

In this issue:

Technical corner: IASB proposes new hedge accounting model

IFRS conversion: It's not just for your accounting department — The importance of creating a change management strategy

Making it happen: R&D costs unaffected by ongoing convergence efforts

Changes ahead: Big bang or staggered — which approach will the FASB take?

Highlights of the 2010 AICPA National Conference: Current SEC developments regarding IFRS

IFRS resources

IFRS contacts

www.deloitte.com/us/ifrs

As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.

IFRS Insights

Achieving a global standard



Technical corner: IASB proposes new hedge accounting model

In response to the global financial crisis and to calls to reduce accounting complexity, the U.S. Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are developing new accounting requirements for financial instruments. One component of this work involves the accounting for hedging activities.

In December 2010, the IASB published an Exposure Draft (ED), *Hedge Accounting*, which includes proposals intended to "align hedge accounting more closely with risk management . . . , establish a more objective-based approach to hedge accounting, [and] address inconsistencies and weaknesses in the existing hedge accounting model." The ED covers only what the IASB describes as the "general" hedge accounting model; in 2011, the IASB anticipates issuing a separate ED for the "portfolio" hedge accounting model. Hedge accounting is the final phase of the IASB's project to replace IAS 39, *Financial Instruments: Recognition and Measurement*.

Although the FASB issued proposed revisions to its hedge accounting requirements under U.S. Generally Accepted

Accounting Principles (GAAP) in 2010 as part of its financial instruments exposure draft¹, the FASB plans to publish a separate discussion paper inviting views on the IASB's hedge accounting proposals in the first quarter of 2011. The FASB will consider the input received on the IASB's proposals when it begins to redeliberate hedge accounting later in 2011.

The bottom line

The proposals in the ED would allow a company to mitigate recognition and measurement differences between hedging instruments (e.g., derivatives) and hedged items (e.g., forecast sales) when certain requirements are fulfilled and include many changes to the current requirements, with the aim of better reflecting risk management activities in the financial statements. Many hedging relationships that do not qualify under IAS 39 would qualify under the ED's proposals.

¹ Proposed FASB Accounting Standards Update (ASU) *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. In addition to hedge accounting, the proposed ASU also addresses classification and measurement of financial assets and financial liabilities and recognition and measurement of credit impairments. See Deloitte's May 28, 2010, *Heads Up* for an overview of the proposed ASU and the November 5, 2010, *Heads Up* for a summary of constituent feedback on the proposed ASU.

Key aspects of the hedge accounting ED

- The IASB's exposure draft proposes a new general hedge accounting model. Proposals for a new portfolio hedge accounting model, including portfolio fair value hedging of interest rate risk, is expected to be issued separately in 2011.
- Although the basic concepts in IAS 39 of fair value hedges, cash flow hedges, and hedges of a net investment in a foreign operation are retained, the proposed rules regarding what items can qualify for hedge accounting, what instruments can be designated in hedging relationships, and what effectiveness testing is required are generally more relaxed.
- Assessing hedge effectiveness would be limited to a forward-looking test with no bright-line threshold (i.e., no 80–125% offset requirement and no retrospective hedge effectiveness test). In many cases, this would not need to be a quantitative assessment, albeit quantitative measurement of ineffectiveness would still be necessary.
- Hedge accounting for risk components of both nonfinancial and financial items would be permitted provided they are separately identifiable and reliably measurable.
- When an option is a hedging instrument, some or all of the change in its time value could be recognized in other comprehensive income (OCI), thereby reducing volatility in profit or loss when compared with current IFRS.
- The presentation of fair value hedges would change in the financial statements.
- Hedge accounting for net positions and groups of items would be extended.
- "Basis adjustments" would be mandatory for certain cash flow hedges.
- Voluntary dedesignation of a hedging relationship would not be permitted if the risk management objective for the hedge remains unchanged.
- A hedging relationship could be altered without the reset of the hypothetical derivative.
- A derivative could be included as a hedged item if combined with an eligible exposure.

