

PricewaterhouseCoopers'

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# IFRS – Understanding the basics: How and when conversion will affect banks

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# Agenda

- Introduction: IFRS – where are we?
- Key technical issues for banks
- Conversion process
- Next steps

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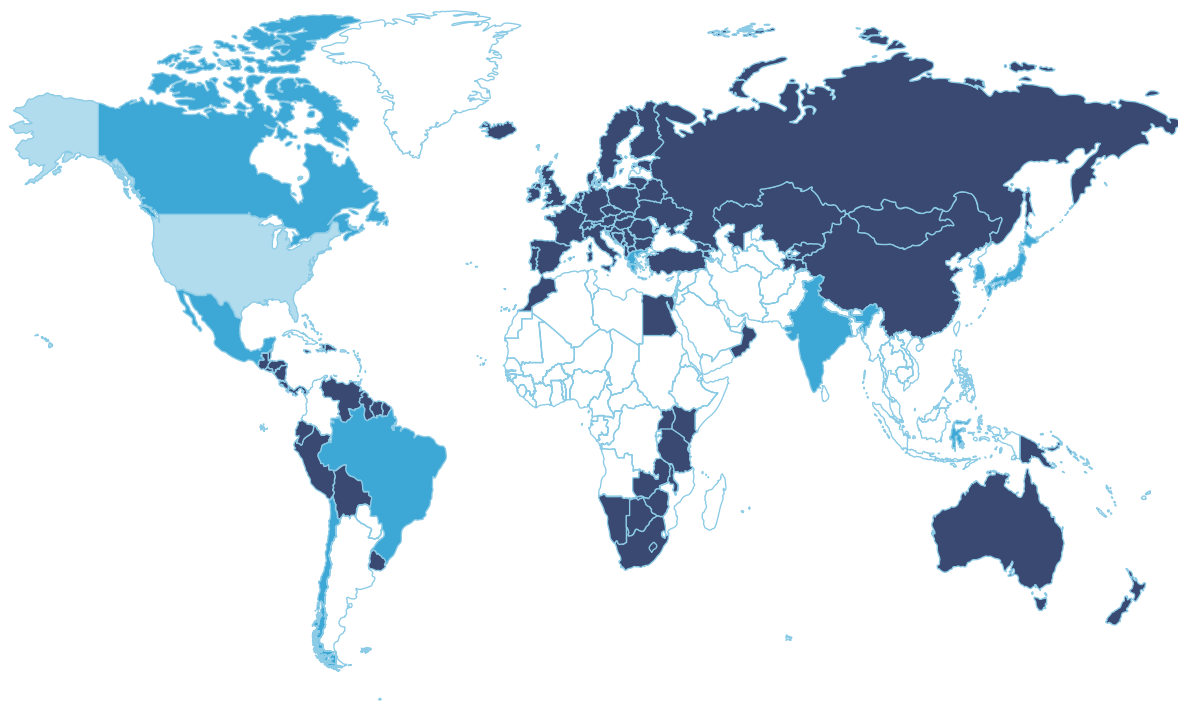
## Overview

- IFRS—International Financial Reporting Standards
- Standard setter—International Accounting Standards Board (IASB) founded in 2001 and based in London
- International Accounting Standards Committee Foundation
  - Appoint IASB members
  - Exercise oversight
  - Raise funds
  - Similar to Financial Accounting Foundation (FAF)
- On 27 February 2006, FASB and IASB published a Memorandum of Understanding (MOU) that reaffirms the boards' shared objective of developing high quality, common accounting standards for use in the world's capital markets

## Introduction: IFRS – where are we?

# The world has chosen IFRS

More than 110 countries require or permit the use of IFRS, or are converting



Top 10 Global Capital Markets	
US	US GAAP
Japan	Converging to IFRS
UK	IFRS
France	IFRS
Canada	Converting to IFRS
Germany	IFRS
Hong Kong	IFRS
Spain	IFRS
Switzerland	IFRS or US GAAP
Australia	IFRS

- Countries seeking convergence with the IASB or pursuing adoption of IFRS
- Countries that require or permit IFRS
- Countries with no current plans to convert to IFRS

