

IFRS industry series

Staying on track

Examining International Financial Reporting
Standards for the US railroad industry



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What companies can do now

The heart of the matter

US financial reporting will
see unprecedented change
over the next several years

International Financial Reporting Standards (IFRS) have been affecting US companies for some time, whether through the companies' business dealings with non-US customers and vendors that use IFRS or through non-US subsidiaries' adoption of IFRS. Soon, US railroad companies will feel the increasing effects of IFRS at home as key aspects of accounting principles generally accepted in the United States (US GAAP) and IFRS continue to converge.

The next several years will bring near-constant change to US financial reporting. IFRS will be a main driver of the change, coming at railroad companies on a variety of fronts:

- Convergence of key areas of US GAAP and IFRS
- Ongoing adoption of IFRS by subsidiaries and competitors, as additional countries switch to IFRS (adoption may be further accelerated now that there's a version of IFRS tailored to small and medium-sized entities)
- Continued influence of IFRS on foreign counterparties' structuring of deals and transactions, as additional key US trading partners adopt IFRS for capital-market and statutory purposes
- Ultimate adoption of IFRS in the United States

Recent developments

In February 2010, the Securities and Exchange Commission (SEC) published a statement of continued support for a single set of high-quality global accounting rules. The commission acknowledged that IFRS is best positioned to be the global standard. The statement described the issues and the events that must occur this year and in 2011, when the SEC expects to make a final decision on whether, when, and how to incorporate IFRS into the US domestic reporting system.

The commission further stated that if it does move forward with IFRS in 2011, companies will need adequate time for the transition and IFRS reporting would begin in approximately 2015 or 2016. Timing for the convergence projects has since been pushed back, but the SEC stated that this change will not impact its ability to make a decision on IFRS in 2011. Although a final decision has yet to be made, these developments indicate the SEC's continued commitment to the objective of a single set of high-quality standards.

In addition, IFRS adoption is ongoing elsewhere in the world. Multinational companies need to closely manage IFRS adoption by non-US subsidiaries. Adoption elections that non-US subsidiaries deem best for themselves won't necessarily be best for their US parent or the organization as a whole.

These elections can have a wider impact than just accounting; they could impact broader corporate initiatives such as tax planning. In addition, elections may also vary widely among subsidiaries, diminishing the potential benefit and cost savings from having one set of accounting principles within a company. A working understanding of IFRS, corporate oversight, and careful planning can help to maximize the benefits of a consistent adoption.

Looking forward

IFRS will impact the railroad industry as a whole, but the specific impact of a transition will vary from one railroad company to another. We believe that using the insights gained from this paper, executives in the railroad industry will have a better understanding of the potential impact of IFRS on their industry and individual companies.

An in-depth discussion

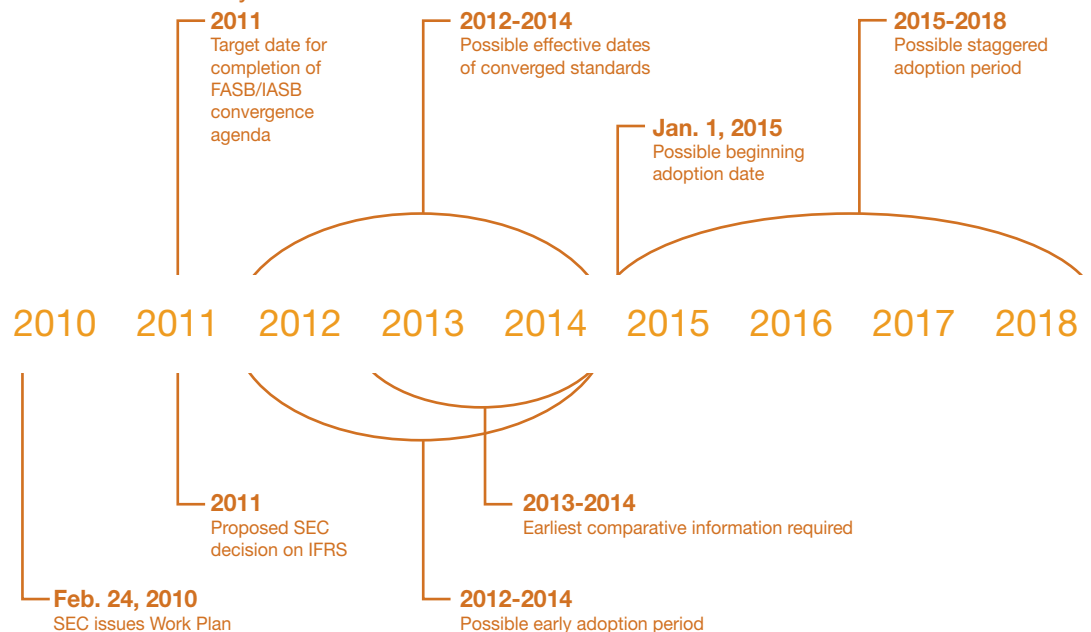
How IFRS may affect your company

A good working knowledge of International Financial Reporting Standards is no longer just optional for companies in the United States, but a business imperative. As more and more companies apply IFRS and US GAAP and IFRS continue to move closer as a result of convergence, US companies must consider how to prepare for the impact of convergence, global IFRS adoption, and potential US adoption, of IFRS.

The railroad industry is no exception. It will be affected on all fronts, including:

- Property, plant, and equipment
- Lease accounting
- Revenue recognition
- Derivatives and hedge accounting
- Taxes
- Share-based payments
- Pension and other postretirement benefit (OPEB) liabilities
- Provisions
- Joint ventures
- First-time adoption exemptions and exceptions

While there is still time before the formal conversion date to IFRS, the window in the United States is relatively narrow, especially for such a complex industry as railroads. Assuming that the SEC determines in 2011 to incorporate IFRS into the US domestic reporting system, a possible timeline may be:



Property, plant, and equipment

The railroad industry is capital intensive, and therefore property, plant, and equipment (PP&E) have a significant impact on a railroad company's balance sheet. The industry's nationwide system of locomotives, freight cars, and support equipment depends on a complex matrix of tracks, bridges, tunnels, stations, and communication hubs. The industry's expanse of equipment and property¹ requires constant maintenance to maximize safety and profits and minimize depreciation.

Group method of depreciation accounting

The Uniform System of Accounts (USOA) established by the Surface Transportation Board (STB) allows for railroads to use a group method of depreciation, which is the predominant industry practice for Class I North American railroads. However, the method is not as widely used by the shorter-line railroads. Under US GAAP, railroads generally use the same depreciation methods and rates for financial statements filed with both the STB and the SEC.

The component approach

Fixed assets comprise a number of components that may have different useful lives. Under IFRS, each significant component must be depreciated separately; this is often referred to as the component approach. Under US GAAP, entities use another method, composite depreciation, in which the complete asset is depreciated over one useful life and the cost of a new component is capitalized without derecognizing the replaced component.

