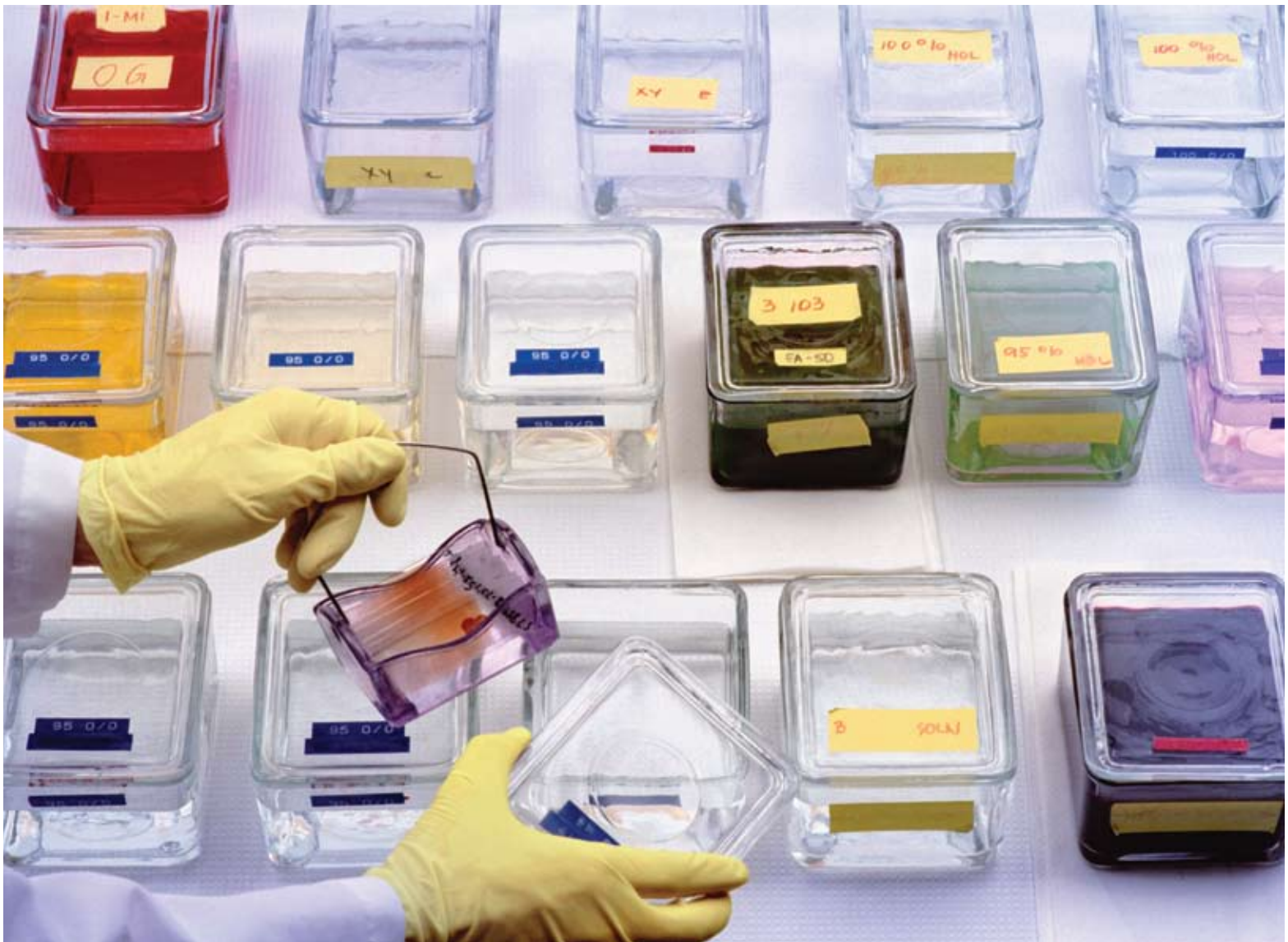


# Putting IFRS in motion\*

Key accounting issues for pharmaceuticals  
and life sciences companies



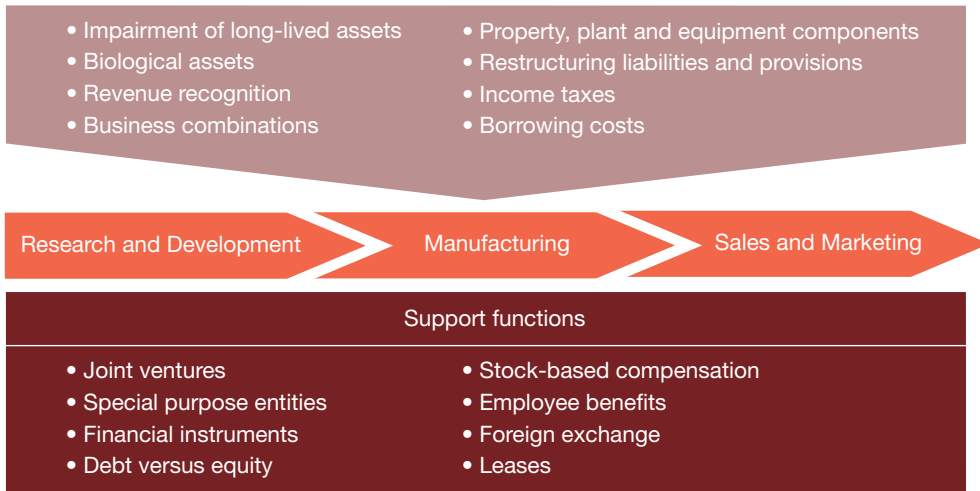
Canadian publicly accountable companies will be required to adopt International Financial Reporting Standards (“IFRS”) for interim and annual financial statements for fiscal years beginning on or after January 1, 2011, with early adoption permitted by securities regulators on a case-by-case basis.



Canadian publicly accountable companies will be required to adopt International Financial Reporting Standards (“IFRS”) for interim and annual financial statements for fiscal years beginning on or after January 1, 2011, with early adoption permitted by securities regulators on a case-by-case basis. The move to IFRS will fundamentally change the way Canadian companies report their business results to analysts, investors and other stakeholders. IFRS will have a significant impact on businesses across all industries. Given the prevalence of strategic transactions among pharmaceuticals and life sciences companies, including acquisitions and alliances, companies may find it useful to understand how the new financial reporting requirements could impact these transactions. Several major international pharmaceuticals and life sciences companies are already reporting under IFRS, and the transition has had a significant impact on their financial reporting. Significant areas impacting the pharmaceuticals and life sciences value chain and associated IFRS accounting issues are outlined below:

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**Value chain and significant accounting issues**



One of the most significant challenges in converting from Canadian GAAP to IFRS is determining which Canadian GAAP differences will impact the organization. Included in this publication are issues that we believe are of financial reporting interest because of their particular relevance to pharmaceuticals and life sciences companies. The existence of differences, and their materiality to an entity’s financial statements, depends on a variety of specific factors, including: the nature of the entity, its interpretation of the more principles-based IFRS standards and industry practice. This summary outlines some of the significant accounting differences that arise between Canadian GAAP and IFRS for pharmaceuticals and life sciences companies, based on standards issued as at January 1, 2009.

## First-time adoption of IFRS

Under IFRS 1, First-time Adoption of IFRS, the underlying principle is retrospective application of all standards (with certain optional exemptions and mandatory exceptions) at the entity's first reporting period. The International Accounting Standards Board ("IASB") acknowledged that in some cases it may be too difficult, too costly or even impossible to accumulate historical information on an IFRS basis. The IASB, therefore, decided to allow preparers of financial statements to select alternatives to retrospective application in certain areas such as business combinations, leases and pension liabilities. The IASB also considered that retrospective

application is subjective in certain areas and, therefore, decided to prohibit retrospective application in certain areas such as de-recognition of financial assets and financial liabilities and accounting for estimates.