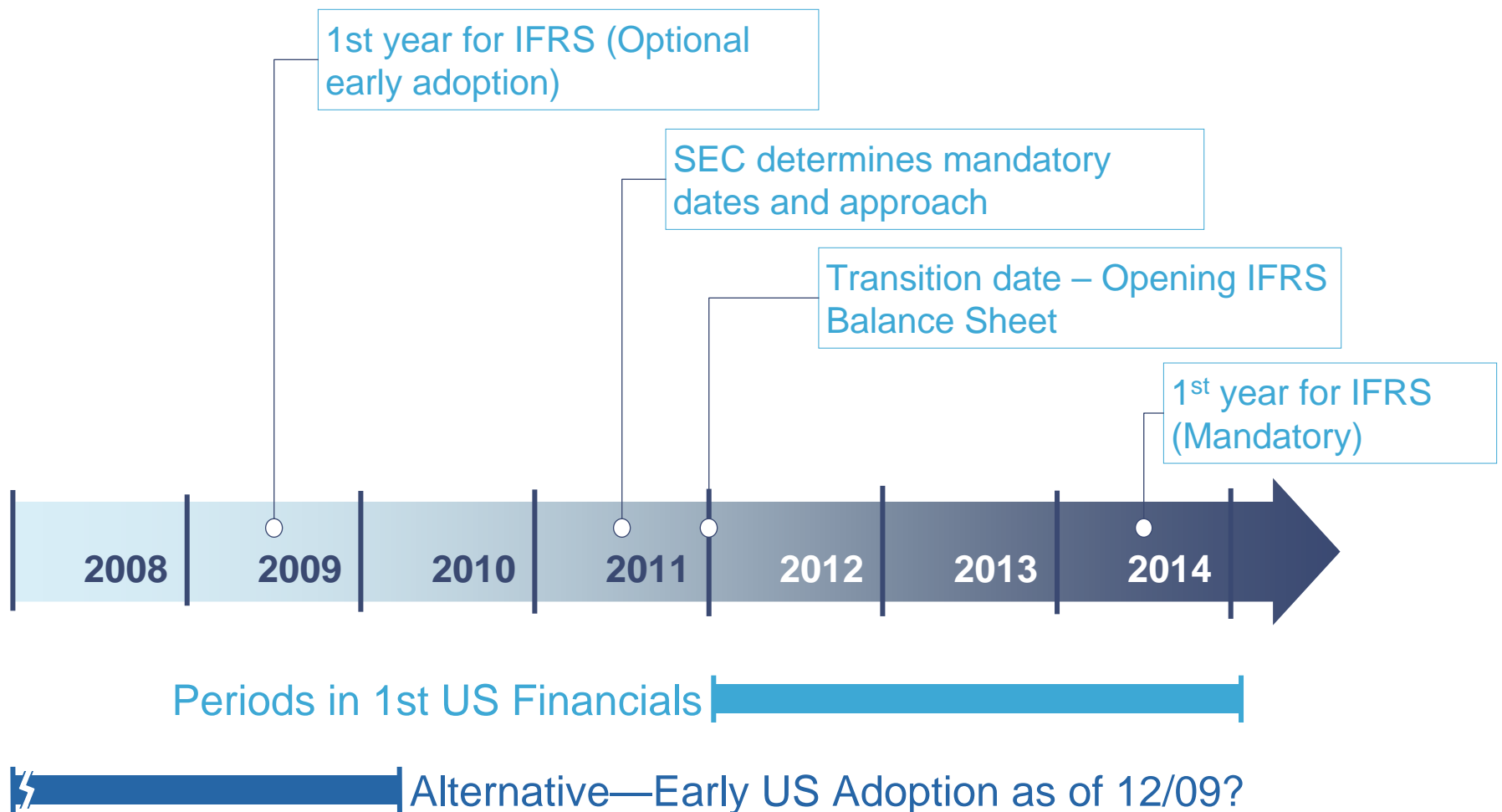
## SEC roadmap for potential use of IFRS by US issuers

- Issued on November 14, 2008:
    - With 90-day comment period
    - Similar to the proposed roadmap released in August 2008
  - Proposed phased-in mandatory adoption in 2014
  - SEC to review progress and vote in 2011 on final mandatory adoption
- Milestones to support conversion:*
- Improvements to IFRS
  - Accountability and independent funding of IASCF and IASB
  - XBRL compatibility
  - IFRS education and training in the US
  - Limited early use of IFRS only to enhance the comparability
  - The anticipated timing of future rulemaking by SEC
  - The implementation of the mandatory use of IFRS

Applied only for companies reporting on the Form 10-K

## Introduction: IFRS – where are we?

# US transition time table



Introduction: IFRS – where are we?