Under US GAAP, Class I railroads utilize the group method of depreciation, under which an entity depreciates the aggregate cost of a group of equipment that is fairly homogeneous, despite differences in the service lives of individual items. Group depreciation usually is applied to groups of assets that are significant in number but have relatively small unit values.

For equipment and road assets under the group method of depreciation, gains and losses for normal retirements are deferred in the balance sheet; however, gains and losses on abnormal retirements are booked through the income statement.

IFRS requires accounting for separate asset components if the components' useful lives are different from the asset's useful life, which is at a lower level than what US GAAP requires. Rails, for example, may have a shorter useful life, and therefore a shorter depreciation period, than other track infrastructure. The cost of the various components may not be readily available, so valuing components may pose a challenge to companies. In accordance with IFRS, the cost of an item of PP&E is the cash price equivalent at the recognition date.

Under IFRS, all gains and losses arising from derecognition of an item of PP&E shall be included in profit or loss when the item is derecognized. There is no option under IFRS to defer recognition of gains and losses for normal retirement of equipment and road assets. Accordingly, railroads will need to evaluate their existing systems and accounting processes to enable recognition of gains and losses on asset retirement and componentization of assets as required by IFRS.

¹ Property can be categorized as either equipment or road. Equipment property consists primarily of locomotives and freight cars with lesser amounts of other equipment. All other property is road, which consists of track structure (e.g., rails, ties, ballast, and other track material), land bridges, tunnels, stations and office buildings, communication systems, etc.

Currently there are no first-time adoption exceptions or exemptions for PP&E accounting under International Accounting Standard (IAS) 16, *Property, Plant, and Equipment*, that would allow railroads to utilize group depreciation through the date of adoption. However, there is a first-time adoption exemption that allows companies to use fair value at the date of transition to IFRS, the date of an event (i.e., initial public offering), or a revaluation or allocation of an amount determined under previous GAAP to measure the value of an item of PP&E.

The US GAAP and IFRS guidance differs widely on componentization and recording of normal gains and losses in disposition (or retirement) of equipment and road assets. Recognition of gains and losses on normal retirement will present a significant challenge for railroads in converting to IFRS. However, because Class I railroads already componentize their road and equipment property as required by the STB's USOA, it appears that railroads should be able to more readily comply with the componentization requirement of IFRS.

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Although the component approach is not complex, its implementation can often create an administrative burden associated with gathering data and changing systems, if necessary. Companies can often underestimate the time and effort associated with this issue when doing project planning. The degree of complexity and the level of change necessary in this area can range widely from company to company, depending on the underlying systems and the availability of historical data.

Depreciation studies

These studies include retirement dispersion, survivor curves, useful life (expressed either in terms of years or productive capacity), salvage value, and removal costs. The STB has accepted three methods of grouping assets in depreciation studies: broad group, vintage group, and equal life group. Broad group and vintage group are average service life models and are commonly used in practice.

Depreciation studies are necessary under the group method to periodically adjust depreciation rates because of changes in estimates. Depreciation studies use a number of estimated variables based on historical databases or statistical models or are determined judgmentally.

The STB requires that Class I railroads perform road depreciation studies at least once every six years and equipment depreciation studies at least once every three years. Class II carriers perform depreciation studies only when requested by the STB.

Class III carriers are not required to perform depreciation studies. Any differences identified from these studies are deferred in the balance sheet.

Although under IFRS the STB will most likely still require railroads to perform depreciation studies, the component level for assessment of depreciation and useful lives will be lower, and each asset will be specifically identifiable.

Measurement

Under IFRS, companies have a choice on how to measure PP&E, while US GAAP allows only the historical cost method. Under IFRS, a company can choose to use either the historical cost method and carry the assets at cost less accumulated

Locomotive maintenance

Historically, railroads have expensed locomotive overhaul costs as incurred and capitalized the cost of remanufacturing locomotives when those activities meet certain unit-of-property capitalization criteria.

For assets carried under the historical cost method or revaluation method, it is important for companies to review the assets' useful life, residual value, and depreciation method at least annually. Companies that report under IFRS typically carry their assets at historical cost and do not opt for the revaluation method. However, use of the revaluation method would result in volatility in balance sheets since this revaluation is recorded in equity. US GAAP allows only the historical cost method.

depreciation and impairment charges or the revaluation method and revalue the assets regularly to fair value. Companies can even elect different methods between asset classes, assuming that the asset classes will be treated consistently going forward.

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US GAAP allows three alternatives for major maintenance and overhauls: expense as incurred, deferral, and the built-in overhaul method. The expense as incurred method expenses maintenance costs in the period in which they are incurred, as maintenance activities do not represent separately identifiable assets or property units. The deferral method capitalizes and amortizes maintenance expenses in a systematic, rational manner over the estimated period until the next planned major maintenance activity.

The built-in overhaul method recognizes costs of major maintenance in the carrying amount of the item of PP&E and depreciates these capitalized costs over the period until the next major overhaul, provided such costs meet the definition of an asset (i.e., probable of future economic benefits and reliably measurable). At the time of the next major overhaul, the new costs are capitalized, and any remaining carrying amount relating to the previous major overhaul is derecognized.

IFRS allows for only the built-in overhaul method. Therefore, companies currently employing this policy of accounting for their major maintenance activities will be least affected.

Under both IFRS and US GAAP, routine maintenance costs are expensed as incurred.

Property impairment

IAS 36, *Impairment of Assets*, requires that nonfinancial assets be assessed for impairment. Under IFRS, impairment testing is a one-step process that requires the asset's carrying value to be compared to the higher of fair value less costs to sell or value in use (which is typically a pre-tax, discounted cash-flow model reflecting the entity's intended use). This same impairment model is used when assessing all types of assets, including long-lived tangible and intangible assets and goodwill; the same cannot be said for US GAAP, in which different impairment models are used based on the type of asset being evaluated.

Under US GAAP, impairment is a two-step process for PP&E to be held and used. First, recoverability is assessed on an undiscounted cash-flow basis, then the impairment is measured as the amount by which the carrying amount exceeds the fair value of the assets.

One potential impact of this difference is that impairments would become more common because the one-step approach uses discounted cash flows under IFRS, versus nondiscounted cash flows under US GAAP.

The "value in use" is the present value of the future cash flows derived from an asset. Some assets do not generate independent cash flows and are tested in groups of cash generating units (CGUs). A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflow from other assets or groups of assets. The estimated future cash flows should reflect management's best estimate of the economic conditions that will exist over the assets' remaining life. The "fair value less costs to sell" is the amount obtainable from the sale of an asset or CGU in an arm's-length transaction between knowledgeable, willing parties, less costs of disposal. An impairment loss should be recognized if the recoverable amount is less than the asset's carrying value.

Fair value less costs to sell may be difficult to determine for some railroad-specific assets or CGUs because there is no market with third parties for these assets. If value in use exceeds the carrying amount of the tested asset or CGU, there is no need to determine fair value less costs to sell because there is no impairment. Fair value less costs to sell is required only if value in use is lower than the carrying amount. The excess of fair value less costs to sell over value in use reduces the amount of impairment. In rare circumstances when fair value less costs to sell cannot be reliably determined, IAS 36 allows using only the value in use to determine the amount of the impairment loss.