Where differences exist and there is no exemption available, companies may have to dedicate significant effort to remeasure various historical transactions under IFRS. Early identification of Canadian GAAP differences and consideration of the exemptions are critical for a successful conversion.

### Key accounting issues

Area	Key issues	What companies need to consider
<b>Impairment of long-lived assets</b>	Level of impairment and one-step impairment test	<p>Under IAS 36, Impairment of Assets, impairment testing is performed at the level of cash generating unit, which may be at a more detailed level than the current Canadian GAAP requirement. In addition, under IAS 36, companies are required to explicitly assess whether there are any indications of impairment. There is no such explicit requirement under Canadian GAAP.</p> <p>Both Canadian GAAP and IFRS require assets to be tested for recoverability whenever events or circumstances indicate that the carrying amount may not be recoverable.</p> <p>Under IFRS, there is no initial assessment of an asset's recoverability based on undiscounted cash flows as there is under Canadian GAAP. Rather, the carrying value of the asset is compared to the higher of the asset's "value in use" (which is the estimated cash flow derived from an asset discounted using a pre-tax rate) and its "fair value less costs to sell" in determining whether an impairment charge is required and, if so, the amount. This accounting difference may result in companies requiring writedowns under IFRS to assets that were previously considered recoverable using the initial undiscounted cash flow test under Canadian GAAP.</p> <p>Impairment charges are also subject to reversal under IFRS (except for goodwill); therefore, companies will need to track their impairments.</p>
<b>Biological assets</b>	There is no guidance under Canadian GAAP on accounting for biological assets	<p>If a pharmaceuticals or life sciences company undertakes agricultural activity (for example, grows plants from which particular drugs are developed), then that activity will fall within the scope of IAS 41, Agriculture – Biological Assets.</p> <p>Biological assets should be measured, both at initial recognition and at each subsequent reporting date, at their fair value less costs to sell, except when fair value cannot be reliably measured. IAS 41 specifies that, if available, the quoted price in an active market is the appropriate basis for determining the fair value of the asset in its present location and condition.</p> <p>Gains and losses that arise on remeasuring biological assets or agricultural produce at fair value less estimated costs to sell are recognized directly in the income statement in the period in which the gain or loss arises.</p>

Area	Key issues	What companies need to consider
<b>Revenue recognition</b>	<p>The recognition of revenue for licensing, royalty agreements as well as upfront and milestone payments is a judgmental area, and the need to get the right model is paramount</p>	<p>IFRS is much more principles-based than current Canadian and US GAAP. The application of these principles may allow for changes in accounting policies relating to revenue recognition that would be advantageous for companies to consider. Practically, the key areas will be in the evidence required to split multi-element contracts and in evidencing arrangements with customers.</p> <p>One characteristic of pharmaceuticals and life sciences companies is the creation of revenue by contracting collaboration or licensing agreements. These arrangements often involve pharmaceuticals companies providing the financial, marketing and development expertise and life sciences companies providing the new drug candidates, targets and cutting-edge science. In recent years this has led to the creation of a significant number of strategic alliances, collaboration agreements and a whole host of other types of arrangements, which may include upfront and milestone payments, participation in joint steering committees and royalties.</p> <p>Each agreement is unique and may contain complex clauses and, therefore, it is difficult to provide a “one-size-fits-all” accounting solution. Each agreement should be evaluated on its own merits, and the accounting should reflect the substance and commercial reality of the arrangement. While Canadian, US GAAP and IFRS provide guidance on revenue recognition, as yet there is no specific industry guidance or literature as to how these types of arrangements should be accounted for.</p> <p>The IASB and the Financial Accounting Services Board (“FASB”) have undertaken a joint project to develop a new, comprehensive standard for revenue recognition. The new standard will replace the existing IAS 18, Revenue. The IASB and FASB issued a discussion paper in December 2008 setting out their preliminary views, to be followed by an exposure draft in 2010 and a final standard in 2011. Careful analysis will be required to understand the implications of the proposed changes and assess the impact on current revenue recognition policies of pharmaceuticals and life sciences companies.</p>
<b>Business combinations</b>	<p>The new standard changes important elements of business combination accounting</p>	<p>There are significant differences in the revised IFRS 3, Business Combinations (IFRS 3R), standard that will impact future business acquisitions. These differences include, but are not limited to:</p> <ul style="list-style-type: none"> <li>• What constitutes a business under IFRS 3R can differ from that under Canadian GAAP and EIC 124, Definition of a Business. This can have significant consequences for determining if the acquisition must be accounted for as a business combination or an asset acquisition;</li> <li>• All elements of consideration are fair valued (i.e. contingent consideration);</li> <li>• Transaction costs associated with the acquisition are expensed and not included in goodwill; and</li> <li>• Pre-existing interests are fair valued through income.</li> </ul> <p>In January 2009, the Canadian Institute of Chartered Accountants (“CICA”) issued new Handbook Section 1582, Business Combinations; Section 1601, Consolidated Financial Statements; and Section 1602, Non-controlling Interests. These sections replace the former Section 1581, Business Combinations, and Section 1600, Consolidated Financial Statements, and establish a new section for accounting for a non-controlling interest in a subsidiary. These sections provide the Canadian equivalents to IFRS 3R and IAS 27, Consolidated and Separate Financial Statements. The new sections will be effective on January 1, 2011, with early adoption permitted.</p>