## Why is the US moving to IFRS?

*“A global set of high-quality accounting standards would be an international language of disclosure, transparency and comparability. It's a goal worth pursuing.”*

SEC Chairman Christopher Cox

- Creates a global accounting language
- Allows companies access to global capital markets
- Serves information needs of investors
- Acceptance of IFRS in the US increased by Foreign Private Issuers' IFRS reporting (without GAAP reconciliation)

## State of the market

- Many US banks have engaged in initial discussions on IFRS over the last year, some have begun initial analyses
- Recent market turmoil has moved focus of key personnel to other areas
- Conversion to IFRS is still out there in the medium term ...
- How should banks be considering IFRS throughout 2009 and shortly thereafter?

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## Prioritization: which topics are most challenging and why?

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Financial impacts

- Balance sheet gross up, income statement and equity impacts

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Analysis effort

- Work to analyze and determine solutions and gather initial data

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Operational impacts

- Building and implementing new process and systems changes across the business
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## Financial instruments – classification and measurement

### Under IFRS:

- IAS 39 has four categories of financial assets:
  - Financial assets “At fair value through profit or loss” (FVTPL)
  - Loans and receivables (L&R)
  - Held-to-maturity (HTM)
  - Available-for-sale (AFS)
- Classification drives measurement
- No LOCOM for HFS loans – these are at FVTPL (or possibly AFS)

### Impacts

The scope of IAS 39 is broader than FAS 115, which is specific to marketable securities

IAS 39 applies to all financial instruments; it’s “one-stop shopping” for FAS 114, 5, 115, 91, 133, 140, 150, 159, etc.

IFRS does not have specialized industry guidance like the AICPA Audit Guides

Re-assess classification at date of transition to IFRS

## Financial instruments – reclassification: IAS39 amendment ...

### Under IFRS:

From July 1, 2008, reclassifications from held for trading are permitted:

- If financial asset meets L&R definition and entity now has intent and ability to hold it for foreseeable future or to maturity
- Other financial assets may be reclassified only in rare circumstances

From July 1, 2008, assets classified as AFS may be reclassified as L&R provided:

- They would have met L&R definition and
- Entity has intent and ability to hold the asset for foreseeable future or to maturity

### Impacts

Deutsche Bank	
Assets reclassified	€24.9b
Impact on PBT	€825m

HBOS	
Assets reclassified	£12.2b
Impact on PBT	£588m

Lloyds TSB	
Assets reclassified	£2.9b
Impact on PBT	£114m

Commerzbank	
Assets reclassified	€44.0b
Impact on PBT	€800m

## Netting

### Under IFRS:

- Netting rules follow *a cash flow approach* without special accommodations:
  - Legal right of offset; and
  - *An intention to settle net or realize transactions simultaneously*

Netting of derivatives not allowed unless legal right to offset exists and intent to settle on a net basis (simultaneously)

### Impacts

Likely grossed up:

- Leveraged leases
- Repos
- Derivatives
- Trade-date payables/receivables

## Debt vs. equity

### Under IFRS:

- Significantly different debt/equity classification models
- IAS 32 principles:
  - Equity: 'fixed for fixed'
  - Liability: no unconditional right to avoid payment of cash
- Split accounting for compound instruments

### Impacts

More instruments are likely to meet the definition of liability

Legal form is not necessarily relevant

“Components approach” for hybrid securities

“Components approach” may result in an additional charge to interest expense

## Financial instruments – impairment for AFS and HTM debt instruments

### Under IFRS:

- Impairment triggered by credit-related events impacting recovery of contractual cash-flows
- Measurement of impairment:
  - AFS – based on fair value,
  - HTM – based on DCF
- Reversal of impairment losses through earnings is permitted
- Subsequent declines in fair value of impaired debt instruments:
  - No “new cost basis”
  - Policy choice: impairment loss or OCI *if further decline in FV isn't credit-related*