The crucial elements of a value in use calculation are the estimated future cash flows and the selection of the appropriate discount

rate. The cash flows exclude any estimated future cash flows expected to arise from future restructuring or from improvements or enhancements to the asset's performance through future capital expenditure. They

The determination of CGUs creates particular challenges for railroad companies because of the nature of the business. For example, an individual asset, such as track between two certain mile markers, would not

IFRS requires the discount rate for value-in-use calculations to be determined on a pre-tax basis. Thus, a CGU's pre-tax cash flows should be discounted at the pre-tax discount rate. In many cases, the only observable market rate of return is a post-tax discount rate.

also exclude finance costs (for example, interest paid) and income taxes. Cash flows include decommissioning costs or proceeds from disposal at the end of the asset's life. They should be based on the most recent budgets and forecasts that management has approved and on reasonable and supportable assumptions.

IFRS requires the discount rate for value-in-use calculations to be determined on a pre-tax basis. Thus, a CGU's pre-tax cash flows should be discounted at the pre-tax discount rate. In many cases, the only observable market rate of return is a post-tax discount rate. This is the case, for example, where the discount rate is derived from an entity's weighted average cost of capital, which many companies look toward when estimating the appropriate discount rate for a CGU. Deriving a pre-tax discount rate from a post-tax discount rate is a key practical issue and may be a complex exercise, since generally it is not simply a matter of grossing up the required post-tax rate of return at the standard or effective rate of tax and discounting the pre-tax cash flows at that grossed-up rate. To reflect the specific amount and timing of future cash flows, the post-tax rate will generally need to be adjusted much more carefully.

be considered a CGU if, to generate cash flows, it was dependent on other assets such as the rail infrastructure or terminals. CGUs in the railroad industry are best indicated by how the cash is generated. If one regular transport route, consisting of the trains, the tracks, and the terminals on that route, can generate cash inflows independently from other routes, it should be treated as a CGU.

Finally, under IFRS, an impairment of long-term assets (excluding goodwill) can be reversed, while US GAAP does not allow for a reversal of impairment. An entity must assess at the end of each reporting period whether there is any indication that an impairment loss recognized in prior periods for an asset, other than goodwill, may no longer exist or may have decreased. If any such indication exists, the entity shall estimate the recoverable amount of that asset and increase the carrying amount to its recoverable amount (not to exceed the carrying amount that would have been determined had no impairment loss been recognized for the asset in prior periods).

Lease accounting

Classification of leases

IFRS provides criteria for lease classification that are similar to US GAAP criteria. However, the IFRS criteria do not override the principle that classification is based on whether the lease transfers substantially all of the risks and rewards of ownership to the lessee. Operating under this principle could result in different lease classifications for similar leases under US GAAP and IFRS.

Railroads lease locomotives, rail cars, heavy equipment and machinery, facilities, and other equipment and tools. In addition, many railroads operate on track pursuant to trackage rights or leases. These leases are classified as either operating or capital (finance) leases. Leases are agreements in which the lessor conveys to the lessee the right to use an asset for an agreed period in return for payments.

While the lease classification criteria identified in US GAAP are consistent with the criteria in IFRS, there are no quantitative breakpoints or bright lines to apply with IFRS (e.g., present value of minimum lease payments equals or exceeds 90 percent of the fair value of the leased asset). For example, a lease of special-purpose assets that only the lessee can use without major modification would generally be classified as a financing lease (i.e., the equivalent of a capital lease under US GAAP). This would also be the case for any lease where the lessor is not subject to significant risk with respect to the residual value of the leased property.

IFRS defines a finance lease for both the lessor and lessee as a lease that transfers substantially all the risks and rewards incidental to ownership of an asset and, accordingly, lease classification by

the lessor and the lessee should typically be symmetrical.

IAS 17, *Leases*, lists the following indicators that individually or in combination would lead to a finance lease:

- The lease transfers ownership of the asset to the lessee.
- The lessee has the option to purchase the asset at below-market value so that it is reasonably certain that the lessee will exercise the option.
- The lease term is for the major part of the asset's economic life.
- The present value of the minimum lease payments is close to the fair value of the leased asset when the lease contract is signed.
- The leased assets are of a specialized nature so that only the lessee can use them without major modifications.
- The lessor's losses associated with the cancellation of a lease are borne by the lessee.
- Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee—for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease.
- The lessee extends the lease term at substantially below-market rent.

The indicators are not always conclusive and require careful attention.

When transitioning to IFRS, companies should give consideration to the classification of leases. A common pitfall is not reevaluating the initial lease classification on the date of transition, whereby inappropriate classification could result. For example, a 15-year lease period for an asset with a 20-year useful life might be a finance (capital) lease at inception. However, if the reassessment is done with two years left on the lease, it may well be an operating lease. Therefore, at the transition date, leases should be assessed assuming the IFRS lease guidance had been applicable at the inception of the lease. The lease classification at the transition date will then be based on this assessment.

In August 2010, the FASB and IASB jointly issued a leasing exposure draft addressing accounting by both the lessee and lessor for which the final standard is expected to be issued by mid-2011. Under the new approach, the operating lease accounting model would be eliminated. As such, all rights and obligations under lease arrangements, including those in effect when the new standard is issued, would be accounted for as assets and liabilities on the balance sheet—representing a major change from current practice.

The exposure draft proposes that lessees and lessors should apply a right-of-use model in accounting for all leases, which means that:

- a. A lessee would recognize an asset representing its right to use the leased asset for the lease term and a liability to make lease payments
- b. A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would do one of the following:

- i. Recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach)
- ii. Derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach)

Assets and liabilities recognized by lessees and lessors would be measured on a basis that:

- a. Assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease
- b. Uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease
- c. Is updated when changes in facts or circumstances indicate that there would be a significant change in these assets or liabilities since the previous reporting period

This area will be important to follow from a convergence perspective, especially since the current and past practice for railroads has been to enter into lease contracts for locomotives, rail cars, and other equipment with terms that qualify for operating lease treatment. At present, US GAAP and IFRS account for the lease payments arising from operating leases by recognizing them in the period in which they occur. The new model would require lessees to recognize the assets and liabilities arising from these leases, thereby increasing the railroads' assets and liabilities and potentially impacting financial covenants related to long-term debt or other agreements.

Leases involving land and buildings

Under US GAAP, land and building elements are generally accounted for as a single unit, unless the land represents 25 percent or more of the total fair value of the leased property. Under IFRS, the land and building elements must be considered separately unless the land element is not material.

Under IFRS, when a sale-leaseback transaction results in a lease classified as an operating lease, the accounting treatment is more complex because the sale price must be compared to the asset's fair value. If the sale price is at fair value, there has been a normal sale transaction, and any profit or loss arising from the sale is recognized immediately. If the sale price is below fair

Under IFRS, when a sale-leaseback transaction results in a finance lease, the gain or loss (unless there has been an impairment of the asset's value, which is more typical) is amortized over the lease term, irrespective of whether the lessee will reacquire the leased property. This is contrary to US GAAP, where the gain is amortized in proportion to the amortization of the leased asset.

