

IFRS conversion: Understanding the key tax issues for Pharmaceuticals, Life Sciences and Medical Devices companies

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Introduction

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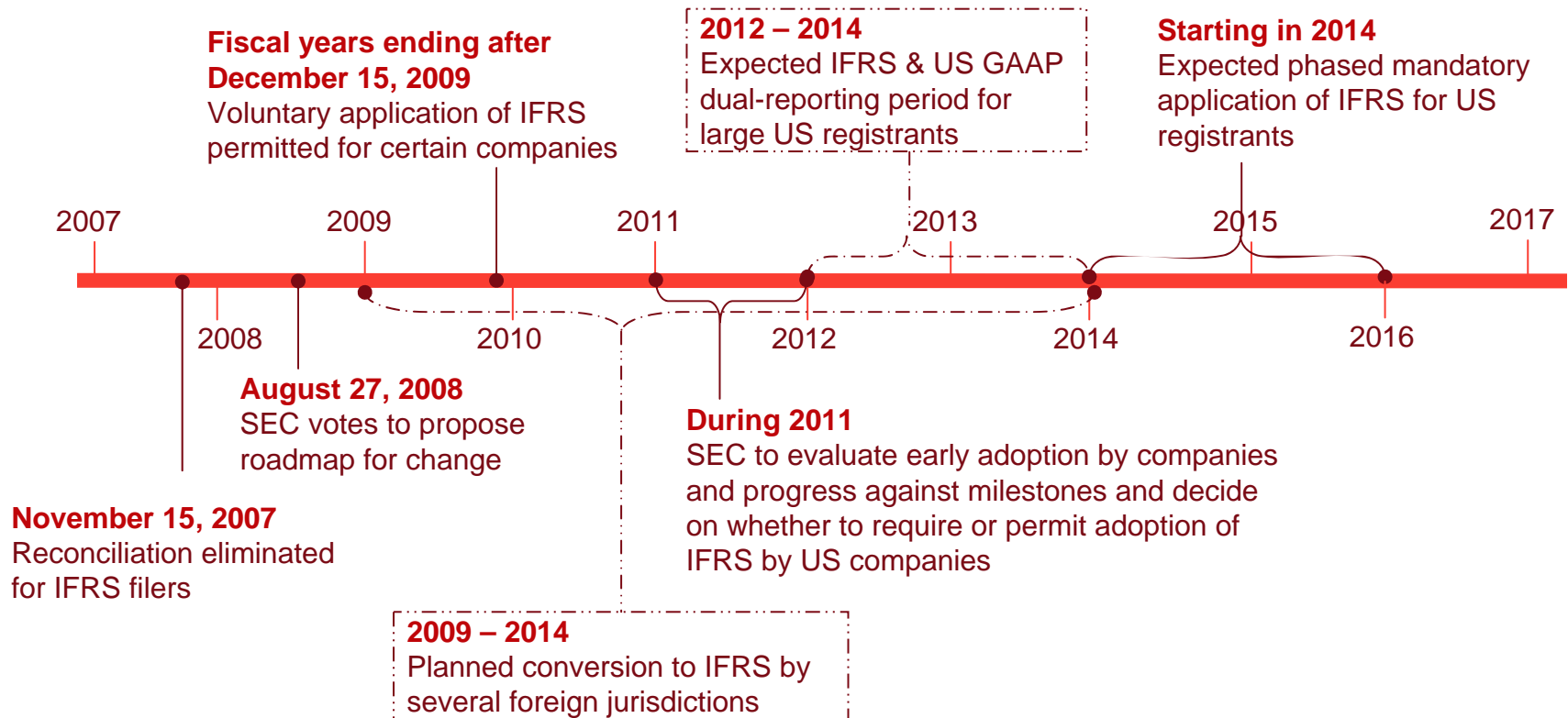
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Overview and regulatory developments

IFRS overview

- Two step implementation
- Voluntary early adoption for limited entities
 - Based primarily on market capitalization and size within industry
 - IFRS must be the most used accounting standard in that industry
- Mandatory adoption by all US registrants in 2014 if milestones are met
- Milestones include:
 - Continued improvements to IFRS- Education and training in the US
 - Independent funding of the IASB - XBRL acceptance of IFRS
- SEC to reconvene in 2011 to determine if milestones are met
- 60 day comment period is closing, though some commenters requested more time to consider the roadmap
- In her confirmation hearing, Mary Shapiro (SEC Chair), indicated the Commission's focus on IFRS is likely diminish during her tenure
- Conversely, others in the new Administration support moving to IFRS