### Impacts

Intent to hold thru recovery irrelevant under IFRS; could be less impairment under IFRS

Factors affecting current FV don't impact P&L for impaired HTM investments

Further declines in fair value may be recorded as impairment charges earlier under IAS 39 than under FAS 115 (unless not related to credit)

## Financial instruments – impairment for AFS equity securities

### Under IFRS:

- Trigger event for impairment
  - “Significant or prolonged decline in fair value” test versus OTTI under GAAP
- Measurement of impairment losses based on fair value
- Not permitted: Reversal of impairment losses
- Subsequent declines in fair value of impaired AFS equity securities:
  - No “new cost basis”
  - Systematically recorded in P&L

### Impacts

P&L volatility could be significantly increased

Upon first-time adoption, AFS OCI reserves could be higher than currently under GAAP

## Financial instruments – impairment for Loans and Receivables

### Under IFRS:

- Broadly similar principles (same ALL expected by SEC)
- DCF principles should be considered when calculating loss severity factors for homogenous loans
- Impaired loans accrue interest at EIR
- Objective evidence of impairment is required
- No “Day 1” allowance may be recorded upon initial recognition of the loan
- “Incurred loss” model is strictly applied

### Impacts

Documentation exercise required to substantiate ALL

Opportunity to rethink the impairment model / convergence with Basel II

## Consolidation and derecognition

### Under IFRS:

- Model differs significantly from GAAP
- Assess consolidation first then derecognition criteria
- Mixed approach under IAS 39:
  - Transfer must have occurred
  - Risks and rewards must be considered
  - Control is assessed if no entity has *substantially all* risks and rewards
- Complex “continuing involvement” accounting if control is retained
- No specialized “investment company accounting”
- Guidance will likely be revised

### Impacts

More entities to be consolidated on balance sheet

QSPEs consolidated; transactions with Qs subject to the pass-through test: very unlikely to pass

Revolving structures most likely to be consolidated, thereby failing the transfer test, assets will remain on balance sheet

CPE conduits must be assessed as well

Funds and portfolio companies may be affected

## Risk management disclosures (IFRS 7)

### Under IFRS:

- All financial instruments (not different product groups as per US GAAP)
- Disclosures in the following areas for credit, liquidity and market risk:
  - the exposures to the risk and how they arise;
  - objectives, policies and processes for managing the risk
  - the methods used to measure the risk
  - any changes to the above
- IFRS 7 requires disclosures “through eyes of management” vs. minimal requirements under GAAP

### Impacts

IFRS & disclosures are included in the financial statements and will be audited

## First time adoption of IFRS (IFRS 1)

- IFRS 1 will require to:
  - Select accounting policies that comply with the IFRSs in force at the closing balance sheet date in the first IFRS financial statements, and apply those policies retrospectively to all of the periods presented in the first IFRS financial statements
  - Prepare an opening balance sheet at the date of transition to IFRS
  - Consider whether to apply any of the fourteen optional exemptions from retrospective application
  - Apply the four mandatory exceptions to retrospective application
  - Make extensive disclosures to explain the transition to IFRS
- Adjustments between US GAAP and IFRS relating to events and transactions prior to the transition are (in general) recognized directly in retained earnings (or another category of equity where appropriate) on the opening balance sheet

## Tax considerations

- IASB is expected to issue exposure draft of IAS 12 (revised) in Q4 2008
- FASB will solicit comments on IAS 12(R) and decide whether to undertake convergence projects to eliminate remaining differences
- Significant differences will likely remain when IFRS is adopted in the US
- Differences between FAS 109 and IAS 12(R)
  - Uncertain tax positions – no FIN 48
  - Equity-based compensation – no windfall pool
  - Intercompany transactions – par. 9(e)
  - Foreign nonmonetary assets and liabilities – par. 9(f)
  - Initial recognition
  - Leveraged leases
  - Enacted versus substantively enacted rate
  - Tax base
  - Special deductions

