demonstrate that the entity's management comprehends the principles-based nature of IFRS. It is a choice that reflects more than the accounting principles of an entity.

ABBEY NATIONAL

2005 Financial Statements

The following cash-generating units include in their carrying value goodwill that is a significant proportion of total goodwill reported by Abbey. These cash-generating units do not carry on their balance sheet any intangible assets with indefinite useful lives, other than goodwill.

Business division	Cash generating	Goodwill	Basis of valuation	Key assumptions	Discount rate	Growth rate
Retail banking	Private banking	90	Value in use: cash flow	3 year plan	6.6%	2.3%
Insurance and asset management	Insurance and asset management	46	Value in use	2006 budget	7.0%	5.0%

9

Communicating the changeover to IFRS

IFRS 1 governs the manner in which an entity converts its financial statements to IFRS. It requires the disclosure of the effects of changes in accounting policies upon conversion, primarily in the form of reconciliations of the opening equity under IFRS to the balances under predecessor GAAP and a reconciliation of the effects of conversion on the entity's income statement for the comparative year. Such reconciliations illustrate for financial statement users the quantitative effects of the various required and elective changes that an entity has applied in the process of conversion to IFRS. An entity should also disclose the nature of the elections that it has made in the course of conversion. Some of these, such as the elimination through opening retained earnings of cumulative translation gains and losses previously charged to Other Comprehensive Income, may simply be elections within the shareholders' equity section of the balance sheet and may only be disclosed as narratives.

The Canadian securities regulators have stated that entities should, to the extent they have determined or quantified the effects of changes required by adopting IFRS, disclose in the MD&A quantitative information about the consequences of conversion before the changeover date.

These reconciliations and disclosures do not generally require explanations of the reasons for choices (where choice exists), nor of the consequences of the changes on trends and patterns in the entity's financial results and position. The requirement is to reconcile the income statement of the year prior to the change, not the year of the change (the alternative approach is embodied in the SEC's changeover proposals). In the 2011 financial statements, investors may not be able distinguish between

the changes in the 2011 IFRS quarterly and annual reports that arise from changes in the entity's underlying performance from those that arise from the adoption of IFRS. Further, prior to the publication of the IFRS compliant financial statements in the beginning of 2011, in most cases a user will be unable to form expectations of 2011 or later performance in IFRS terms. The formation of expectations may be particularly affected by the policies and elections that entity elects on adoption, which need only be completely determined and disclosed in 2011.

The Canadian securities regulators have stated that entities should, to the extent they have determined or quantified the effects of changes required by adopting IFRS, disclose in the MD&A quantitative information about the consequences of conversion before the changeover date. This approach may be frustrated by the lack of completely restated financial information prior to 2011, and a reluctance to publish results that could materially change before completion. A solution to this problem may be drawn from the disclosures of some EU entities which would be a two-step approach: first, publish the 2010 results prepared in accordance with Canadian GAAP in early 2011. Then, shortly thereafter (or earlier, if available), publish complete packages of IFRS-compliant opening (January 1, 2010) balance sheets, quarterly information and full-year restatements of the 2010 year's income. This provides users with a basis for forming quarterly and full-year 2011 expectations in IFRS terms – and the ability to readily assess the results of 2011 as published.

Under this approach, first-quarter 2011 IFRS-compliant financial statements are provided to a fully-informed marketplace, with data for the prior year provided before the publication of the new financial statements. Analysts and other users can formulate their models and expectations for 2011 prior to receiving the first quarter statements. The alternative—to slowly evolve the reporting package, and provide both Canadian and IFRS data, can lead to the publication of IFRS data that are



subject to change as policy choices are made up to the date that the first IFRS-compliant financial statements are published. Experience indicates that changing expectations – even changes resulting from legitimate changes in accounting policy choices – should be avoided. Leaving the publication of any restated data to the first set of IFRS-compliant historical statements may be too late to help form expectations. The Big Bang may be the most effective way to effect change.

IFRS

WestJet Airlines Ltd. 2008 Third Quarter Interim Report

On February 13, 2008, the CICA Accounting Standards Board confirmed the changeover to IFRS from Canadian GAAP will be required for publicly accountable enterprises for interim and annual financial statements effective for fiscal years beginning on or after January 1, 2011. The transition from current Canadian GAAP to IFRS is a significant undertaking that may materially affect our reported financial position and results of operations. This is a forward-looking statement, and as such, we have derived this estimate based on assumptions from our preliminary assessment of Canadian GAAP and IFRS differences. We are currently in the process of finalizing our IFRS transition plan. Through an initial thorough diagnostic review, we have assessed the potential effects of IFRS to accounting and reporting processes, information systems, business processes and external disclosures. The IFRS transition plan also addresses project structure and governance, resourcing and training, and a phased plan to assess accounting policies under IFRS, as well as potential first-time adoption exemptions. We anticipate completing our project scoping, which will include a timetable for assessing the impact on data systems, internal controls over financial reporting (ICFR) and business activities, such as financing and compensation arrangements, in the fourth quarter of 2008.

We have established a working team to conduct further analysis on the potential effects identified in the IFRS transition plan. Additionally, we have established an IFRS Steering Committee to monitor progress and review and approve recommendations from the working team for the transition to IFRS. The Steering Committee comprises senior individuals from Finance, Treasury and Investor Relations. The working team reports to the Steering Committee on a monthly basis, and quarterly IFRS updates are provided to the Audit Committee.

Based on the diagnostic review in the IFRS transition plan, the most significant areas of difference between Canadian GAAP and IFRS applicable to us relate to property and equipment, provisions and leases, as well as the more extensive presentation and disclosure requirements under IFRS.

10 Setting strategically relevant deadlines: why January 1, 2011 may not be the date you should most worry about

The date that IFRS reporting becomes an external reality for most calendar-year end entities is January 1, 2011. After that time, all current and comparative financial statement data should be produced in conformity with IFRS (current Canadian GAAP will not continue to exist as an alternative reporting format for publicly-accountable enterprises). At the same time, for reasons discussed above, matters that may affect conversion and conversion choices themselves may only be resolved on or about December 31, 2010 – just before the conversion date. Nonetheless, there are good reasons why deadlines, particularly internal discussion points for major components of the IFRS conversion process, should be set much earlier than the deadline for external publication of IFRS.

For example, the development of in-house IFRS reporting expertise should clearly exist before the conversion process itself is complete. Similarly, if conversion to IFRS requires changes to IT systems, very long lead times may be necessary for those elements of the conversion process that need to be programmed and tested prior to implementation. These would imply decision points significantly earlier than the external publication date. Other systematic requirements for prospective IFRS compliant data, such as the formal plans, budgets, compensation targets, and other performance benchmarks that are established in advance of the relevant fiscal period, would also imply earlier timelines.

IFRS-compliant data may have consequences for the entity's contracting and business practices (see many of the issues discussed above). In particular, if the adoption of IFRS could have consequences for an entity's business condition, such as from contractual or tax consequences, prudent risk management would dictate that the entity be aware of such consequences in advance of the date the consequences become real. Finding solutions, or at least minimizing adverse consequences by amending or replacing arrangements prior to IFRS becoming effective

may accelerate deadlines for completion of all or some of the changeover before January 1, 2011.

Finally, the experience of other jurisdictions indicates that upon conversion there is an increased likelihood of errors upon the initial implementation of IFRS. Even with the lead time provided by the Canadian Accounting Standards Board, factors specific to the Canadian conversion, such as further changes in IFRS standards (see Issue 7) may challenge implementation capabilities. The best preventive mechanism would be sufficient time for reflection and quality review prior to publication.

Given the finite (and increasingly limited) amount of time that exists until conversion becomes mandatory, the earlier the deadline for completion of elements of the process logically means the less time there is to complete the conversion work itself. To some extent the reduction in time available can be offset by the expansion of the pool of resources working within that time frame. The inclusion of more individuals in the workstream could also enhance organization-wide comprehension and competencies in IFRS, in addition to reducing the risks of untimely completion.

The general focus on the changeover date of January 1, 2011 does, however, gloss over the fact that it is the financial reporting system (and its collateral activities such as financing, contracting, processing, etc.) that is being converted and not simply the financial statements. A systematic approach recognizing that certain functions have early deadlines is less likely to result in an a less-than-satisfactory result for the whole project.



While the decisions and activities that occur upon conversion to IFRS are primarily accounting matters, we believe that there are several choices that have potential strategic consequences. Consequently, it is our view that conversion to IFRS is more than an accounting change; it has implications for an entity's perceived performance, its compensation policies and its communication strategies. These decisions deserve careful consideration by senior management and the board of directors as they will affect more than just your financial statements.

The strategic issues we have considered can be categorized by looking at their potential impact on the valuation of the entity, its performance measurement, the construction and interpretations of bank covenants, and on its cost of capital. The following table summarizes these effects.

	Business valuation	Performance measurement	Bank covenants	Cost of capital
Strategic choices in IFRS 1: identifying elections that may have a significant impact beyond the financial statements	✓	✓	✓	✓
IFRS policies and choices can affect reported cash flows		✓		
Incorporating EBITDA, Operating cash flows, and other Non-GAAP measures into IFRS conversion plans	✓	✓		
The benefits of using fair value as the deemed cost of property, plant and equipment on transition	✓	✓	✓	✓
Employee compensation including defined benefit pension plans: important options on conversion – and after		✓	✓	
Negotiating or re-negotiating bank covenants and other GAAP-related agreements on conversion to IFRS: strategic considerations			✓	✓
Not a stable platform: future changes in IFRS and how these may affect your conversion and communications plans	✓	✓	✓	✓
Approaching the disclosure of the cost of capital and key management compensation: the choices and their messages		✓		✓
Communicating the changeover to IFRS		✓		
Setting strategically relevant conversion deadlines: why January 1, 2011 may not be the date you should most worry about		✓		

As you can see, in many circumstances, IFRS conversion may have effects beyond the financial statements. In our view, if you are making IFRS conversion decisions on these matters, you should carefully review the options available and consider their consequences for the financial statements and beyond before making final decisions. Furthermore, once you have made your decisions, your stakeholders should be informed of what to expect in your first IFRS-compliant reporting. A clear and transparent communications process is invaluable.

...if you are making IFRS conversion decisions on these matters, you should carefully review the options available and consider their consequences for the financial statements and beyond before making final decisions...

There are also many other IFRS conversion matters that are likely to have strategic consequences, but for which an entity has effectively few choices. This document has not highlighted these options, as they are more appropriately considered as matters of compliance and not choice. For those assessments where there is uncertainty as to the appropriate answer, we recommend that you seek professional counsel.

The professionals of Deloitte that are listed on the back cover of this document can assist in many of these circumstances. The advice provided in this publication cannot contemplate the facts and circumstances relevant to any preparer's situation. Thus, it is not intended that this publication provide guidance but rather it raises issues on which guidance may be sought. As a result, we cannot accept any responsibility for decisions made relying on this document: the advice of appropriately qualified professionals should be sought.

If you would like to know what other Canadian companies are doing with respect to the selection of the various elections that are available on first-time adoption of IFRS, we invite you to participate in our IFRS transition study. It is confidential and will take only a few minutes to complete.

The survey results will be shared with all participants in late Spring 2009. See our online survey at:

<http://www.zoomerang.com/Survey/?p=WEB228J32MRE5D>

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Thought leadership

You may obtain these publications from your Deloitte partner:

Assets Held for Sale and Discontinued Operations: A Guide to IFRS 5
DTT, March 2008

Business Combinations and Changes in Ownership Interests
DTT, July 2008

IFRSs in your Pocket 2008
Summary of all IFRS in issue at March 31, 2008
DTT, April 2008

iGAAP 2009: A Guide to IFRS Reporting
DTT, August 2007

How to Monitor a Sea Change: Discussing Your IFRS Changeover Plan in the MD&A
Deloitte, August 2008

iGAAP 2008: IFRS for Canada
Deloitte, November 2008

IFRS transition readiness assessment: How well are you prepared?
Deloitte, April 2008

iGAAP 2008 Financial Instruments IAS 32, IAS 39 and IFRS 7 Explained
Deloitte UK, Published by Lexis Nexis, June 2008

IFRS transition – top issues to address Potential issues related to IFRS transition
Deloitte, April 2008

Interim Financial Reporting: A Guide to IAS 34
DTT, June 2007

Learning

Register to future learning events:

IFRS e-learning for directors: Deloitte & Touche IFRS e-Learning Program for Directors™
Contact your Deloitte IFRS advisor to obtain our IFRS e-learning program for Directors CD

eLearning Modules On IFRS standards
DTT

IFRS Dbriefs for Financial Executives
Webcast, Deloitte US, August 2008

IFRS in Canada – the story so far
Webcast, Deloitte, April 2008

Periodicals

Subscribe to our eNewsletters and Web sites:

Countdown
eNewsletter on transition

DeloitteIFRS.ca
A dedicated website

Standard-setting Activities Digest—International
An unique checklist

www.iasplus.com
DTT Web site dedicated to IFRS

Preparing for IFRS
A Directors' Series session replay

Sector reporting

You may obtain these publications from your Deloitte partner:

Ascending to New Heights With IFRS:
A look at accounting changes and beyond for the process and industrial products industry
Deloitte US, October 2008

IFRS Considerations for the Oil and Gas Industry
Deloitte US, August 2008

IFRS and the Mining Industry: Top Ten Accounting Issues for Canadian Issuers
Deloitte, August 2008

IFRS: Considerations for the Retail Industry
Deloitte US, September 2008

IFRS Considerations for the Automotive Industry
Deloitte US, September 2008

IFRS Considerations for the Technology Industry
Deloitte US, September 2008

IFRS Considerations for Consumer Products
Deloitte US, November 2008

IFRS: Derivative Accounting Considerations under IAS 32/39 and IFRS 7 for Energy Transacting Activities
Deloitte US, November 2008

IFRS for Investment Funds
Deloitte US, December 2008

IFRS in Real Estate: More than just accounting and reporting
Deloitte US, August 2008

IFRS in the Aerospace and Defense Industry
Deloitte US, November 2008

FRS in Tourism, Hospitality and Leisure Industry
Deloitte US, November 2008

IFRS in the Life Sciences
Deloitte US, September 2008

On the road ahead : IFRS top ten issues in insurance industry
Deloitte, September 2008

IFRS in the Manufacturing Industry: Ascending to New Heights with IFRS
Deloitte US, November 2008

The IFRS Journey in Insurance: A Look Beyond the Accounting
Deloitte, August 2008

The Path to IFRS Conversion: Considerations for the banking and capital markets industry
Deloitte US, November 2008

The Path to IFRS: Considerations for the Shipping Industry
Deloitte US, January 2009

Tools

You may obtain these publications from your Deloitte partner:

IFRS Compliance Questionnaire: A compliance assessment tool
DTT, November 2008

Special Report on SEC Comment Letters: Insights for registrants using IFRSs
DTT, January 2008

IFRS Model Financial Statements 2007 Illustrative financial statements
DTT, November 2007

IFRS Portal
Contact your Deloitte IFRS advisor to obtain our IFRS Portal DVD.

IFRS Presentation and Disclosure Checklist: A financial statement review tool
DTT, November 2008

IFRSs and US GAAP A pocket comparison: An IAS Plus guide
DTT, July 2008

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