Area	Key issues	What companies need to consider
<b>Property, plant and equipment</b>	Recognition and revaluation of property, plant and equipment and componentization approach	<p>Property, plant and equipment would initially be recorded at cost. However, IAS 16, Property, Plant and Equipment, provides entities with the option to revalue property, plant and equipment. The revaluation adjustment is recorded directly to equity if the revaluation results in an increase in the carrying value of the property, plant and equipment. If the revaluation adjustment results in a decrease in the carrying value of the property, plant and equipment, it is first recorded in equity to the extent of previous valuation adjustment increases, with any additional decrease recorded in the income statement. The use of the revaluation method requires regular valuations of entire classes of assets.</p> <p>IAS 16 requires that the cost of property, plant and equipment be broken down into its major component parts, which are separately measured and amortized over their respective useful lives. As a result, there may be significantly more tracking required for the individual major component parts. Although Canadian requirements are similar, application of the IFRS model may require greater rigour than traditionally applied under Canadian GAAP.</p>
<b>Restructuring liabilities and provisions</b>	Timing for recording of restructuring provisions, liabilities and other provisions may differ between IFRS and Canadian GAAP	<p>Under IFRS, restructuring costs are not recognized until management is demonstrably committed, i.e. a formal plan exists and details of the restructuring have been communicated to those affected by the plan. Once the criteria are met, general provisions of IAS 37, Provisions, Contingent Liabilities and Contingent Assets, apply.</p> <p>IAS 37 requires that a provision be recognized when there is either a legal or a constructive obligation, while Canadian GAAP generally focuses on legal obligations. Differences may also arise in accounting for termination benefits.</p> <p>Canadian companies generally use a specific threshold when determining whether an event is “likely” to occur. The “probable” threshold used under IFRS is lower, generally accepted to be “more likely than not”. Therefore, provisions may be recorded earlier under IFRS.</p> <p>IASB proposes to make amendments to IFRS to recognize and measure uncertain tax positions. Currently, a probability weighted average or possible outcomes method would be used to measure the liability.</p>
<b>Income taxes</b>	Intercompany transfer of assets and presentation of R&D tax credits	<p>Under IAS 12, Income Taxes, deferred taxes should be recognized immediately on unrealized intra-group profits (e.g. on inventory) at the buyer’s tax rate; this is prohibited under Canadian GAAP.</p> <p>Non-refundable R&amp;D tax credits are in substance similar to government grants. Under IFRS non-refundable R&amp;D tax credits could be reported in the income statement either under other income or netted against the related expenditures. As refundable R&amp;D tax credits are within the scope of IAS 12, the unused R&amp;D tax credits are recognized to the extent that it is probable that future taxable profit will be available. The offsetting entry will be against the income tax expense in the income statement.</p>
<b>Borrowing costs</b>	Capitalization of borrowing costs	<p>Under the revised IAS 23, Borrowing Costs, borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset shall be capitalized as part of the cost of that asset. Under Canadian GAAP, the capitalization of interest is an accounting policy option.</p>