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## Tax considerations

- Tax accounting method changes may be required or desired
  - How will the taxing authorities handle these changes?
  - What will be the impact on cash taxes?
- State and local taxes will change
  - Apportionment factors
  - Property taxes
  - Capital and/or franchise taxes
- International tax planning will be affected
  - Transfer pricing – advanced pricing agreements
  - Interest expense (thin-cap) limitations – debt/equity classification
  - Dividend restriction may be triggered
- Tax systems, processes and control will need to be modified

## What does an IFRS conversion involve?

### Changing Numbers

- Addition of another GAAP and/or change in primary GAAP

### Changing People (a new business language)

- Communication
- Judgment
- Training

### Changing Processes

- Existing processes to be enhanced
- New processes
- Internal controls - SOX

### Changing Systems

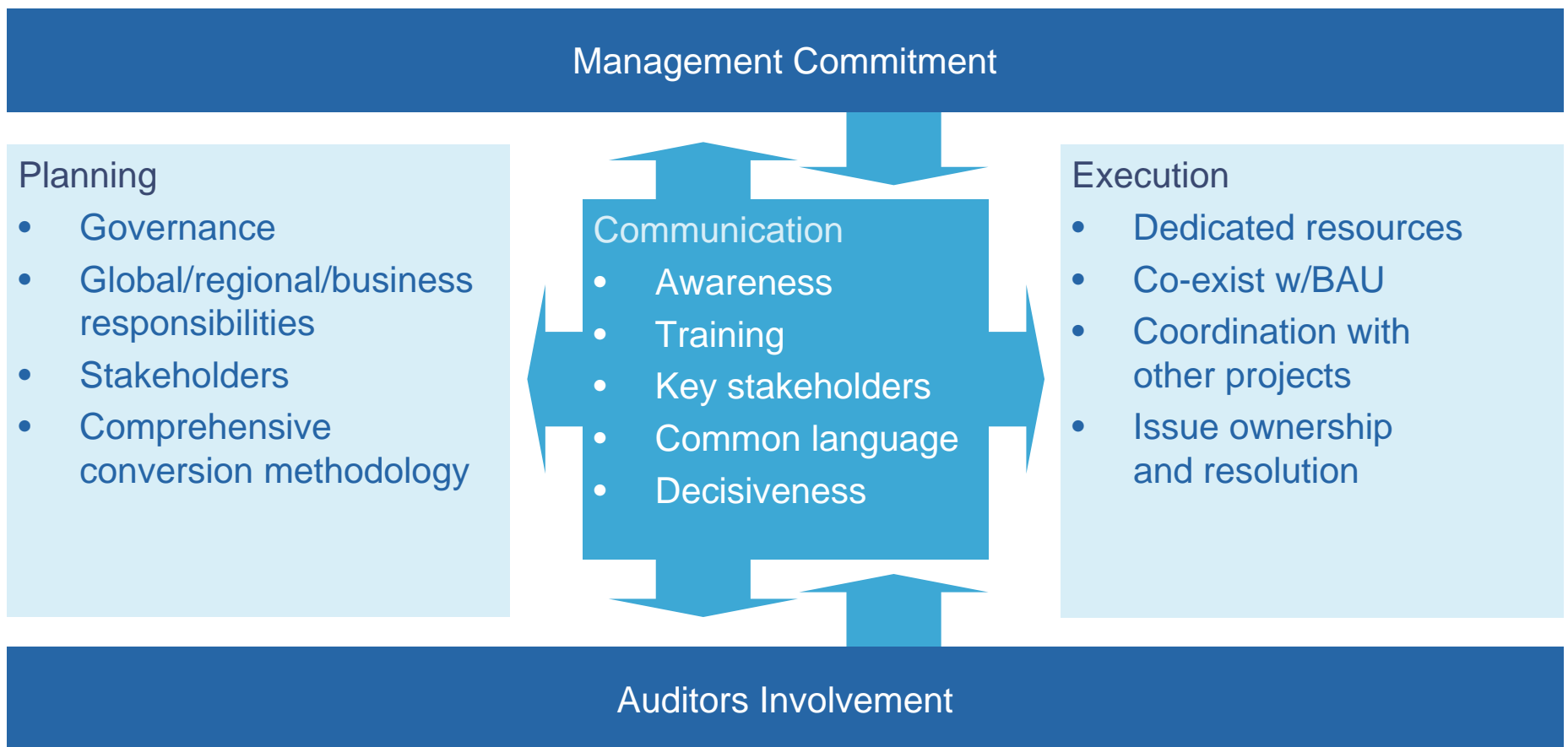
- Data availability and system requirements
- Multi-GAAP solutions
- Primary GAAP changeover