Sale and leaseback transactions

Sale and leaseback is frequently used to raise capital in the railroad industry. The transaction involves the sale of a locomotive or other assets and the leaseback of the same assets, usually under a finance lease. The future lease payments and the sale price are often interdependent because they are negotiated as a package.

Gain recognition in sale-leaseback transactions may differ between IFRS and US GAAP and depends on classification of a leaseback as either a financing or operating lease. Where differences exist, IFRS may lead to earlier gain recognition.

Under IFRS, when a sale-leaseback transaction results in a finance lease, the gain or loss (unless there has been an impairment of the asset's value, which is more typical) is amortized over the lease term, irrespective of whether the lessee will reacquire the leased property. This is contrary to US GAAP, where the gain is amortized in proportion to the amortization of the leased asset.

value, any profit or loss should be recognized immediately. However, if the loss is compensated for by future lease payments at below-market price, it should be deferred in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortized to adjust the future rent over the period for which the asset is expected to be used.

Care must be exercised when evaluating certain transactions involving the legal form of a lease because IFRS requires that the substance of an arrangement overrides the legal form.

Revenue recognition

Freight revenues and expenses

Two methods of accounting are widely accepted for railroad freight revenues and expenses under US GAAP. One method, predominantly employed by the Class I railroads, is to recognize freight revenues based on the proportional performance (or percentage of completion) method provided as of the balance sheet date with freight expenses recognized as incurred. The second method, which is more widely used by the shorter-line railroads, is to recognize freight revenues and expenses based on completed performance when the shipment has been delivered to its destination.

IFRS currently requires that service transactions be accounted for by reference to the stage of completion of the transactions, which under US GAAP is known as the proportional performance method. This method is consistent with how most Class I railroads under US GAAP are currently accounting for freight revenues and expenses.

In June 2010, the FASB and IASB released an exposure draft outlining a new revenue recognition model, which is a contract-based approach focusing on the assets and liabilities that are created when an entity enters into and performs under a contract. The objective of the converged standard is to increase the consistency of revenue recognition for similar contracts, regardless of industry.

Under the proposed model, an entity would identify the contract with the customer, identify the separate performance obligations in the contract, determine the transaction price, allocate the transaction price to the separate performance obligations, and recognize revenue when the entity satisfies each performance obligation.

The proposal defines a performance obligation as an enforceable promise in the contract that includes both explicit and implicit promises to transfer goods and/or services to a customer. If an entity promises to provide more than one good or service, it would account for each promised good or service as a separate performance obligation if the good or service is distinct. A good or service is distinct if either the entity or another entity sells an identical or similar good or service separately or the good or service has a distinct function and a distinct profit margin.

Transaction price and variable consideration

The transaction price is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services promised in the contract. The price reflects the probability-weighted amount of consideration that the entity expects to receive from the customer.

If the amount is variable, an entity would recognize revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. The transaction price can be reasonably estimated if the entity has experience or access to others' experience with similar types of contracts and the entity's experience is relevant to the contract because the entity does not expect significant changes in circumstances. If some of the consideration amount can be reasonably estimated, but not all, the transaction price would include only the amount that can be reasonably estimated.

Railroads typically offer discounts to their customers for shipping a specified cumulative volume or shipping to and/or from

specific locations. Under the proposed revenue recognition model, these discounts would be considered variable consideration. For example, if a freight move is expected to generate \$1,000 of revenue based on contract rates, with a potential volume discount to the customer of \$100 per load if a certain volume target is met for the

Transfer of control

Under the proposed model, an entity would recognize revenue when it satisfies a performance obligation and control of a promised good or service transfers to the customer, which is when the customer is able to direct the use of and receive the benefits from the good or service.

Identifying the performance obligations in a contract will be critical in applying the proposed model and will require significant judgment. This may be particularly challenging for service arrangements and long-term contracts.

year, then \$100 of the \$1,000 consideration would be variable consideration. Under the model, if the company is able to reasonably estimate the transaction price (it has experience with identical or similar types of contracts, and that experience is relevant because the company does not expect circumstances surrounding these types of contracts to change significantly), then the company would record revenue based on the probability-weighted amount of consideration it expects to receive after weighing the possible outcomes.

Under current US GAAP, volume discounts are recorded as a reduction to operating revenues based on actual or projected future customer shipments when they are both probable and estimable.

Allocation of transaction price

An entity would allocate the transaction price to all separate performance obligations in proportion to the stand-alone selling prices of the goods or services underlying each of these performance obligations at contract inception. The entity would then update the transaction price over the life of the contract to reflect changes in circumstances.

When the promised goods or services underlying a separate performance obligation are transferred to a customer continuously, an entity would apply to that performance obligation one revenue recognition method that best depicts the transfer of goods or services to the customer. Acceptable methods include methods based on an entity's outputs or inputs and on passage of time.

Identifying the performance obligations in a contract will be critical in applying the proposed model and will require significant judgment. This may be particularly challenging for service arrangements and long-term contracts. Also challenging will be determination of when performance obligations should be combined and when they should be separated, which will be a key driver in determining the amount and timing of revenue recognition.

Companies should carefully consider the indicators of control transfer and assess whether under the new model there is a continuous transfer of control for the services performed. Careful consideration of the model's principle for revenue recognition and the indicators that demonstrate that the customer has obtained control is needed to determine when the revenue should be recognized. The indicators of control transfer are difficult to apply to certain service trans-

actions such as transportation services, and more guidance may be helpful in making the assessment as to when control transfers. For some companies, this may result in a significant change in the timing of revenue recognition.

In addition, if the recovery of freight costs is expected under the contract and generates or enhances resources of the entity that will be used in satisfying performance obligations in the future, the costs would be deferred as an asset until the related revenue is recognized. Costs of obtaining a contract (costs of selling, etc.) will be expensed as incurred.

Net versus gross

Management will need to consider whether the company is acting as a principal or an agent in a contract; this is applicable to the railroads particularly with interline shipments. Management should consider whether its performance obligation is to provide the goods or services or to arrange for another party to provide the goods or services in determining whether it is the principal or the agent. This proposed principle is consistent with current revenue guidance under US GAAP and IFRS, and therefore no significant impact is expected on the railroad industry.

In addition, if the recovery of freight costs is expected under the contract and generates or enhances resources of the entity that will be used in satisfying performance obligations in the future, the costs would be deferred as an asset until the related revenue is recognized.

This will be an important area to follow from a convergence perspective, especially since industry-specific GAAP that allows for a policy choice for revenue recognition will be replaced by a new model.

Derivatives and hedge accounting

Derivatives and hedging represent one of the more complex topical areas within both US GAAP and IFRS. While IFRS is generally viewed as less rules based than US GAAP, both standards embody a significant volume of detailed implementation guidance.