IFRS adoption



PwC's view on the SEC's proposed roadmap to IFRS

- A single set of global accounting standards is best for investors
- Nearly half of the top pharmaceuticals companies already report under IFRS
- IFRS will enhance US pharma companies' comparability with foreign competitors
- We support the SEC's overall direction, however...
 - US companies should have same alternatives as foreign private issuers
 - A definitive mandatory date should be set as soon as possible
 - Limitations will prevent some companies from adopting IFRS
 - Early adoption should be expanded to a wider range of companies
 - Ongoing US GAAP reconciliation should not be required

Polling question 1

Has the issuance of the SEC roadmap accelerated your company's evaluation of IFRS?

- A. No; my company was involved in IFRS readiness efforts prior to the SEC roadmap release
- B. Yes; as a result of the roadmap release, my company has stepped up its IFRS readiness efforts
- C. No; the release of the roadmap has not accelerated my company's IFRS efforts
- D. Don't know
- E. N/A (PwC participants)

Select IFRS/US GAAP differences

IFRS/US GAAP—Benchmarking differences

- Ongoing differences are related to the timing of recognition
- Dollar impact of adopting IFRS is generally entity/transaction specific
- Large adjustments explained by IFRS first time adoption and policy decisions

Entity	IFRS vs. US GAAP		Number of reconciling items	Selected differences		
	Net income	Equity				
Astrazeneca PLC	38%	-53%	9	Acquisitions	IPR&D	Intangibles
Bayer AG	530%	6%	8	IPR&D	Pensions	Acquisitions
GlaxoSmithKline	21%	-73%	13	Acquisitions	IPR&D	Pensions
Novartis AG	36%	-1%	9	Acquisitions	IPR&D	Pensions
Sanofi-Aventis	-1%	-1%	11	Acquisitions	IPR&D	Intangibles
Unilever NV	14%	-32%	9	Pensions	Fin. Instruments	Disposals
Diageo PLC	-6%	-53%	11	Pensions	Fin. Instruments	Intercompany balances

This information is derived from Form 20-F

Select IFRS/US GAAP differences

IFRS assessment

Accounting area	Considerations	Potential implications
Capitalization of acquired IPR&D and internal development	<ul style="list-style-type: none"> • Capitalization of R&D and internally generated intangibles • Different impairment testing model 	<ul style="list-style-type: none"> • Assess R&D activities for potential capitalization and estimate impact on reported results • Acquired licenses to be capitalized • Impairment testing and measurement both based upon discounted/fair value models (fair value less cost to sell or value-in-use) • Evaluate incremental effort and impact on existing systems to monitor balances and impairment testing
Collaboration agreements	<ul style="list-style-type: none"> • Up-front and milestone payments are capitalized under IFRS when the criteria for recognition have been met 	<ul style="list-style-type: none"> • Review of all significant collaboration agreements to determine whether the contract was for true contract R&D or if a potential asset was acquired under IFRS
Pre-launch inventories	<ul style="list-style-type: none"> • Consistency of assumptions underlying capitalization • Reversal of inventory write-downs 	<ul style="list-style-type: none"> • A consistent view on the probability of success should be taken for both potentially capitalizable development costs and pre-launch inventories • Inventory allowances must be reversed if the fair value recovers (e.g., upon approval)

Select IFRS/US GAAP differences (continued)

Potential differences

Accounting area	Considerations	Potential implications
Revenue recognition	<ul style="list-style-type: none"> Fair value of multiple element arrangements Gross vs. Net presentation 	<ul style="list-style-type: none"> Measurement and timing of revenue recognition Increased judgments and use of estimates on revenue recognized (reverse residual not prohibited) Supporting finance and operational system data requirements may change
Litigation contingencies	<ul style="list-style-type: none"> Threshold for recognition Attorneys' fees Accounting when there is a range of possibilities Discounting 	<ul style="list-style-type: none"> IFRS contingencies may be recognized sooner, as the practical model is "more likely than not" or greater than 50% Attorneys fees need to be included in legal contingency estimates Mid-point of a range of possibilities is used for IFRS, not the minimum
Long-term payables and receivables	<ul style="list-style-type: none"> Long-term payables and receivables must be discounted 	<ul style="list-style-type: none"> Long term payables and receivables must be discounted and accreted to settlement value Interest income/expense recognized over period outstanding
Equity investments	<ul style="list-style-type: none"> All cost method investments must be marked to market 	<ul style="list-style-type: none"> Non-public investments would need to be marked to market as evidence becomes available of decreases or increases in value