### Changing Business

- Product design, financing transactions, customer/vendor contracts
- Business and operational impacts: tax reporting, risk, regulatory capital, debt covenants
- Performance management (KPIs, management accounts, remuneration & bonuses, budgeting & forecasting)

## Conversion process

# Critical success factors



Conversion process

## Key lessons learned

- Be in control of the process
- Keep the business units and key stakeholders engaged
- Prioritize efforts to manage costs
- Pervasive impact to business and operational process
- Identify issues promptly
- Make it repeatable
- Make it explainable

Conversion process

Where should you start?

***Understand the change***

- Identify relevant IFRS – benchmark and gap your current US GAAP policies
- Prepare shell financials to understand format and granularity changes in information to be disclosed

***Determine areas of focus***

- Prioritize effort – financial, analysis and operational efforts
  - Map effort to teams and timeline
- Determine project roadmap, timeline, start the evaluation process....

## Conversion process

### Step 1: Identify IFRS/GAAP differences

IFRS	US GAAP
Technical accounting guidance, crux of difference and accounting policy alternatives under IFRS (where applicable).	Existing Company policy.
<b>Balance Sheet Impact:</b> Qualitative assessment of potential impact on balance sheet (e.g. increase net assets, change in classification and presentation etc.)	
<b>Pre-tax Income Impact:</b> Qualitative assessment of potential impact on income statement (e.g. accretive).	
<b>Key Client Considerations:</b> <ul style="list-style-type: none"> <li>• Process - financial and reporting process implications.</li> <li>• System - system and data limitations.</li> <li>• Operations - business transformation opportunities.</li> </ul>	
<b>Client Owner:</b> Identify key Company stakeholders.	

### Step 2: Draft shell financial statements

	December 31	EXAMPLE OF POTENTIAL IFRS ADJUSTMENTS						December 31,
	2009	1			3			2009
	US GAAP	Consolidation				Fair Value		IFRS
<i>In \$'000</i>		QSPEs	VIEs	Funds	MSRs	Day 1 Gain	Hedge Accounting	
<b>Assets</b>								
Cash and cash equivalents								
Interest-bearing deposits								
Securities purchased under the agreement to resell								
Trading assets								
Securities available-for-sale								
Loans held-for-sale								
Loans								
Allowance for loans								
Premises and equipment								
Goodwill and intangibles and other assets								
Other assets								
<b>Total Assets</b>								