The ED for the portfolio model is expected to include new proposals for portfolio fair value hedge accounting of interest rate risk (often referred to as the "macro hedge accounting model"). This will most likely be relevant for financial institutions or corporations with consumer finance operations. The portfolio model is also expected to consider requirements for open-portfolio hedge accounting (i.e., when the hedged items and hedging instruments that are included in the hedging relationship continuously change over time), which may have a wider relevance.

The general hedge accounting model includes requirements for hedged items that are closed portfolios of items. For such hedges, the hedged items or amounts are specifically identified and designated at inception of the hedge.

The ED does not propose any specific changes to the accounting for hedging a net investment in a foreign operation, commonly referred to as "net investment

hedges." However, the proposed changes to the hedge effectiveness testing requirements apply to all hedging relationships and therefore would also be relevant when testing the effectiveness of a net investment hedge.

The comment period for the ED ends on March 9, 2011, and a final standard is expected to be issued in June 2011. Additional information will be provided in a future issue of *IFRS Insights*.

IFRS conversion: It's not just for your accounting department — The importance of creating a change management strategy

As companies monitor the progress of the U.S. Financial Accounting Standards Board's (FASB) and International Accounting Standards Board's (IASB) project to converge U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), they will more than likely be focused on the impact to their accounting group and the way their financial statements are developed. However, the impact doesn't stop there.

Many areas of the organization will be impacted. And as with any major change, it is important to understand those changes and to develop and implement effective change management strategies.

The conversion to IFRS represents a strategic, enterprise-wide initiative that impacts stakeholders throughout the business. In Deloitte's experience, large change management projects fail when organizations neglect to identify the key stakeholder groups or understand the true nature of the changes, including the critical issues that will need to be addressed through targeted change management strategies.

For example, consider the many groups involved in the order-to-cash process and how each is affected. Since IFRS does not allow Last In, First Out (LIFO) for inventory accounting, it will be important for manufacturing, warehousing, and business unit leaders to consider this when calculating business segment profitability. Similarly, IFRS uses a single-step method for impairment write-downs, rather than the two-step method used in U.S. GAAP, making write-downs more likely. Business unit and operations leaders will need to understand the potential impact on profitability and performance bonuses of these changes.

Case study: Implementing IFRS within R&D

To further illustrate the diverse impacts of IFRS on stakeholders outside of accounting, consider the following example which highlights the change management strategies that a global manufacturing company used to limit disruption to its research and development (R&D) efforts.

The accounting differences between U.S. GAAP and IFRS regarding the treatment of intangible assets meant that the R&D department's development costs would be capitalized under IFRS, where such costs were previously expensed as incurred under U.S. GAAP.

IFRS requires that the R&D and accounting groups work together to define how and when to draw the line between research and development activities. This meant that R&D project leaders had to put new tracking and reporting procedures in place. The conversion to IFRS created unique change management challenges, including:

- Bridging the jargon gap: accounting terminology vs. science-speak — Accountants and R&D scientists tend to speak different languages when discussing the status of innovative projects, so it was critical to get beyond each other's terminology to the heart of what needed to be done to comply with IFRS.
- Communicating the context/purpose of IFRS changes — Change for change's sake is rarely welcomed by any organizational department. Stakeholders wanted to know why the change was taking place, why it was critical that they take part, and how it would impact them and their key partners within the business.
- Minimizing disruption in implementing new tracking and reporting procedures — Determining where research ends and development begins required new criteria to be tracked and reported on a regularly-scheduled basis. Providing R&D with reporting tools that are built on existing reporting structures helped to minimize disruption while allowing the accounting department to get the data that it needed.
- Coordinating changes consistently across global teams and facilities — With multiple R&D groups located across global regions, a clear communications strategy, including specific R&D-focused training sessions, was required to deliver a consistent message.

Working within the framework of the challenges defined above, change management and communication strategies were deployed that engaged R&D leaders, front line scientists, and accounting personnel.