**Research and development costs:** The new Section 3064, Goodwill and Intangible Assets, of the CICA Handbook converges with IAS 38, Intangible Assets. Therefore, no major GAAP difference is expected with regard to recognition principles of intangible assets. One exception is that IFRS permits the use of the measurement method (cost or fair value), whereas Canadian GAAP only permits the cost method. In practice, however, the cost method will be used for intangible assets as it is very rare that an active market exists for them.

## Other general accounting issues

Area	Key issues	What companies need to consider
<b>Joint ventures</b>	Accounting for joint ventures	<p>Under current IFRS standards, joint ventures are accounted for using either the proportionate consolidation method or the equity method. However, the IASB is expected to finalize a new accounting standard in 2009, following issuance of an exposure draft, ED 9, Joint Arrangements, which would limit the use of the proportionate consolidation method. The new standard also introduces the “dual approach”, which considers that a single joint arrangement may contain more than one type of arrangement; a joint operation and a joint venture, for example, each type of arrangement having a specific accounting treatment.</p> <p>Joint venture arrangements will, therefore, need to be carefully analyzed to determine the appropriate accounting under the revised IFRS standard.</p>
<b>Special purpose entities (SPE)</b>	Consolidation accounting	<p>In general, consolidation guidance between IFRS and Canadian GAAP is relatively similar as both standards operate under a similar control framework.</p> <p>However, IFRS (SIC-12, Consolidation – Special Purpose Entities) does not deal with variable interest entities in the same manner as Canadian GAAP (AcG-15, Consolidation of Variable Interest Entities) and relies on more general consolidation principles based on the concept of control.</p> <p>In December 2008, the IASB issued an exposure draft, ED 10, Consolidated Financial Statements. The project objective is to publish a single IFRS standard on consolidation, replacing IAS 27 and SIC-12. The exposure draft addresses the following aspects:</p> <ul style="list-style-type: none"> <li>• A revision of the control definition in order to apply the same control criteria to all entities. The work on the revised control definition will focus on, but is not limited to, the consolidation of structured entities, the new term introduced for SPE; and</li> <li>• Enhanced disclosures regarding consolidated and non-consolidated entities.</li> </ul>
<b>Financial instruments</b>	How are financial instruments, including derivatives and hedges accounted for and disclosed?	<p>Financial instrument accounting is relatively similar given the recent adoption of CICA Handbook Section 3855, Financial Instruments – Recognition and Measurement, under Canadian GAAP.</p> <p>There are subtle differences in the standards applicable to derivatives and hedging that will need to be analyzed and addressed. For example, IFRS does not allow the use of the “shortcut method” for interest rate swaps or the “critical terms match method” for retrospectively assessing effectiveness for cash flow hedges.</p> <p>IFRS 7, Financial Instruments: Disclosures, has extensive disclosure requirements for financial instruments; however, the new CICA Handbook Section 3862, Financial Instruments – Disclosures, that is effective for years beginning on or after October 1, 2007, eliminates the majority of these differences.</p> <p>A current IASB project is proposing to broaden the definition of a derivative, which may have implications on derivatives and embedded derivatives.</p>
<b>Debt versus equity</b>	Distinction of debt and equity instruments	<p>IFRS has different guidance than Canadian GAAP in the examination and classification of compound financial instruments (i.e. convertible instruments). Therefore, existing compound instruments will need to be re-examined to determine whether they have been appropriately classified.</p> <p>In our experience, under IFRS, fewer financial instruments will result in equity classification.</p>