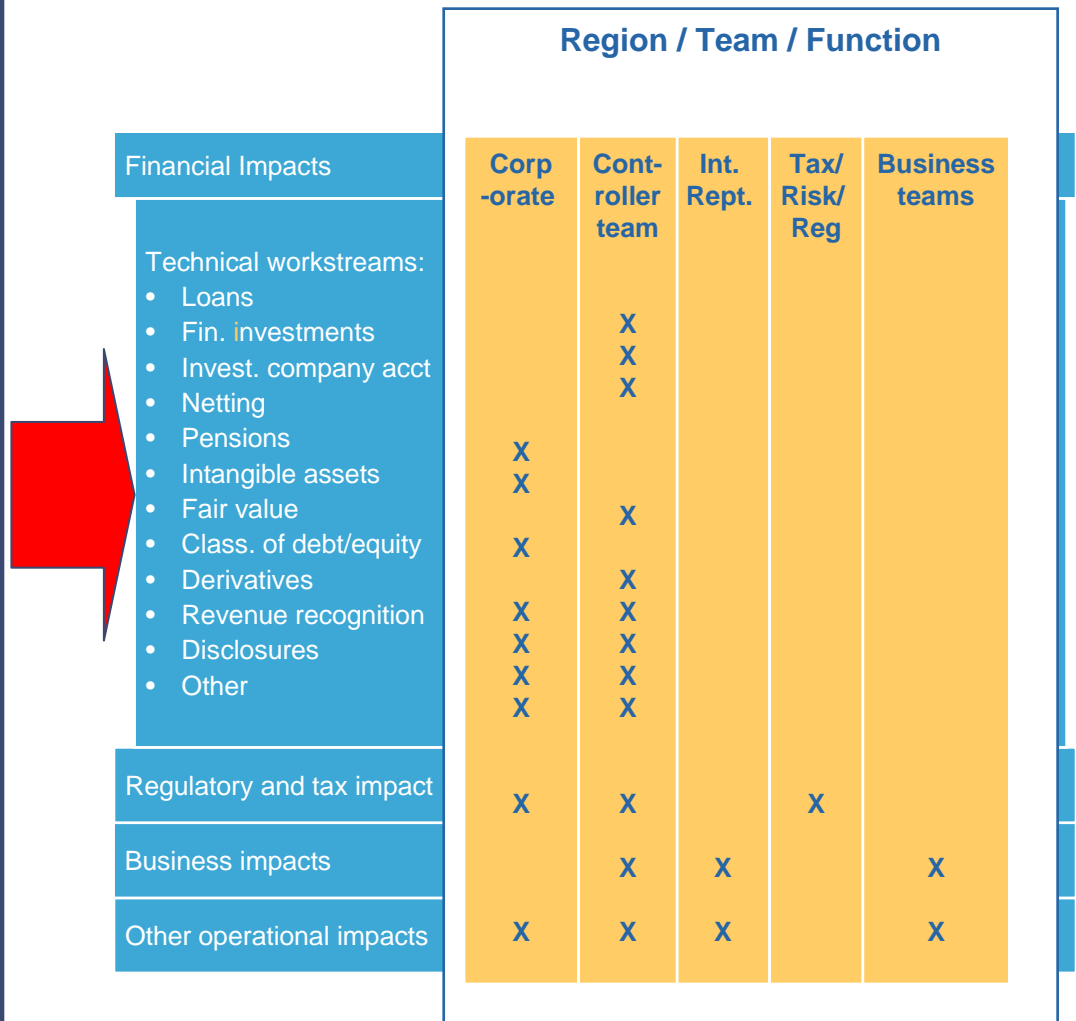
# Conversion process

## Step 3: Prepare Heat Map

	Accounting Area	Typical Impact*	
		\$ Financial	¥ Effort
1	Consolidation	Dark Blue	Dark Blue
2	Financial asset/liability recognition & de-recognition	Dark Blue	Dark Blue
3	Netting	Dark Blue	Light Blue
4	Taxes	Dark Blue	Light Blue
5	Hedge accounting	Light Blue	Dark Blue
6	Effective interest method	Light Blue	Dark Blue
7	Allowance for credit losses (on- & off- balance sheet)	Light Blue	Dark Blue
8	Reporting & disclosures	Light Blue	Dark Blue
9	Fair value option	Light Blue	Light Blue
10	Liabilities v. equity	Light Blue	Light Blue
11	Leasing	Light Blue	Light Blue
12	AFS definition & measurement	Light Blue	Light Blue
13	Valuation and profit recognition for traded instruments	Light Blue	Light Blue
14	Goodwill & intangible assets	Light Blue	Light Blue
15	Embedded derivatives	Light Blue	Light Blue
16	Share-based payments	Light Blue	Light Blue
17	Employee benefits & retirement plan	Light Blue	Light Blue
18	Provisions & contingencies	Light Blue	Light Blue