They reached out to the global R&D leaders early on in the IFRS impact analysis phase so they could be engaged throughout the life of the conversion by sharing feedback, developing reporting tools, and co-authoring communications to field staff. Months in advance of the IFRS conversion, accounting team personnel and members of the larger conversion team made site visits to R&D facilities to discuss potential impacts and to listen closely for ideas and concerns from front line staff.

Building upon the R&D leadership discussions and insights documented at the facility site visits, they conducted a change management and training needs assessment to identify IFRS impacts to reporting systems and processes. The assessment aided in the design of relevant training and tools to ease the conversion. The training materials will feature "IFRS 101" basics to bridge the accounting jargon/science-speak gap, walk participants through intangible asset condition requirements that sit at the center of new accounting policies, and preview new reporting tools by applying them to common project management scenarios.

Conclusion

No matter what part of the organization, there are a number of considerations that can be taken into account when preparing to adopt IFRS:

- Assess early-on if you have the types of individuals needed for conversion within all areas impacted by IFRS, so you can start building that into your talent management program
- Determine early-on your company's ability to deliver IFRS training and understand existing training limitations so you can be ready to deploy the training in a timely and effective manner
- Make sure that the learning and development programs you create now are scalable and sustainable
- Prepare your people as early as possible for the changes to the organization, processes, systems, and technology that may take place during the conversion period
- Communicate early and often about IFRS conversion, especially to the people outside of accounting and finance who will be involved in the project and to those whose jobs may change going forward

Don't assume that conversion is limited just to finance and accounting; instead, treat this as a strategic, enterprise-wide initiative and communicate it appropriately. And most importantly, don't let it disrupt the business.

Making it happen: R&D costs unaffected by ongoing convergence efforts

As the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board continue down the path towards converging Generally Accepted Accounting Principles in the United States (U.S. GAAP) and International Financial Reporting Standards (IFRS), it's important to note that even after the convergence efforts are complete there may still be areas where significant differences will remain.

One such area is research and development (R&D) costs². Under U.S. GAAP, R&D costs are generally expensed as incurred, while under IFRS, development costs are generally capitalized as intangible assets when certain criteria are met.

This article focuses on the recognition of internally-generated intangible assets under IFRS for development costs and highlights some of the potential conversion implications and considerations beyond accounting.

R&D costs — Recognition

IAS 38, *Intangible Assets*, states that an intangible asset should be recognized if it is probable that the expected future economic benefits attributable to an asset will flow to the entity and the cost of the asset can be measured reliably. Entities are required to separate project costs into two phases: research and development.

In the research phase, an entity cannot determine whether a project will generate future economic benefits, so research expenditures must be expensed when incurred. Once a project progresses to the development phase, if entities can demonstrate that the project will provide future economic benefits, further costs would be capitalized prospectively, assuming the capitalization criteria were met. The extent to which development costs are capitalized often depends on the industry in which an entity operates. In some industries, product development follows a formal process with standard milestones which can often be used to document the advancement of a project from research to development as well as the achievement of certain capitalization criteria.

R&D costs — Measurement

The cost of an internally-generated intangible asset includes all directly-attributable costs necessary to create, produce, and prepare the asset to be capable of operating in a manner intended by management. These costs include material and services used or consumed, and employee costs and benefits that arise from generating the intangible asset, as well as fees to register legal rights and amortization of patents and licenses used. The standard also provides examples of costs that are not included in the cost of the intangible asset (i.e., selling, administrative, and other overhead expenditures not deemed directly attributable to the asset).

Any recognized intangible asset is subsequently subject to amortization over its estimated useful life and impairment testing.

First-time adoption considerations

IFRS 1, *First-time Adoption of IFRS*, requires full retrospective application related to R&D costs. This may prove challenging as expenditures prior to the transition date must be considered for possible recognition. In some cases, internally-generated intangible assets will not qualify for recognition if the entity did not accumulate cost information or did not perform an assessment of future economic benefits at the time the cost was incurred.