Railroads consume large amounts of diesel fuel. Long-term commodity contracts and derivatives are often used as a protection against price change. Such contracts may contain common provisions that create embedded derivatives if a contract uses a pricing formula with variables other than the

need to measure quantitatively the amount of hedge ineffectiveness. The US GAAP shortcut method is available only for certain fair value or cash flow hedges of interest rate risk using interest rate swaps when certain stringent criteria are met. IFRS has no equivalent shortcut method.

IFRS does acknowledge that in certain situations, little or no ineffectiveness could arise, but IFRS does not provide an avenue whereby an entity may assume no ineffectiveness. Because the shortcut method is not accepted under IFRS, companies using

Although the hedging models under IFRS and US GAAP are founded on similar principles, their application differs in a number of ways. Some of the differences result in IFRS being more restrictive than US GAAP, whereas other differences provide more flexibility under IFRS.

market price of the fuel being purchased. Railroads may use derivatives and embedded derivatives to assist in managing their overall exposure to fluctuations in fuel prices and in interest rates and foreign currency.

Although the hedging models under IFRS and US GAAP are founded on similar principles, their application differs in a number of ways. Some of the differences result in IFRS being more restrictive than US GAAP, whereas other differences provide more flexibility under IFRS. As companies work to understand and embrace the new opportunities and challenges associated with adopting IFRS in this area, they must carefully consider the various aspects of data requirements and underlying systems support.

Areas where IFRS is more restrictive than US GAAP include the nature and frequency of measuring and assessing hedge effectiveness. As an example, US GAAP provides for a shortcut method that allows an entity to assume no ineffectiveness and, hence, bypass an effectiveness test as well as the

the shortcut method under US GAAP will need to prepare the appropriate level of IFRS-compliant documentation if they want to maintain hedge accounting.

The documentation will need to be in place no later than at the transition date to IFRS if hedge accounting is to be maintained on an uninterrupted basis. For a railroad whose first IFRS-based financial statements will be issued for the three years ending on December 31, 2015, hedging documentation needs to be in place as of January 1, 2013, if the entity wants to continue to apply hedge accounting on an uninterrupted basis.

IFRS is also more restrictive than US GAAP in relation to the use of internal derivatives. Restrictions under the IFRS guidance may necessitate that entities desiring hedge accounting enter into separate, third-party hedging instruments for the gross amount of foreign currency exposures in a single currency, rather than on a net basis, as many treasury centers do currently under US GAAP.

At the same time, in a number of areas IFRS provides opportunities not available under US GAAP. Such opportunities arise in a series of areas where hedge accounting can be accomplished under IFRS. For example, under IFRS, an entity can achieve hedge accounting in relation to the foreign currency risk associated with a firm commitment to acquire a business in a business combination (whereas US GAAP would not permit hedge accounting).

IFRS allows an entity to use a single hedging instrument to hedge more than one risk in two or more hedged items. This difference may allow entities under IFRS to adopt new and sometimes more complex risk management strategies while still achieving hedge accounting. IFRS is more flexible than US GAAP with respect to the ability to achieve fair value hedge accounting in relation to interest rate risk within a portfolio of dissimilar financial assets and in relation to hedging a portion of a specified risk and a portion of a time period to maturity (i.e., partial-term hedging) of a given instrument to be hedged.

The FASB and IASB have currently undertaken a project to significantly improve the decision usefulness of financial instrument reporting for users of financial statements. The project will replace the FASB's and IASB's respective financial instruments standards with a common standard. The boards believe that simplification of the accounting requirements for financial instruments should be an outcome of this improvement. The boards believe that this project will reconsider the recognition and measurement of financial instruments, address issues related to impairment of financial instruments and hedge accounting, and increase convergence in accounting for financial instruments.

As part of this project, in May 2010, the FASB issued a proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. In addition, in November 2009, the IASB issued IFRS 9, *Financial Instruments*, which covers classification and measurement of financial assets. The IASB made a decision to retain most of the existing classification and measurement guidance in IAS 39 for financial liabilities. However, the IASB also tentatively decided to propose changes to the fair value option for financial liabilities and issued an exposure draft, *Fair Value Option for Financial Liabilities*, in May 2010.

The IASB has also made tentative decisions about impairment and issued an exposure document on amortized cost and impairment in November 2009. This project is ongoing as the FASB and IASB continue to work toward achieving convergence.

Taxes

Transitioning to IFRS accounting policies will impact a company's tax function. From a financial reporting perspective, key differences exist between US GAAP and IFRS with respect to accounting for income taxes.

As companies progress in their IFRS efforts, it is critical that their tax function understands IFRS and the potential tax implications in the United States and in each foreign jurisdiction in which

As companies progress in their IFRS efforts, it is critical that their tax function understands IFRS and the potential tax implications in the United States and in each foreign jurisdiction in which the organization operates, develops a tax-specific implementation plan, and is thoroughly involved in the company's overall conversion process from beginning to end.

Examples of these differences include accounting for uncertain tax positions, tax consequences of share-based compensation, unrealized intragroup profits, measurement of nonmonetary assets and liabilities where the local currency is not the functional currency, intraperiod allocation related to subsequent changes in deferred tax balances, outside basis differences, recognition of deferred tax assets, and determination of the tax basis. As a result of these and other differences, the accounting and disclosure requirements associated with income taxes, including the effective tax rate, may be impacted.

In addition to tax accounting, several components of a company's tax planning structure could also be affected by the transition to IFRS, including cash taxes, tax accounting methods, domestic and international tax planning, and transfer pricing. Further, a company's tax processes, systems, and internal controls may require modifications to properly reflect the transition to IFRS.

the organization operates, develops a tax-specific implementation plan, and is thoroughly involved in the company's overall conversion process from beginning to end.

For more information on the tax considerations associated with the transition to IFRS, please visit our IFRS-Tax webpage at www.pwc.com/usifrs/tax.

Share-based payments

Scope

Despite the progress made by the IASB and FASB toward converging the frameworks in this area, a multitude of significant differences remains. Some awards categorized

In addition, companies that issue awards with graded vesting (e.g., awards that vest ratably over time, such as 25 percent per year over a four-year period) may encounter

Under US GAAP, the guidance is driven by the legal definition of an employee, with certain specific exceptions/exemptions. IFRS focuses on the nature of the services provided and treats awards to employees and others providing employee-type services similarly.

as nonemployee instruments under US GAAP will be treated as employee awards under IFRS.

Under US GAAP, the guidance is driven by the legal definition of an employee, with certain specific exceptions/exemptions. IFRS focuses on the nature of the services provided and treats awards to employees and others providing employee-type services similarly. For awards that are categorized as nonemployee instruments, the measurement date and expense will be different under US GAAP and IFRS.

accelerated expense recognition and potentially a different total value to be expensed (for a given award) under IFRS. The impact in this area could lead some companies to consider redesigning the structure of their share-based payment plans. By changing the vesting pattern from graded to cliff, companies can avoid a front-loading of share-based compensation expense, although this may be desirable to some organizations.