Area	Key issues	What companies need to consider
<b>Stock-based compensation</b>	Differences in accounting for stock-based compensation	<p>IFRS is similar in many respects to existing Canadian GAAP accounting for stock-based compensation; however, there are certain measurement and other differences. For example, under IFRS, if a stock-based award is granted with a graded vesting schedule, each tranche must be accounted for as a separate arrangement. Under Canadian GAAP, a company can alternatively elect to treat an entire award as one arrangement with the fair value determined using an average life of the award and amortized over the period of the award on a straight-line basis.</p> <p>In addition, under IFRS 2, Share-based Payment, an estimate for forfeitures must be made when determining the number of equity instruments expected to vest.</p>
<b>Employee benefits</b>	Although broadly similar in concept, there are practical differences in this area that could have a significant impact on accounting conclusions	<p>Accounting for employee benefits is a complex area that is governed by IAS 19, Employee Benefits, which applies to both short-term and long-term employee benefits. Although many aspects of Canadian GAAP are aligned with IFRS on this topic, there are several areas where differences may arise. The following are some of the key areas where differences exist between the IFRS standard and Canadian GAAP as it relates to defined benefit plans:</p> <ul style="list-style-type: none"> <li>• Actuarial gains and losses are either recognized directly in equity or in the income statement using the “corridor” approach or through the application of an accelerated recognition approach, whereas Canadian GAAP does not permit the recognition of actuarial gains and losses directly in equity;</li> <li>• Under the “corridor” approach, the minimum amortization of actuarial gains and losses is over the average remaining service period of employees participating in the plan regardless of whether the majority of participants are active or inactive. Canadian GAAP requires the amortization of actuarial gains and losses over the average remaining life expectancy of the former employees when all, or almost all, of the employees in the plan are no longer active; and</li> <li>• The plan assets and obligation must be measured with sufficient regularity that the amounts recognized in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date. Canadian GAAP permits the use of a date not more than three months prior to the date of the financial statements.</li> </ul> <p>The IASB recently issued a discussion paper on employee benefits with the intention of issuing an exposure draft in 2009. The discussion paper proposes eliminating the deferred recognition and smoothing features of IAS 19, which would essentially eliminate the ability to defer recognition of actuarial gains and losses and past service costs.</p> <p>The accounting for defined contribution plans under IAS 19 is substantially converged with Canadian GAAP.</p>
<b>Foreign exchange</b>	IFRS provides more definitive guidance on functional currency and how it is determined than exists under Canadian GAAP	<p>The IFRS transition project will provide an opportunity to re-evaluate companies’ Canadian operations, foreign operations and foreign subsidiaries to determine their respective functional currencies for translation purposes. IFRS requires translation from an entity’s functional currency to the reporting currency using the current rate method.</p>
<b>Leases</b>	Lessee accounting for operating leases could differ	<p>Lease classification concepts under IAS 17, Leases, are similar to those under Canadian GAAP. A substance rather than legal form analysis is applied under both Canadian GAAP and IFRS; however, under Canadian GAAP, there are certain quantitative thresholds or bright-line tests used to assess the classification between operating and finance (i.e. capital) leases. Under IFRS, there are no similar bright-line tests; rather, the classification is determined using qualitative guidelines and professional judgment. Upon review of the specific fact pattern for each lease agreement, a different conclusion on the lease classification could result under IFRS.</p> <p>The IASB and US standard-setters have initiated a joint project to review the overall accounting for leases by lessees. A discussion paper is expected in the first quarter of 2009 followed by an exposure draft in 2010, which is anticipated to require that lessees capitalize all leases on the balance sheet. If adopted, this standard will have a significant impact on the balance sheets of pharmaceuticals and life sciences companies that currently have operating leases for their manufacturing and distribution locations as well as machinery and equipment off-balance sheet.</p>

# How we can help

PwC has unparalleled experience in helping many of the world's largest companies adopt IFRS. Our dedicated resources and experience in working with many of the more than 12,000 companies that have already made the transition to IFRS have taught us valuable lessons that will help Canadian pharmaceuticals and life sciences companies with their own conversion process. We have assisted, and are assisting, a large number of pharmaceuticals and life sciences organizations with IFRS conversion projects globally and in Canada.

To combine our collective experiences and promote consistency across our clients, we have established a pharmaceuticals and life sciences group in Canada. The group has access to a multidisciplinary team of over 1,100 dedicated pharmaceuticals and life sciences specialists from some of the key territories in which IFRS is currently being adopted or already applies, including Europe and Australia. The group has knowledge and experience in providing solutions for the accounting issues faced by the Canadian pharmaceuticals and life sciences sector and plays a key role in resolving new issues that emerge.

Our experience has shown that a critical success factor for IFRS conversion is a well-planned implementation, which is started several years in advance of the required convergence date.

Our industry-focused teams specialize in IFRS/GAAP conversions for a wide range of organizations – from large, complex institutions, requiring detailed analysis, to organizations with more straightforward requirements. These teams are supported by our Capital Markets Group, a global team of over 500 IFRS conversion experts, who specialize in multi-GAAP environments and the related conversion implications.

**PwC professionals can help you plan and complete your transition to IFRS by providing:**

- **An initial diagnostic of Canadian GAAP/IFRS accounting differences**
- **Advice on selection of appropriate accounting policies**
- **Advice on development of an IFRS implementation plan**
- **Training for all levels of your staff, including your board of directors**
- **IFRS trained and experienced people to supplement your IFRS team**
- **Project management support to your IFRS team**
- **Communication strategies and change management support**
- **Assessment of your requirements for data, processes, systems and controls**
- **Advice on process and system solutions to embed IFRS**
- **Competitor benchmarking**
- **M&A target accounting conversion assistance**
- **Valuation advice under IFRS fair value and impairment models**
- **Tax planning considerations on conversion to IFRS**

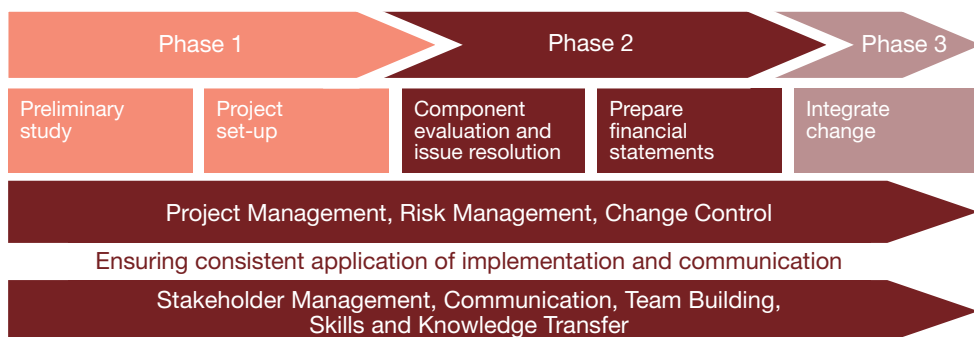
## PwC's Transition/IFRS Methodology

While compliance with the new rules is the driver for IFRS projects, our experience indicates that a methodical approach to the conversion process can yield wider benefits. Our Transition/IFRS methodology is a robust, tried and tested framework that has an inherent flexibility, enabling us to adapt it to work most effectively within your organization and one that we would tailor to your needs and phases, as outlined below. This methodology has consistently delivered successful results.

Typically, each IFRS transition project consists of three phases. In Phase 1, the diagnostic stage, we carry out an initial impact analysis and plan the later phases. Phase 2 consists of the detailed steps necessary to prepare the first complete IFRS financial statements. In Phase 3, we take the information, issues and solutions gathered and integrate them into your underlying financial systems and processes.

Transition/IFRS acts as a springboard from which you can launch and control your conversion project, accessing the support and guidance you need as the implementation progresses.

We are ready to help you manage the conversion process with fewer headaches. To learn more about how we can help, visit our website at [www.pwcifrs.ca](http://www.pwcifrs.ca) or contact one of the IFRS professionals listed on the last page of this publication. As well, please visit [www.pwc.com/ca/lifesciences](http://www.pwc.com/ca/lifesciences) to learn more about the pharmaceuticals and life sciences industry.



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