Careful planning is generally necessary to recognize an asset in the opening IFRS balance sheet. Often an entity must ensure that it has a system and/or process in place to assess whether the capitalization criteria have been met and to separately accumulate development costs by project.

R&D cost examples

Research

- Activities related to obtaining new knowledge
- Searching for, evaluating, and selecting final applications of research findings or other knowledge
- Searching for alternative materials, devices, products, processes, systems, or services
- Formulating, designing, evaluating, and selecting final alternatives for new or improved material, devices, products, processes, systems, and services

Development

- Designing, constructing, and testing of pre-production prototypes and models
- Designing tools, jigs, molds, and dies involved in new technology
- Designing and constructing a pilot plant at less-than-commercial scale
- Designing, constructing, and testing a chosen alternative

² In the 2008 Memorandum of Understanding, the FASB indicated that it will consider in the future whether to undertake a project to eliminate differences in the accounting for research and development costs by fully adopting IAS 38 at some point in the future.

Financial implications

Over time, the effect on profit as a result of capitalizing (and amortizing) development costs under IFRS (as compared to expensing under U.S. GAAP) should equalize. Certain key financial metrics, however, may be impacted by the classification of R&D expenses as amortization expense under IFRS. Entities must be prepared to clearly communicate these impacts to investors and key stakeholders.

Process, system, and tax considerations

For most companies, the change in the accounting for development costs under IFRS will require changes to their processes and internal controls. Processes and controls must be implemented to:

- Document that the recognition criteria are met
- Track and assign related costs
- Capitalize and amortize the related intangible asset
- Test the resulting intangible asset for impairment

Many entities may find they don't currently have the infrastructure to segregate development costs from research costs and to track the development costs by project. Entities may find it necessary to implement various system solutions and/or manual processes to comply with the requirements under IFRS.

Capitalization of development costs may also have significant impacts on income taxes due to the calculation of research and experimentation tax benefits and the creation of additional book-to-tax differences.

What now?

Entities may find it beneficial to assess accounting, process, system, and tax implications related to development costs, including identifying gaps in needed information in the near-term to ensure processes are in place to assess whether capitalization criteria have been met and to capture development costs when incurred. Such information will substantiate capitalizing development costs in an entity's opening IFRS balance sheet and may have the added benefit of further supporting an entity's tax incentives associated with research activities.

Changes ahead: Big bang or staggered — which approach will the FASB take?

The U.S. Financial Accounting Standards Board (FASB) expects to release a tidal wave of new accounting standards in 2011. Realizing that adopting the new guidance will undoubtedly create a significant burden on certain of the FASB's constituents, the FASB recently issued a discussion paper (DP), *Effective Dates and Transition Methods*, which asked stakeholders (including preparers

of financial statements, auditors, users of financial statements, standard setters, market regulators, and others) to weigh-in on: (1) the time and effort they would need to adopt several new and significant accounting and reporting standards, and (2) the dates those new standards should be effective. All comments were due by January 31, 2011, so now the FASB will review the feedback and release next steps.

The following list of projects falls within the DP's scope:

- Accounting for financial instruments and revisions to the accounting for derivative instruments and hedging activities, including netting of financial instruments (see article in this newsletter for additional information)
- Balance sheet — offsetting
- Comprehensive income
- Discontinued operations
- Financial instruments with characteristics of equity
- Financial statement presentation
- Insurance contracts
- Leases
- Revenue recognition — revenue from contracts with customers

The DP noted that the effective dates of the projects within the DP's scope would be either: (1) the same date for all projects (what some have termed the "big bang"), or (2) separate dates for each respective project (a staggered approach).

While we wait

Whether the new standards are issued in a big bang approach or are staggered, many of these projects, if finalized, could cause significant changes to financial reporting and operations. The proposed standards would potentially affect a variety of departments throughout organizations, including accounting and finance, sales, information technology, legal, and treasury.

While waiting for additional guidance from the FASB, you should begin to think about the impacts on your company and:

- Assess your information technology systems
- Evaluate the existing terms of your contracts and agreements
- Evaluate accounting policies to ensure consistent application in areas in which significant judgment is required
- Consider the impact on financial ratios and metrics

Stay tuned to future issues of *IFRS Insights* for additional information.