High
Medium
Low

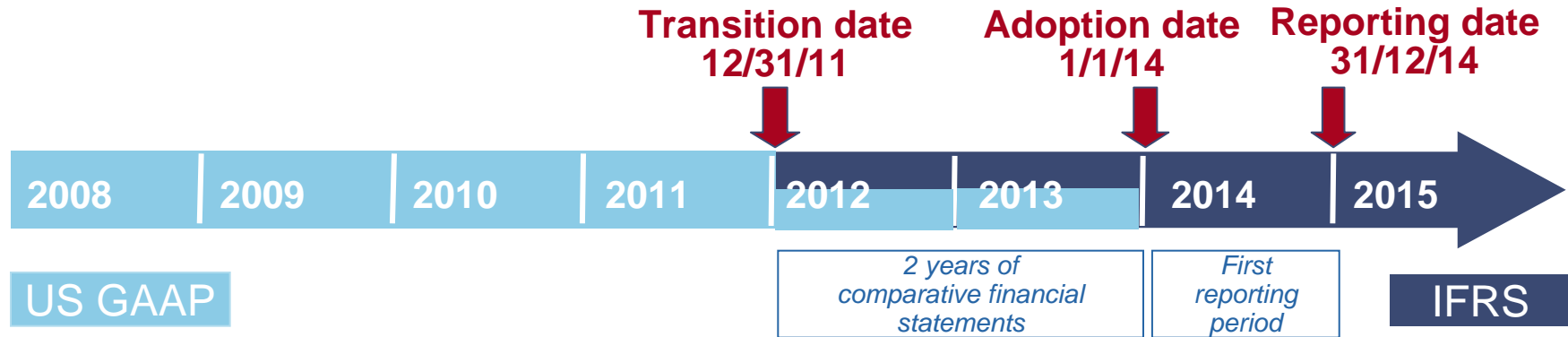
## Step 4: Prepare Work Map



- Impact Study workstreams
- Locations/operations/functions in scope for workstream

# Conversion process

## Timeline for conversion – when to start?



### Start early : convert at Transition Date



### Phased approach: start early and convert by Adoption Date



### Start late : convert at Adoption Date



## When? Transition vs. adoption date

Options	Pros	Cons
<b>Start early</b>	<ul style="list-style-type: none"> <li>• IFRS produced real time, no need for retrospective accounting for comparatives</li> <li>• Ready to communicate IFRS impacts internally/externally promptly</li> <li>• Financial, operational and business issues are identified early</li> <li>• Prompt informed engagement with standard setters and peers on key issues</li> <li>• SOx testing performed promptly and efficiently</li> </ul>	<ul style="list-style-type: none"> <li>• Potential budget and resource constraints</li> <li>• Less IFRS knowledge</li> <li>• Dual reporting throughout comparative period</li> </ul>
<b>Phased approach</b>	<ul style="list-style-type: none"> <li>• Conversion effort managed gradually – less impact to resources</li> <li>• Most data gathering required will be identified in advance of comparative period</li> <li>• Key impacts identified before Transition date</li> <li>• Staggered training efforts</li> </ul>	<ul style="list-style-type: none"> <li>• May have to generate comparatives retrospectively</li> <li>• Challenges gathering certain comparative data retrospectively</li> <li>• Later identification of issues</li> </ul>
<b>Start late</b>	<ul style="list-style-type: none"> <li>• US GAAP / IFRS convergence will be advanced during project</li> <li>• Lessens strain on resources, focused and measured consideration</li> <li>• IFRS training deployed, less cost spent on external resources</li> </ul>	<ul style="list-style-type: none"> <li>• No ‘quick response’ to peer group decisions</li> <li>• Higher operational risk in generating comparatives and gathering related data</li> <li>• Cost/inefficiencies may occur if business and operational issues are identified later</li> </ul>

Conversion process

Consider IFRS “as you go”

Consider IFRS in current reporting efforts to manage effort up front and identify issues early:

- New transactions, products, customer and vendor contracts
- Other ongoing reporting projects – USGAAP, regulatory, risk
- Financial and operational infrastructure change projects
- Tracking international operations’ progress with IFRS

## Key IFRS publications/content

- International Financial Reporting Standards and International Accounting Standards (IAS) – authoritative pronouncements
- PwC's IFRS Manual of Accounting
- PwC's IFRS Pocket Guide 2008
- Similarities & Differences: A Comparison of IFRS and US GAAP
- 10Minutes on IFRS & the related whitepaper (“IFRS: The Right Step for US Business”)
- Tax Thought Leadership
  - IFRS – The Right Move Toward Convergence: What IFRS Will Mean to US Tax Executives
  - Tax ramifications of IFRS stock-compensation accounting
- IFRS News

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