Measurement and attribution

Differences within the two frameworks may result in differing grant dates and/or different classifications of an award as a component of equity or as a liability. Once an award is classified as a liability, it needs to be measured to fair value at each period through earnings, which introduces earnings volatility while impacting balance sheet metrics and ratios. Certain types of awards (e.g., puttable awards and awards with vesting conditions outside service, performance, or market conditions) are likely to have different equity-versus-liability classification conclusions under the two frameworks.

Pension and OPEB liabilities

Most of the major railroads have defined benefit pension plans and some have other postemployment benefit plans, both of which generate significant liabilities. To measure the expense associated with these benefits, railroads must make various assumptions including discount rates used to value certain liabilities, expected return on plan assets used to fund these benefits, salary increases, employee turnover rates,

required to disclose the full funded status within the notes to the financial statements.

US GAAP permits the use of a calculated asset value in the determination of expected returns on plan assets. IFRS prohibits the use of a calculated value, instead requiring that the actual fair value of plan assets at each measurement date be used.

Differences between US GAAP and IFRS can result in different classifications of a plan as a defined benefit or a defined contribution plan. It is possible that a benefit arrangement that is classified as a defined contribution plan under US GAAP may be classified as a defined benefit plan under IFRS, and vice versa.

anticipated mortality rates, and expected future healthcare costs. These assumptions are based on historical experience as well as current facts and circumstances. Railroads typically use third-party actuaries to assist them in measuring the expense and liability associated with these benefits.

In this area of accounting, IFRS and US GAAP currently have a number of significant differences. However, both the FASB and IASB have major projects on their agendas on accounting for pension and other post-employment benefits that may result in greater convergence.

Under IFRS, a company can adopt a policy that recognizes gains and losses in other comprehensive income (OCI). Gains and losses treated in accordance with this election would not be subsequently recycled through the income statement. Other policy elections available under IFRS for gain and loss recognition are similar to those under US GAAP.

Under IFRS, companies are not required to present the full funded status of their postemployment benefit plans on the balance sheet. However, companies are

IFRS does not require a company to present various components of pension cost as a net amount. As such, companies are permitted to present components of a net pension cost within different line items on the income statement. The flexibility provided under IFRS would enable companies to record the interest expense and return on plan assets components of pension expense as part of financing within the income statement.

Differences between US GAAP and IFRS can result in different classifications of a plan as a defined benefit or a defined contribution plan. It is possible that a benefit arrangement that is classified as a defined contribution plan under US GAAP may be classified as a defined benefit plan under IFRS, and vice versa. Plan classification differences would result in changes to the expense recognition model, as well as the balance sheet presentation.

The IASB issued an exposure draft, *Defined Benefit Plans: Proposed amendments to IAS 19*, of proposed amendments to its current standard on accounting for employee benefits. The IASB proposal would significantly change an employer's recognition of its defined benefit obligations and costs. The

FASB's project is not active, but the FASB is currently monitoring the work of the IASB to determine the next steps on its project. The key provisions of the exposure draft that will differ from US GAAP are as follows:

- The IASB proposes that the changes arising from actuarial gains and losses be immediately recognized in OCI in a statement of comprehensive income. Unlike US GAAP, however, the IASB's proposal would prohibit those OCI amounts from being subsequently amortized and considered in determining future net income (i.e., they would not be recycled).
- The proposed guidance would eliminate the flexibility currently afforded in the presentation of benefit expense under IFRS. Under the proposal, the cost of benefits accrued in the current period (service cost) and benefit changes (prior service cost and curtailments) would be recognized as an operating expense. Net interest expense or income would be recognized as a financing component based on the net surplus or deficit of the plan times the discount rate. Any other remeasurements (e.g., actuarial gains and losses, the effect of the asset ceiling, and settlements) would be recognized net of tax in OCI as a remeasurement component.

Provisions

Railroads employ large workforces, have operations in densely populated urban areas, and transport hazardous waste. Railroads are therefore exposed to the potential for various claims and litigations for labor and employment, personal injury, property damage, environmental liability, and other matters.

Under US GAAP, the cost of injuries to employees and others on railroad property is charged to expense based on estimates of the number of incidents each year and the ultimate cost, which includes amounts for incurred but unasserted claims. Many railroads use third-party actuaries to assist them in properly measuring the expense and

In addition, there may be differences in the expense classification because IFRS requires that provisions for pollution caused by transportation services should be charged to costs of sales if the income statement is presented by function and expense.

The amount recognized as a provision for IFRS is the best estimate of expenditure required to settle the present obligation as of the balance sheet date. The anticipated cash flows are discounted to their present value if the effect of discounting is material. Under US GAAP, a provision is discounted only when the timing of the cash flows is fixed or reliably determinable.

The recording of provisions is required for both IFRS and US GAAP if the outflow of resources is probable. However, the definition of *probable* differs under IFRS and US GAAP. IFRS defines it as “more likely than not,” or greater than a 50 percent likelihood. US GAAP defines it as “likely to occur,” or generally 75 percent or greater in practice.

liability, which are adjusted each reporting period. For other types of claims and litigations such as environmental liability, railroads accrue the cost of remediation when their obligation is probable and such costs can be reasonably estimated.

In addition, railroads incur significant costs to investigate and remediate known, unknown, or future environmental contaminations. Railroads have significant liabilities or provisions relating to these areas.

The recording of provisions is required for both IFRS and US GAAP if the outflow of resources is probable. However, the definition of *probable* differs under IFRS and US GAAP. IFRS defines it as “more likely than not,” or greater than a 50 percent likelihood. US GAAP defines it as “likely to occur,” or generally 75 percent or greater in practice. This difference could lead to additional liabilities under IFRS that are not recognized under US GAAP.

A range of possible outcomes is established when measuring provisions. When no amount within that range represents a better estimate of the provision than any other amount, there is a difference in the amount recorded under IFRS and US GAAP. For IFRS, a company would measure the provision based on the midpoint of the range, while for US GAAP, the low point of the range would be used to measure the liability.

At the time of this publication, the IASB is working on a stand-alone project on provisions. It has issued an exposure draft that proposes to require that potential liabilities be measured at the present value of the amount that an entity would rationally pay to be relieved of the obligation at the balance sheet date. If this amount is uncertain, then the provision is measured on a probability-weighted average of all possible outcomes. The final standard is expected to be issued in 2011.

Restructuring provisions

Companies may experience differences between IFRS and US GAAP in the timing or underlying events that trigger the recognition of restructuring provisions.

A provision is recognized in IFRS when an entity is demonstrably committed to the restructuring. This usually occurs when a company has a legal obligation or when the entity has a detailed formal plan for the restructuring. Communication to specific, affected employees is not required, although management must have raised the valid expectation in those affected that it will carry out the restructuring by starting to implement the plan or announcing its main features to those affected by it. Recognition under US GAAP for one-time termination benefits requires communication of the details of the plan to employees who could be affected.

Joint ventures

Joint ventures and partnering arrangements in the railroad industry allow entities to share the risks and capital costs of services. Under US GAAP, the term *joint venture* refers only to jointly controlled entities, where the arrangement is conducted through a separate entity. The scope of joint activity is much broader under IFRS than under US GAAP. IAS 31, *Interests in Joint Ventures*, defines a joint venture as “a contractual agreement whereby two or more parties undertake an economic activity that is subject to joint control.”

The concept of joint control is the contractually agreed sharing of control of an economic activity, which exists only when the strategic financial and operating decisions relating to the activity require the unanimous consent

entity will follow the equity method, provided significant influence exists.

Under US GAAP, proportional consolidation typically is not permitted. US GAAP requires an assessment of whether the joint venture is a variable interest entity before the accounting model can be determined. Under IFRS, such considerations fall under SIC Interpretation 12, *Consolidation—Special Purpose Entities*. This guidance may result in more entities being consolidated under IFRS because the consolidation requirements are less restrictive than under US GAAP.

In September 2007, the IASB issued Exposure Draft 9, *Joint Arrangements*, which would amend existing provisions of IAS 31. The exposure draft’s core principle

The scope of joint activity is much broader under IFRS than under US GAAP. IAS 31, *Interests in Joint Ventures*, defines a joint venture as “a contractual agreement whereby two or more parties undertake an economic activity that is subject to joint control.”

of the parties sharing control. This includes jointly controlled entities as well as jointly controlled operations (each venturer uses its own assets for a specific project) and jointly controlled assets (project carried on with assets that are jointly owned). A transition to IFRS would necessitate close consideration of business relationships and alliances to determine which arrangements may be accounted for as joint ventures.

Accounting for joint ventures under IFRS depends on the type of arrangement identified. For example, if the arrangement results in a jointly controlled entity, IFRS permits the use of either proportionate consolidation or the equity method. If an arrangement does not result in a jointly controlled entity (i.e., one entity has clear control through, for example, voting rights or qualitative factors), the controlling entity typically will follow consolidation accounting while the other

is that parties to a joint arrangement recognize their contractual rights and obligations arising from the arrangement. The exposure draft therefore focuses on the recognition of assets and liabilities by the parties to the joint arrangement.

Exposure Draft 9 proposes two key changes. The first is the elimination of proportionate consolidation for a jointly controlled entity. Entities that currently use proportionate consolidation to account for jointly controlled entities may need to account for such arrangements by using the equity method. The second change is the introduction of a dual approach to the accounting for joint arrangements, whereas IAS 31 allowed for three types of joint arrangements. The board determined that joint arrangements and joint operations would be merged into a single type of joint arrangement called joint operations. The key change is that a

single joint arrangement may contain more than one type — for example, joint assets and a joint venture. Parties to such a joint arrangement account first for the assets and liabilities of the joint assets arrangements and then use a residual approach to equity accounting for the joint venture part of the joint arrangement.

The board is continuing its discussions. The final standard is expected to be issued at the end of 2010. As drafted, the exposure draft broadly achieves convergence in principle with US GAAP, which generally requires the use of the equity method to account for jointly controlled entities.

The IASB grants limited exemptions from adoption requirements in specified areas where the cost of complying with them would be likely to exceed the benefits to users of financial statements. The IASB also prohibits retrospective application of IFRS in some areas, particularly where retrospective application would require judgments by management about past conditions after the outcome of a particular transaction is already known.

First-time adoption exemptions and exceptions

The IASB grants limited exemptions from adoption requirements in specified areas where the cost of complying with them would be likely to exceed the benefits to users of financial statements. The IASB also prohibits retrospective application of IFRS in some areas, particularly where retrospective application would require judgments by management about past conditions after the outcome of a particular transaction is already known.

The selection and application of the optional exemptions can be complicated. Careful consideration and analysis should be applied to ensure the most appropriate actions are taken. The following chart summarizes the elections available to companies under IFRS 1, *First-time adoption of IFRS*.

Exemption	Choice	Exemption applies to all items? ²
Business combinations (IFRS 3R)	For all transactions qualifying as business combinations under IFRS 3R, a company can choose to: <ul style="list-style-type: none"> • Not restate business combinations before the date of transition • Restate all business combinations before the date of transition • Restate a particular business combination, in which case all subsequent business combinations must also be restated and the IAS 36 impairment guidance must be applied 	No
Deemed cost	For property, plant, and equipment, a company can choose to measure the value using: <ul style="list-style-type: none"> • Fair value at the date of transition as deemed cost • A revaluation in accordance with previous GAAP as deemed cost • Fair value at the date of an event such as a privatization or an initial public offering as deemed cost • An allocation of an amount determined under previous GAAP as deemed cost <p>The first two elections can also be applied to intangible assets that meet the criteria for revaluation in IAS 38 and to investment properties where the cost method in IAS 40 is applied. The first two elections may not be used for any other assets or for liabilities.</p>	No

² This column designates whether the exemption should be applied to all transactions ("Yes") or only selected transactions based on the guidance in IFRS 1 ("No"). This designation does not apply to assets and liabilities of a subsidiary that has already adopted IFRS. In that case (where a parent becomes a first-time adopter later than its subsidiary), IFRS 1 requires the parent to use the "same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the parent acquired the subsidiary." Once a subsidiary has adopted IFRS, the carrying amounts of assets and liabilities of that subsidiary cannot be adjusted later when the parent adopts IFRS (except as necessary to conform to the parent's policies).

Exemption	Choice	Exemption applies to all items? ²
Employee benefits	Recognition of all cumulative actuarial gains and losses as an adjustment to opening retained earnings is allowed. Deferral of the recognition of future actuarial gains and losses using the corridor approach in IAS 19 may still be applied prospectively.	Yes
Cumulative translation differences	The cumulative translation reserve may be reset to zero.	Yes
Compound financial instruments	A compound financial instrument does not need to be bifurcated if the liability component is not outstanding at the transition date.	No
Assets and liabilities of subsidiaries, associates, and joint ventures	A subsidiary that adopts IFRS later than its parent can elect to apply IFRS 1 or to use the carrying amounts of its assets and liabilities included in the consolidated financial statements, subject to eliminating any consolidation adjustments. If a parent adopts IFRS later than its subsidiary, the parent, in its consolidated financial statements, must measure the assets and liabilities of the subsidiary at the same carrying amounts as in the IFRS financial statements of the subsidiary, adjusting for normal consolidation entries.	No
Designation of previously recognized financial instruments	A company may choose to designate a financial instrument as a financial asset or financial liability “at fair value through profit or loss” or may designate a financial asset as available for sale at its transition date. If it is impracticable (as defined in IAS 8) for an entity to apply retrospectively the effective interest method or the impairment requirements of IAS 39, the fair value of the financial asset at the date of transition to IFRS shall be the new amortized cost of that financial asset at the date of transition to IFRS.	No

² This column designates whether the exemption should be applied to all transactions (“Yes”) or only selected transactions based on the guidance in IFRS 1 (“No”). This designation does not apply to assets and liabilities of a subsidiary that has already adopted IFRS. In that case (where a parent becomes a first-time adopter later than its subsidiary), IFRS 1 requires the parent to use the “same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the parent acquired the subsidiary.” Once a subsidiary has adopted IFRS, the carrying amounts of assets and liabilities of that subsidiary cannot be adjusted later when the parent adopts IFRS (except as necessary to conform to the parent’s policies).

Exemption	Choice	Exemption applies to all items? ²
Share-based payment transactions (IFRS 2)	A company is encouraged (but is not required) to apply IFRS 2 to any equity instruments that were granted on or before November 7, 2002, or that were granted after that date and vested before the date of transition, but only if the company has previously disclosed publicly the fair value of the instruments, determined at the measurement date. In addition, a company may choose (but is not required) to apply IFRS 2 to a liability relating to share-based payment transactions that were settled prior to the date of transition to IFRS.	Yes
Insurance contracts (IFRS 4)	A company that issues insurance contracts and has a date of adoption before January 1, 2006, may choose not to restate comparatives for IFRS 4. The company applies its previous GAAP to insurance contracts for its comparatives.	No
Decommissioning, liabilities included in the cost of property, plant, and equipment	When accounting for asset retirement obligations, first-time adopters may apply a shortcut method by: <ul style="list-style-type: none"> • Measuring the liability at transition date in accordance with IAS 37 • Estimating the amount of the liability that would have been included in the cost of the related asset when the liability first arose • Calculating the accumulated depreciation on that discounted amount, as of the date of transition to IFRS 	No
Leases	A company may elect to assess whether an arrangement contains a lease at the date of transition, rather than at the inception of the arrangement.	No
Fair value measurement of financial assets and financial liabilities at initial recognition	First-time adopters can choose to measure their Day One profits on initial recognition of financial instruments either: <ul style="list-style-type: none"> • Retrospectively to all transactions • Prospectively for all transactions entered into after October 25, 2002 • Prospectively for all transactions entered into after January 1, 2004 	No
Service concession arrangements	Companies may elect to apply the transitional provisions of IFRIC 12, rather than full retrospective application.	No

² This column designates whether the exemption should be applied to all transactions ("Yes") or only selected transactions based on the guidance in IFRS 1 ("No"). This designation does not apply to assets and liabilities of a subsidiary that has already adopted IFRS. In that case (where a parent becomes a first-time adopter later than its subsidiary), IFRS 1 requires the parent to use the "same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the parent acquired the subsidiary." Once a subsidiary has adopted IFRS, the carrying amounts of assets and liabilities of that subsidiary cannot be adjusted later when the parent adopts IFRS (except as necessary to conform to the parent's policies).

Exemption	Choice	Exemption applies to all items? ²
Borrowing costs	If the accounting treatment for capitalized interest required by IAS 23 is different than a company's previous accounting policy, the company may apply IAS 23 to borrowing costs related to qualifying assets capitalized on or after January 1, 2009, or the date of transition to IFRS, if later.	No
Investments in subsidiaries, jointly controlled entities, and associates	In their separate financial statements, first-time adopters can measure their investment in subsidiaries, jointly controlled entities, and associates at either: <ul style="list-style-type: none"> • Cost, determined in accordance with IAS 27R • Deemed cost, defined as fair value (determined in accordance with IAS 39) at the company's IFRS transition date • Deemed cost, defined as previous GAAP carrying amount at the IFRS transition date 	No
Transfer of assets from customers	If the accounting treatment for transfers of assets from customers required by paragraph 22 of IFRIC 18 is different than a company's previous accounting policy, the company may apply IFRIC 18 to transfers of assets from customers on or after July 1, 2009, or the date of transition to IFRS, whichever is later. In addition, the first-time adopter may designate any date before the date of transition to IFRS and apply IFRIC 18 to all transfers of assets from customers received on or after that date.	No
Extinguishing financial liabilities with equity instruments	A first-time adopter may apply the transitional provisions in IFRIC 19, <i>Extinguishing Financial Liabilities with Equity Instruments</i> .	No

² This column designates whether the exemption should be applied to all transactions ("Yes") or only selected transactions based on the guidance in IFRS 1 ("No"). This designation does not apply to assets and liabilities of a subsidiary that has already adopted IFRS. In that case (where a parent becomes a first-time adopter later than its subsidiary), IFRS 1 requires the parent to use the "same carrying amounts as in the financial statements of the subsidiary (or associate or joint venture), after adjusting for consolidation and equity accounting adjustments and for the effects of the business combination in which the parent acquired the subsidiary." Once a subsidiary has adopted IFRS, the carrying amounts of assets and liabilities of that subsidiary cannot be adjusted later when the parent adopts IFRS (except as necessary to conform to the parent's policies).

Mandatory exceptions from retrospective application

There are also several mandatory exceptions to full retrospective application of IFRS. As described below, some of these exceptions may or may not have an impact on US companies:

Expected to impact US companies	Not expected to impact many US companies
Hedge accounting	Derecognition of financial assets and financial liabilities
Estimates	Classification and measurement of financial assets
Noncontrolling interests	

What this means for your business

What companies can do now

Independent of when the United States ultimately adopts IFRS, these standards are already having a significant impact on US businesses. The impact will only increase in the next several years as convergence takes place and eventual adoption of IFRS gains momentum.

Awareness and preparedness are essential. Given the timeline, companies should be thoughtful and measured in their approach as they consider this complex challenge. Following are our suggestions for what companies should be doing now:

- **Focus on the challenge.** The next several years will bring major changes to US financial reporting. Whether changes arrive through convergence, an SEC-mandated move to IFRS, or continued IFRS adoption by subsidiaries and counterparties, the effect on US businesses will be considerable.
- **Perform an assessment.**
 - Keep it high level and strategic.
 - Consider the implications for accounting, business strategies and policies, tax, financing, long-term contracts, stakeholders, compensation programs, systems, processes, and controls.
 - Anticipate the impacted behaviors of non-US customers and vendors using IFRS already.
- **Be poised to adapt to ongoing change.** Use scenario planning to incorporate likely convergence and IFRS adoption expectations into your strategic thinking and business planning. Closely follow SEC actions, new FASB and IASB standards, and the increasing international acceptance of IFRS and IFRS for small and medium-sized entities (SMEs) for statutory purposes.
- **Maintain corporate oversight.** Influence transition timing, strategies, and policy decisions of non-US subsidiaries that are increasingly likely to be using IFRS or IFRS for SMEs in the foreseeable future. IFRS adoption for statutory reporting continues in many territories. The United Kingdom is one example, with its proposal to adopt IFRS for statutory purposes in 2012.
- **Identify what can be done now.** Being mindful of the specific aspects of convergence and conversion that will take the longest to prepare for, and consider smaller, controlled, one-off projects and “easy wins” where desirable.

By staying focused on aspects of convergence and adoption that have a long lead time, railroad companies can stay ahead of the game. A new era of financial reporting is approaching, and it will have a significant impact as a driver of change throughout the industry.

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