Select IFRS/US GAAP differences (continued)

IFRS assessment

Accounting area	Considerations	Potential implications
Leasing	<ul style="list-style-type: none"> Substance of transaction 	<ul style="list-style-type: none"> Potentially more leases on balance sheet (lease classification), impacting forecasts and debt covenants
Hedging	<ul style="list-style-type: none"> Short-cut method is not allowed 	<ul style="list-style-type: none"> Full documentation of criteria for recognizing and measuring hedge effectiveness must be prepared
Impairment assessments of long-term assets	<ul style="list-style-type: none"> Impairment assessments for long-term assets (fixed assets, intangibles) is not based on undiscounted cash flows Goodwill impairments done in one step Reversal of impairment losses required in certain circumstances 	<ul style="list-style-type: none"> Assets may need to be written down in opening balance sheet based IFRS approach Assets may be written back up after adoption Different considerations in determining value-in-use and fair value less cost to sell as compared to undiscounted cash flow methods Systems should track 'normal' depreciation to support impairment reversals
Debt/Equity	<ul style="list-style-type: none"> Classification of certain instruments is required to be bifurcated and/or may be more likely to be classified as debt rather than equity 	<ul style="list-style-type: none"> Leverage ratios may change, affecting both subsidiary and the consolidated financial statements

Other IFRS/US GAAP differences

- Property, plant and equipment
- Insurance receivable recognition
- Presentation and disclosure
- Consolidation and derecognition
- Financial instruments
- Provisions and contingent liabilities
- Partial recognition of CTA
- Employee benefits
- Share based payments
- Accounting for income taxes

Polling question 2

Is your company's tax department actively involved in the overall IFRS readiness effort?

- A. Very involved in discussions
- B. Somewhat involved in discussions
- C. Not involved in discussions
- D. Don't know
- E. N/A (answered "No IFRS discussions have occurred" and PwC participants)

IFRS conversion issues for Tax

IFRS conversion issues for Tax

- Not just a change in accounting for income taxes
- IFRS conversion will impact all areas of the global tax function:
 - Tax accounting
 - Tax planning
 - Tax compliance

Tax accounting issues

Most of the significant differences that currently exist between FAS 109 and IAS 12 are expected to be eliminated with the exception of the following:

- Uncertain tax positions
- Stock-based compensation
- Intercompany transactions (FAS 109, par. 9(e) and 9(f))

ETR volatility:

- Changes to pre-tax income will dilute or magnify the impact of any reported permanent differences
- Uncertain tax positions
- Intercompany transfers
- Stock-based compensation

Tax planning issues

Cash tax impact—US and Non-US:

- International tax planning:
 - Statutory accounts
 - Debt planning
 - Cash repatriation
- State tax planning:
 - Impact on allocation and apportionment factors
 - Impact on non-income taxes

Polling question 3

Has your company begun to assess the use or planned use of IFRS at its non-US subsidiaries?

- A. Yes; it may have a significant impact
- B. Yes; not expecting a significant impact
- C. Yes; haven't quantified the impact yet
- D. No
- E. Don't know
- F. N/A (PwC Participants)

Tax compliance issues

Tax accounting methods:

- IFRS does not allow LIFO
- Potentially hundreds of pretax changes which will need to be assessed for each jurisdiction
- Will the change in pre-tax income flow-through to taxable income?
- A substantial number of accounting method changes for tax may be required

Transfer pricing:

- Policies and planning
- Documentation, maintenance and monitoring
- Availability of comparable data

Other Tax issues

Tax processes and technology:

- Tax accounting and compliance currently setup to analyze US GAAP data

Sarbox 404:

- Sarbox 404 controls will need to be reviewed and potentially updated

IFRS—Potential areas of tax-related impact

The following represents a sample of key tax considerations and potential areas of impact from an IFRS conversion. This list is not meant to be all-inclusive

Effective tax rate and cash flows (in general)

- Changes to pre-tax income
- Changes to local tax accounting methods (US and non-US)
 - Local cash taxes
- Consolidated reporting of joint ventures and equity investments
- Stock option accounting
- Sensitivity to tax rate changes
- Other tax-accounting impacts
 - E.g., tax reserve assessments, valuation allowance determinations

Repatriation and other international tax concepts

- APB 23 and cash repatriation
- Retained Earnings/Distributable Reserve determinations
- E&P and tax pool calculations (Form 5471 reporting)
- Foreign tax credits and related allocations (FSI, interest allocations)
- Subpart F and Section 956
- Thin cap limitations

Transfer pricing

- Calculation of transfer pricing model payments on a local GAAP basis
- Benchmarking/consistency with transfer pricing comparable sets

State taxes

- Solvency of entities (valuation of assets) in entity reduction planning
- Apportionment and allocations (sales and property factors)
- Property tax (fair value accounting under IFRS)
- Franchise tax (debt versus equity classifications)
- State conformity with IFRS

Global accounting—Overall policies and related positions

- Accounting methods (US and non-US)
- Debt/Equity classifications (intercompany balances and other)
- Impairment assessments
- Foreign exchange gains/losses
- Functional currency of various non-US entities
- Rate arbitrage transactions
- Inter-company transactions (Paragraph 9(e) and 9(f) elimination)
- Changes due to tax effects on purchase accounting under FAS 141(R)
- Valuation allowance determinations
- FIN 48 and tax contingency reserve assessments
- APB 23
- FAS 123R
- Tax impact of compensation and benefit plans
- Impact on prior tax planning

Transformation of tax processes, functions and technology

- Tax technology and systems implementation
- Data Warehouse requirements
- Consistent application of IFRS principles (local jurisdictions)
- Principles-based approach, with more subjective analysis
- Streamlined financial reporting and related cost reduction
- IFRS-based tax return starting point
- Centralized tax-compliance function
- Financial benchmarking and analysis
- Resource requirements and training

Polling question 4

As your company begins their IFRS conversion process, do you expect your company's tax department will perform a detailed review of its current tax methods of accounting in conjunction with the company's review of book accounting policies?

- A. Yes
- B. No
- C. Maybe
- D. Don't know
- E. N/A (PwC participants)

IFRS conversion issues for Human Resources

Overview of IFRS 2, *Share-Based Payment*

- International Financial Reporting Standard 2 (IFRS2)
- Just like FAS 123R, IFRS2 specifies the accounting and disclosure treatment by entities making share-based payments
- Requires entities to recognize an expense, measured at fair value, in respect of the share-based payments they make
- The term 'share-based payments' includes all types of executive stock option and share purchase plans

IFRS2 and income taxes for options

- IFRS2 provides that no tax deduction benefit can be recognized for income statement purposes based upon the value of the award (e.g., the grant date Black Scholes value which is used under FAS 123R to book deferred tax assets (DTA's))
- Instead a deferred tax asset is recognized only if and when the share options generate intrinsic value that could be deductible for tax purposes:
 - Therefore, an entity that grants an at-the-money options will not recognize tax effects until that award is in-the-money, assuming that a tax deduction is locally available
 - This creates a mark to market effect where DTA's are adjusted for share value changes

IFRS2 and income taxes for equity compensation

- As a result, deferred tax assets are adjusted over the life of the award to reflect the tax deduction embedded in the award at any measurement period
- The DTA amount that is recorded as a reduction to the tax provision is limited to the accounting expense multiplied by the tax rate
- Any excess deduction is reflected in the DTA balance with a corresponding entry to APIC
- Thus DTA's are always fluid, sometimes affecting earnings, sometimes just APIC

IFRS2 and income taxes

- IFRS2 does not utilize an APIC pool to write off unrealized deferred income tax benefits:
 - If an equity deduction does not meet the underlying accounting expense, FAS 123R allows a company to offset shortfall by windfalls from other awards
- Instead IFRS2 utilizes an individual award approach in determining the income statement impact of a settled award
- Thus, the ultimate income statement effect of an award is based upon that award's specific value delivery
- IFRS2 does not require a company to reclassify excess tax benefits to the financing section of the cash flow statement

Other IFRS2 issues

- Companies must accrue employer payroll tax liabilities for outstanding awards
- Companies who “net settle” their equity compensation for withholding taxes must treat the estimated tax withholding portion as a liability award
- Companies that chargeback their equity compensation costs must accrue the chargeback liability based upon the equity award value

Polling question 5

How does your company intend to deal with the more intense data and systems requirements for tracking deferred taxes related to stock option awards under IFRS?

- A. Handle internally; systems are already configured to capture IFRS data
- B. Handle internally; systems will need to be adjusted
- C. Handle externally through a third party vendor; vendor will address software configuration issues
- D. Combination of both internal and external
- E. Not material to our company
- F. N/A (PwC participants)

Questions