Highlights of the 2010 AICPA National Conference: Current SEC developments regarding IFRS

It's hard to imagine a better venue than the annual American Institute of Certified Public Accountants' (AICPA) conference for the U.S. Securities and Exchange Commission (SEC) to keep constituents posted on deliberations regarding whether, how, and when public company SEC registrants in the United States will be incorporating International Financial Reporting Standards (IFRS) into their U.S. financial reporting systems.

SEC Chairman Mary Schapiro highlighted that the SEC's decision on IFRS is a top priority and further indicated that if the SEC does decide to incorporate IFRS into the U.S. financial reporting system, constituents would most likely have at least four years to comply.

International convergence of financial reporting standards

Senior representatives from the SEC, U.S. Financial Accounting Standards Board (FASB), and International Accounting Standards Board (IASB) all stressed the importance of high-quality financial reporting standards. Ms. Schapiro recognized the progress the FASB and IASB have made in converging international accounting standards but conceded that "the path towards convergence has proved steep and winding at times." She stated that "[c]onvergence [of accounting standards] is a top priority for the SEC" but cautioned that the converged standards must be "high-quality improvements over current standards."

Further clarifications of Ms. Schapiro's views on IFRS incorporation were provided in a question-and-answer session following her prepared remarks. She indicated that the SEC is still on track to make a final decision in 2011 regarding the use of IFRS by U.S. issuers (although the SEC does not feel bound to a June 2011 decision deadline). In addition, she believes that a minimum four-year implementation period is "likely" but a decision about that is still "a specific decision point for the Commission."

Representatives from the FASB and IASB also weighed in on their convergence progress. Sir David Tweedie, chairman of the IASB, emphasized the need for a single set of high-quality, global standards. He outlined the potential benefits of such a set of standards, including greater cross-border investment, increased comparability of financial information across political boundaries, lower cost of capital, and easier consolidation of global entities.

Leslie Seidman, chairman of the FASB, noted that the FASB and IASB have been working together since 2001, intending to eliminate significant differences between U.S. Generally Accepted Accounting Principles and IFRS by developing joint standards in areas in which significant improvements are warranted, yet trying to avoid creating new differences in the process.

Other topics

IFRS was not the only topic of interest at this year's conference. The SEC staff and other presenters shared their views on a range of financial reporting, auditing, and standard-setting topics, including: the need to restore and uphold investor confidence and public trust, the Dodd-Frank Act, communicating with investors, and the impact of continued economic uncertainty on financial reporting and internal control over financial reporting. Additional information on all of these topics can be found in our [Heads Up](#) publication.

IFRS resources

If you're looking to learn more about IFRS, join us for two days of IFRS executive training in Atlanta, GA on March 22–23 or in San Jose, CA on May 17–18. [Check our Website for more details and registration information.](#) If you are unable to attend a classroom session, please consider our [IFRS e-learning program](#) which provides CPE credit.

Additionally, companies in the oil and gas industry should consider attending our 2011 Oil & Gas IFRS Summit in Houston on May 24–25. Please contact [Scott Harvey](#) for additional information.



IFRS contacts

Joel Osness

New York
Deloitte & Touche LLP
+1 212 492 3910
josness@deloitte.com

Nick Difazio

Detroit
Deloitte & Touche LLP
+1 313 396 3208
ndifazio@deloitte.com

Sam Doolittle

San Francisco
Deloitte & Touche LLP
+1 415 783 4343
sdoolittle@deloitte.com

Tom Omberg

New York
Deloitte & Touche LLP
+1 212 436 4126
tomberg@deloitte.com

Alfred Popken

New York
Deloitte & Touche LLP
+1 212 436 3693
apopken@deloitte.com

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte, its affiliates, and related entities shall not be responsible for any loss sustained by any person who relies on this publication.

Copyright © 2011 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited