


IFRS readiness series

Preparing your first IFRS financial statements*

Adopting IFRS



*connectedthinking

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IFRS—A reality for US business

Conversion is coming

Most of the world already talks to investors and stakeholders about corporate financial performance in the language of International Financial Reporting Standards (IFRS). All signs suggest the United States (US) will soon follow.

By acting now, well in advance of IFRS conversion deadlines, US companies have a rare opportunity to make time work for them. Early action will allow companies to control costs, understand and manage the challenging scope of implementation, and ensure a smooth transition plan.

Conversion experience in Europe, Asia, and Australia shows that conversion projects often take more time and resources than anticipated. Historically, that has led some companies to rush and risk mistakes or outsource more work than necessary, driving up costs and hindering the embedding of IFRS knowledge within the company.

At the same time, conversion brings a one-time opportunity to comprehensively reassess financial reporting and take “a clean sheet of paper” approach to financial policies and processes. Such an approach recognizes that major accounting and reporting changes may have a ripple effect impacting many aspects of a company’s organization.

Adopting IFRS will likely impact key performance metrics, requiring thoughtful communications plans for the Board of Directors, shareholders and other key stakeholders. Internally, IFRS could have a broad impact on a company’s infrastructure, including underlying processes, systems, controls, and even customer contracts and interactions.

Many of these business effects will require attention; others can be addressed at the discretion of the company. In both cases, companies that identify these impacts early will be in a better position to take appropriate action. No company will want to embrace every available change in connection with adopting IFRS, but insightful companies will want to understand their options so that they know what the possible changes are, which options are most appealing, and how best to pursue them.

The process of conversion demands robust change management, initiated and championed by a company's leadership. PricewaterhouseCoopers (PwC), drawing on its broad experience with conversion project in dozens of countries, has a full spectrum of publications aimed at providing insight for top executives as they confront IFRS conversion. Moving forward, PwC will continue to stand at the vanguard of IFRS conversion developments, providing guidance and assistance.

As US companies convert from US generally accepted accounting principles (US GAAP) to IFRS they will need to apply IFRS 1, *First-time Adoption of International Financial Reporting Standards*. The IASB issued IFRS 1 to assist companies with the process of converting from their current GAAP to IFRS. The overriding principle of IFRS 1 is full retrospective application of all IFRS standards. The IASB recognized how challenging retrospective application may be for many companies, particularly where data and information may not be readily available. Accordingly, IFRS 1 includes several optional exemptions and mandatory exceptions to retrospective application to ease the burden of first-time adoption. Even with these accommodations, the conversion process remains complex and time-consuming and presents management with some tough decisions.

The purpose of this volume is to help US companies address some of those decisions by understanding the process of selecting their new IFRS accounting policies and applying the guidance in IFRS 1 as they begin to prepare for their first IFRS financial statements. This publication provides specific considerations for US companies and is part of the firm's ongoing commitment to help companies navigate the switch from US GAAP to IFRS.

Adopting IFRS

This guide explains when and how International Financial Reporting Standard (IFRS) 1, *First-Time Adoption of International Financial Reporting Standards*, is applied in preparing a company's first IFRS financial statements. This overview of the requirements of IFRS 1 explains the selection of accounting policies as well as the implications of the optional exemptions and mandatory exceptions. It also provides key considerations for US companies that are or are considering adopting IFRS, guidance on interim reports during a company's first year of IFRS, and answers to some common questions that arise when applying IFRS 1. This guide includes amendments to IFRS 1 and other authoritative pronouncements through June 30, 2008.

What is IFRS 1?

The International Accounting Standards Board (IASB) created IFRS 1 to help companies transition to using IFRS as their basis of financial reporting. The key principle of IFRS 1 is full retrospective application of all IFRS standards in effect as of the closing balance sheet date ("reporting date") to a company's first IFRS financial statements. In other words, a company's first set of IFRS financial statements should present its financial position and performance as if the company had always reported using IFRS.

IFRS 1 requires companies to:

- Identify the first IFRS financial statements.
- Prepare an opening balance sheet at the date of transition to IFRS.
- Select accounting policies that comply with IFRS, and apply those policies retrospectively to all periods presented in the first IFRS financial statements.
- Consider whether to apply any of the optional exemptions from retrospective application.
- Apply the mandatory exceptions from retrospective application.
- Make extensive disclosures to explain the transition to IFRS.

The IASB recognized how challenging retrospective application may be for many companies, particularly for certain standards where data and information may not be readily available. As a result, the IASB included several optional exemptions and mandatory exceptions to the general principles of IFRS 1 that provide practical

accommodations to help make first-time adoption less onerous. Additionally, guidance is provided to illustrate the application of difficult conversion topics, such as the use of hindsight and the application of successive versions of the same standards.

Despite the relief from retrospective application of some standards, companies will still need to make significant changes to existing accounting policies to comply with IFRS. Changes may come in key areas such as revenue recognition, financial instruments and hedging, employee benefit plans, impairment testing, provisions, and stock-based compensation. No significant exemptions exist for IFRS disclosure requirements, and companies will likely need to collect new information and data for some disclosures.

When to apply IFRS 1

IFRS 1 is applied when a company prepares its first IFRS financial statements. These are the first financial statements to contain an explicit and unreserved statement of compliance with IFRS. Most companies will apply IFRS 1 when they move from their previous Generally Accepted Accounting Standards (GAAP) to IFRS. For example, IFRS 1 must be applied even if a company's financial reporting:

- Included a reconciliation of some items from a previous GAAP to IFRS.
- Complied with some, but not all, IFRSs, in addition to a previous GAAP—for example, a jurisdictional version of IFRS.
- Complied with IFRS in all respects, in addition to a previous GAAP, but did not include an explicit and unreserved statement of compliance with IFRS.
- Was prepared in accordance with IFRS, but used them only for internal purposes (i.e., the IFRS financial statements were not distributed to the company's owners or external users).
- Was prepared as a group reporting package using IFRS principles.
- Did not prepare financial statements.

When is IFRS 1 not applied?

IFRS 1 cannot be applied if a company previously issued financial statements that contained an explicit and unreserved statement of compliance with IFRS. It also cannot be applied when a company prepared financial statements that included an unreserved statement of compliance with IFRS and:

- Decided to stop presenting separate financial statements in accordance with a previous GAAP;
- Decided to delete an additional reference to compliance with a previous GAAP; or
- The auditors' report on the previous IFRS financial statements was qualified.

Overriding principles

The overriding principles of IFRS 1 require a company to apply all IFRS standards to its financial statements. In its opening IFRS balance sheet, a company should:

- Include all assets and liabilities that IFRS requires.
- Exclude any assets and liabilities that IFRS does not permit.
- Classify all assets, liabilities and equity in accordance with IFRS.
- Measure all items in accordance with IFRS.

Exceptions to these general principles exist where one of the optional exemptions or mandatory exceptions does not require or permit recognition, classification, and measurement in accordance with IFRS.

Adjustments as a result of applying IFRS for the first time are recorded in retained earnings or another equity category in the opening IFRS balance sheet. For example:

- A company with defined benefit plans may elect to recognize all cumulative actuarial gains and losses in retained earnings at the transition date, even if it adopts a policy of deferring actuarial gain and loss recognition using the corridor approach prospectively.
- A company must test goodwill for impairment at the transition date in accordance with IAS 36, *Impairment of Assets*, with any resulting impairment charges recorded in opening retained earnings.
- A company that decides to use the revaluation model allowed by IAS 16, *Property, Plant and Equipment*, would recognize the difference between the original cost and the revalued amount of a building in an equity account that captures revaluation reserves.

Consolidate all controlled entities

Companies may also be required to consolidate entities that were not consolidated under their previous GAAP (or vice versa). There are no IFRS 1 exemptions from the consolidation principles of IAS 27R, *Consolidated and Separate Financial Statements*, or Standing Interpretation Committee (SIC)-12, *Consolidation-Special Purpose Entities*. Companies will be required to consolidate any entity over which they are able to exercise control (as defined by IAS 27R). Subsidiaries that were previously excluded from the group financial statements are consolidated as if they were first-time adopters on the same date as the parent. If a company presents parent company stand-alone financial statements, the difference between the cost of the parent's investment in the subsidiary and the subsidiary's net assets under IFRS is treated as goodwill.

Consolidation under IFRS focuses on the definition of control in IAS 27R—“the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.” SIC 12 provides additional guidance to determine when an entity controls a special purpose entity (SPE). Unlike FIN 46R, IAS 27R does not make a distinction between variable interest and voting interest entities. Rather, the same control-based model applies to all entities for consolidation purposes. This difference may result in certain entities being consolidated or deconsolidated in a company’s first IFRS financial statements.

Key US consideration

Some US companies may need to consolidate Qualified Special Purpose Entities (QSPEs) established to facilitate securitization transactions. SIC-12 does not have the same scope exception for QSPEs as FAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

Common US GAAP to IFRS adjustments

The chart below summarizes some implications of the necessary adjustments to the opening balance sheet using IFRS 1, although it is not all-inclusive. For more information on IFRS versus US GAAP differences, refer to the PwC publication *IFRS and US GAAP: similarities and differences*.

Accounting requirement	Implications
<p>Recognize assets and liabilities required under IFRS</p>	<p>Companies may recognize additional assets and liabilities, for example:</p> <ul style="list-style-type: none"> • Financial assets and liabilities in securitization structures • Assets and liabilities under finance (i.e., capital) leases • Development costs that meet the IAS 38, <i>Intangible Assets</i>, capitalization criteria • Provisions meeting the IFRS recognition threshold of probable (defined as “more likely than not”) • Provisions for executory contracts that meet the definition of an onerous contract
<p>Derecognize assets and liabilities that IFRS does not permit</p>	<p>Some assets and liabilities recognized under US GAAP may have to be derecognized, for example:</p> <ul style="list-style-type: none"> • Insurance reimbursement assets that do not meet the virtually certain recognition criteria of IAS 37, <i>Provisions, Contingent Liabilities and Contingent Assets</i> • Certain types of regulatory assets and liabilities recognized under FAS 71, <i>Accounting for the Effects of Certain Types of Regulation</i> • Deferred costs that do not meet the definition of an asset
<p>Classify all assets and liabilities in accordance with IFRS</p>	<p>Assets and liabilities that might be reclassified at the transition date include:</p> <ul style="list-style-type: none"> • Investments in accordance with IAS 39, <i>Financial Instruments: Recognition and Measurement</i> (e.g., use of the fair value option is limited under IAS 39) • Certain financial instruments previously classified in mezzanine or equity under US GAAP that meet the IAS 32, <i>Financial Instruments: Presentation</i>, definition of a financial liability • Debt issuance costs (must be netted against the related financial liability) • Bifurcated debt and equity components of compound financial instruments • Hedging relationships that do not meet the IAS 39 criteria for hedge accounting
<p>Measure all assets and liabilities in accordance with IFRS</p>	<p>Assets and liabilities that might be measured differently include:</p> <ul style="list-style-type: none"> • Financial instruments, including accounts receivables • Long-term employee benefit obligations and pension assets • Inventory, if currently using LIFO • Provisions • Deferred tax assets relating to stock options • Uncertain tax positions • Impairments of property, plant and equipment, and intangible assets • Deferred revenue related to customer loyalty programs • Noncontrolling interests (i.e., minority interests) • Deferred taxes related to intercompany asset transfers

Sequence of adjustments

Some adjustments included in the opening IFRS balance sheet will depend on other adjustments (such as deferred taxes and any noncontrolling interests). Therefore, some balances should be calculated after other adjustments have been processed.

In general, we would expect companies to make adjustments in the following sequence.

- Recognition of assets and liabilities whose recognition is required
- Derecognition of assets and liabilities whose recognition is not permitted
- Adjustments to values of recognized assets and liabilities
- Recognition and measurement of deferred tax
- Recognition and measurement of noncontrolling interest
- Adjustment to goodwill balances

IFRS 1 requires goodwill to be tested for impairment at the transition date. That test compares the carrying amount of cash generating units (CGU) to which goodwill has been allocated to the recoverable amount of the CGU. The carrying amount will depend on all other adjustments before it can be finalized. It is therefore important that companies test goodwill balances for impairment as a last step.

Selected definitions

The opening IFRS balance sheet

The opening IFRS balance sheet is the starting point for all subsequent accounting under IFRS.

IAS 1, *Presentation of Financial Statements*, requires a company to include a balance sheet as of the beginning of the earliest comparative period presented when a policy is applied retrospectively. Accordingly, IFRS 1 requires that the opening balance sheet be prepared and presented in the first IFRS financial statements.

The preparation of the opening IFRS balance sheet may require the capture of information that was not accumulated under a company's previous GAAP. Companies need to identify the differences between IFRS and their previous GAAP early so that all of the information required can be produced.

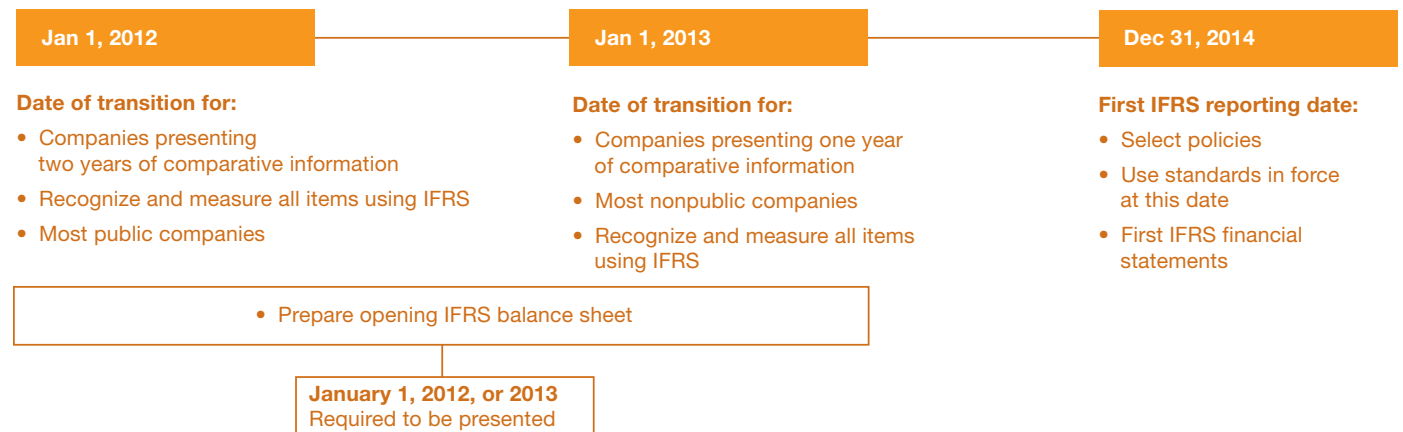
For example: IAS 38 requires the capitalization of internally generated intangible assets (e.g., development costs) when certain criteria are met. Such intangibles are subsequently amortized over their useful lives. Companies would need to capture the appropriate cost data from periods prior to the transition date and apply the appropriate useful lives to properly present the net unamortized intangible asset balance in the opening IFRS balance sheet.

Transition date

Transition date is identified as the beginning of the earliest period for which full comparative information is presented in accordance with IFRS.

For example: If a company prepares its first IFRS financial statements for the year ending December 31, 2014, with one year of comparatives, the date of transition to IFRS will be January 1, 2013, and the opening IFRS balance sheet will be prepared at that date. A company required to present two years of comparative information will have a transition date of January 1, 2012, and should prepare an opening balance sheet at that date.

The transition date concept is illustrated in the following chart:



Key US consideration

Generally, US domestic registrants with the Securities and Exchange Commission (SEC) are required to include in their Form 10-K filings audited balance sheets as of the end of each of the two most recent fiscal years and audited statements of income, cash flows and stockholders' equity for each of the three fiscal years preceding the date of the most recent audited balance sheet. The SEC may provide relief to registrants by allowing them to include only one year of comparative financial statements when filing their first set of IFRS financial statements. Companies should monitor the SEC's decisions in this area as these will impact their transition date and the timing of their conversion activities.

Date of adoption

Date of adoption, although not defined in IFRS 1, is commonly understood as the beginning of the fiscal year for which IFRS financial statements are first prepared. The term should not be confused with a company's transition date. A company that prepares its first IFRS financial statements for the year ended December 31, 2014, therefore has an adoption date of January 1, 2014.

Reporting date

Reporting date is defined as the closing balance sheet date for the first IFRS financial statements. For example, a company that files its first IFRS financial statements for the year ended December 31, 2014, has a reporting date of December 31, 2014.

A company may apply a standard that has been issued at the reporting date, even if that standard is not mandatory, as long as the standard permits early adoption. With limited exception, the same IFRS standards must be used for all financial statement periods presented.

For example: If a company with a reporting date of December 31, 2014, elects to apply an issued standard whose mandatory application date is June 30, 2015 but which permits early adoption, it must apply that standard to all financial years presented, even if one of the periods precedes the issue date of the standard.

The transition guidance in individual standards, and the guidance in IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, for changes in accounting policies apply only to existing IFRS users and are not used by first-time adopters unless the respective standard or IFRS 1 requires otherwise. The IASB has stated that it will provide specific guidance for first-time adopters in all new standards.

Selecting IFRS accounting policies

A number of IFRS standards allow companies to choose between alternative policies—for example, the fair value model or the cost model for measurement of investment property under IAS 40, *Investment Property*. IFRS also has less prescriptive guidance than US GAAP. First-time adoption of IFRS represents a one-time opportunity for US companies to comprehensively reassess and change their accounting policies. Companies should carefully select their accounting policies, with a full understanding of the implications on both the opening IFRS balance sheet and future financial statements.

Key US consideration

Changes to accounting policies subsequent to first-time adoption need to comply with the criteria in IAS 8 and, for SEC registrants, would typically require receipt of a preferability letter from the SEC. In their first-time adoptions of IFRS, many foreign private issuers intentionally established their IFRS policies to be as close as possible to US GAAP to minimize the reconciling items reported in their Annual Form 20-F filings. Now that the US GAAP reconciliation has been eliminated for FPIs applying IFRS, some of those companies are considering whether they should use different IFRS policies, but may find it challenging to justify and report an accounting policy change.

Companies need to be thoughtful and strategic in selecting the accounting policies to be applied to the opening IFRS balance sheet. Though many companies may be tempted to take the path of least resistance—to choose accounting policies most similar to their US GAAP policies—that path may prove less expedient than it appears. Starting with a “clean sheet of paper” that considers all the possibilities may be a better approach. The goal should be the selection of policies that result in information that is reliable and relevant to the economic decision-making needs of users.

The role of professional judgment

While many accounting policies will be derived directly from IFRS standards and interpretations, in some instances knowing how to apply those standards or interpretations may not be obvious. Because IFRS is less prescriptive than US GAAP, there may be a wider range of acceptability under IFRS in certain areas. For these reasons, the use of sound and well-documented professional judgment becomes even more important in an IFRS reporting environment. Management will need to exercise judgment to develop and apply accounting policies that faithfully present the economics of transactions and are decision-useful to readers of the financial statements.

Can US GAAP be used?

This question is frequently asked by US companies when they find that IFRS does not contain the same level of detailed application guidance and interpretations found in US GAAP. Companies mistakenly infer that IFRS guidance is insufficient or missing. IAS 8 incorporates a hierarchy for developing and applying an accounting policy when no IFRS standard specifically applies to a transaction, event or condition.

Although IAS 8 allows companies to look to other standard-setters and industry practices, including US GAAP, for accounting guidance, US companies will need to resist the natural tendency to automatically default to US GAAP. Relying on the guidance of another standard-setter or on industry practice should be the last resort.

Key US consideration

US companies are more likely than non-US companies to conclude IFRS guidance is insufficient because of a difference in perception. Because US GAAP has more bright lines, industry-specific guidance, and detailed rules and exceptions, companies are likely to look for that level of detail in IFRS principles. They generally will not find it. However, US companies should not simply default to US GAAP. Instead, they will need to apply the hierarchy outlined at right. In the majority of cases they will find an IFRS principle that is relevant to their circumstances, and they will need to exercise judgment to develop an appropriate policy. Only after thorough exploration of IFRS standards, interpretations and framework should US companies look to US GAAP for guidance.

IAS 8 states that where there are no specific standards or interpretations applicable to a transaction, management should refer to the following sources and consider their applicability in this order:

- IFRS standards and interpretations that deal with similar and related issues
- Definitions, recognition criteria, and measurement concepts for assets, liabilities, income and expenses in the IASB’s Framework

In considering the above, the standard allows companies to take into consideration the most recent pronouncements of other standard-setting bodies that use a similar conceptual accounting framework, other accounting literature and accepted industry practices to the extent they do not conflict with the IFRS standards, interpretations and Framework.

Optional exemptions and mandatory exceptions from retrospective application

Optional exemptions

First-time adopters can elect to apply all, some, or none of the optional exemptions. The exemptions are designed to provide companies some relief from full retrospective application. This will simplify the task of preparing the first IFRS financial statements for many companies. However, the application of the exemptions is not necessarily straightforward. Some exemptions allow for alternative methods of applying relief, while others have conditions attached.

The following chart outlines the optional exemptions available as of the publication of this guide:

Optional exemptions		
Business combinations	Apply standards in force at reporting date	Share-based payment transactions
Fair value as deemed cost		Insurance contracts
Employee benefits		Decommissioning
Cumulative translation differences		Leases
Compound financial instruments		Fair value measurement of financial assets and financial liabilities at initial recognition
Assets and liabilities of subsidiaries, associates, and joint ventures		Service concession arrangements
Designation of previously recognized financial instruments		Borrowing costs
		Investments in subsidiaries, jointly controlled entities, and associates

Business combinations

A company choosing to apply this exemption is not required to restate business combinations to comply with IFRS 3R, *Business Combinations*, where control was obtained before the transition date. The exemption gives relief to companies by not requiring them to recreate information that may not have been collected at the date of the business combination. The exemption is available to all transactions that meet the definition of a business combination under IFRS 3R. The classification under previous GAAP is not relevant for determining whether the exemption can be applied. The exemption also applies to acquisitions of investments in associates and joint ventures. This means that entities taking advantage of the exemption will not have to revisit past acquisitions of associates and joint ventures and establish fair values and amounts of goodwill under IFRS. However, application of the exemption is complex, and certain adjustments to transactions under previous GAAP may still be required.

When the exemption is applied:

- Classification of the combination as an acquisition or a pooling of interests does not change.
- Assets and liabilities acquired or assumed in the business combination are recognized in the acquirer's opening IFRS balance sheet, unless IFRS does not permit recognition.
- Deemed cost of assets and liabilities acquired or assumed is equal to the carrying value under previous GAAP immediately after the business combination.
- Assets and liabilities that are measured at fair value are restated to fair value in the opening IFRS balance sheet, with the offset being recorded in equity (for example, available-for-sale financial assets).

Assets and liabilities that were not recognized under a company's previous GAAP immediately after the business combination are recognized on the opening IFRS balance sheet only if they would be recognized in the acquired entity's separate IFRS balance sheet.

For example:

Company C prepares its first IFRS financial statements for the year ending December 31, 2010. The date of transition to IFRS is January 1, 2009, and the opening IFRS balance sheet is prepared as of that date. Company C will apply the business combinations exemption.

Company C acquired Company D in 2008. Company D had in process research and development (IPR&D) that met the conditions in IFRS for capitalization at the time of the acquisition. The IPR&D was measured and recorded at fair value by Company C in its original accounting for the business combination, but was then immediately written off as required by US GAAP.

Company C should recognize an intangible asset in its opening IFRS balance sheet at an amount equal to the fair value of the IPR&D at the date of acquisition, less accumulated amortization to the date of transition. This will require judgment in determining an appropriate useful life to assign to the intangible asset. As goodwill was already adjusted for this item at the time of the

business combination under US GAAP (because the intangible was initially recognized by Company C before being written off), the corresponding adjustment should be made against retained earnings.

Under IFRS 1, when recognizing an asset or liability associated with a business combination prior to the transition date, the recording of the offsetting debit or credit depends on the nature of the entry. Most assets or liabilities will be adjusted through retained earnings. Two adjustments, however, are recorded against goodwill arising from prior business combinations:

- Goodwill is increased for an intangible asset recognized under previous GAAP that does not qualify for recognition as an asset under IAS 38, or goodwill is decreased for an intangible asset that was subsumed in goodwill under previous GAAP and qualifies for recognition as a separate intangible asset under IAS 38 (both instances should be rare when US GAAP is the previous GAAP).
- Goodwill is impaired at the transition date after applying IAS 36.

Key US consideration

The issuance of IFRS 3R and FAS 141R, *Business Combinations*, substantially converged the accounting for business combinations under IFRS and US GAAP, respectively. However, differences remain in the recognition and measurement of noncontrolling interests (NCI) and contingencies. Under IFRS, an acquirer can elect a policy to measure NCIs either at fair value or their proportionate share of the acquiree's identifiable net assets. Under US GAAP, NCIs are always measured at fair value.

Under IFRS, contingent assets of an acquiree are not recognized; however, all contingent liabilities are recognized if they can be *reliably measured*. Under US GAAP, a contingent asset may be recognized as a result of business combination, and all contractual contingent assets and liabilities are recognized while a noncontractual contingent asset or liability is recognized only if it is *more likely than not* that it will give rise to an asset or liability.

US companies need to be aware of these remaining differences as business combinations are completed in the coming years and adjust for these differences, if applicable, in the IFRS opening balance at the transition date. Consider, for example, a noncontractual contingent liability that may not have been recognized under FAS 141R because it did not meet the *more-likely-than-not* threshold should be recognized in the IFRS opening balance sheet if it can be *reliably measured*.

Goodwill impairment testing at transition date

Goodwill must be tested for impairment at the date of transition to IFRS, using the impairment testing method required by IAS 36.

Key US consideration

IAS 36 uses the term cash-generating unit (CGU), which is defined as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets. Similar to US GAAP, IAS 36 requires goodwill acquired in a business combination to be allocated to the operations that will benefit from the synergies of the combination. However, IAS 36 states that goodwill must be allocated to the CGU, or groups of CGUs, that represent the lowest level within the company at which goodwill is monitored for internal management purposes, and specifies that the group of CGUs shall not be larger than an operating segment (as defined in IFRS 8, *Operating Segments*). US GAAP (FAS 142, *Goodwill and Other Intangible Assets*), uses the term “reporting unit” for purposes of allocating and testing goodwill for impairment, which may be different from a CGU under IFRS. A reporting unit is an operating segment or a component (one level below an operating segment). FAS 142 also provides specific guidance on what constitutes a component, when components may be aggregated, and when an operating segment can be considered a reporting unit.

The impairment measurement model is also different between IAS 36 and FAS 142. IAS 36 uses a one-step goodwill impairment test based on the discounted cash flows of the CGU or groups of CGUs to which the goodwill is allocated. FAS 142 uses a two-step impairment test for goodwill, first comparing the fair value of the reporting unit to its carrying amount and then measuring goodwill impairment using the implied fair value of goodwill.

The differences in both the impairment measurement models and the definition of the levels at which goodwill is assigned and tested may result in impairment testing differences at the date of transition.

If a company chooses to forgo the exemption and restate a business combination that occurred prior to the transition date in accordance with IFRS 3R, then all business combinations that took place after that restated business combination must also be restated in accordance with IFRS 3R. In addition, from the date that a company applies IFRS 3R to its business combinations, it must also comply with IAS 27R and IAS 36.

Example: A company plans to file its first IFRS financial statements for the year ended December 31, 2014, with two years of comparative financial statements. The company’s transition date is January 1, 2012. The company chooses to restate an acquisition that occurred in October 2008 in accordance with IFRS 3R. All acquisitions that occurred after October 2008 must also be restated in accordance with IFRS 3R, even if they occurred before the transition date. In addition, the company must also comply with IAS 27R and IAS 36 beginning at October 2008.

Fair value as deemed cost

Companies can elect to remeasure property, plant and equipment at fair value at the transition date and use that fair value as their deemed cost. The “fair value as deemed cost” exemption may be applied on an asset-by-asset basis. This exemption may also be applied to investment property if an entity elects to use the cost model in IAS 40, *Investment Property*, or to intangible assets that meet both the recognition and revaluation criteria in IAS 38, *Intangible Assets* (including reliable measurement of original cost and the existence of an active market). A company may not use these elections for other assets or for liabilities.

This exemption was created so that companies would not have to recreate depreciated cost records for fixed assets, a significant simplification for many companies around the world. A company that applies the fair value as deemed cost exemption at the IFRS transition date is not required to revalue these assets in subsequent periods. When the exemption is applied, deemed cost is the basis for subsequent depreciation and impairment tests. Though it is unlikely that many US companies will need this exemption, some may want to consider taking advantage of it for strategic reasons.

A previous revaluation may be used as deemed cost only if it resulted in a carrying amount that was broadly comparable to fair value or was based on a price index that was applied to cost. The exemption may be applied to any individual item of property, plant and equipment.

Employee benefits

Under IAS 19, a company may recognize actuarial gains and losses from defined benefit and similar plans either by applying the “corridor approach” (the method commonly used under US GAAP) or any other systematic method that results in accelerated recognition. Retrospective application of the corridor approach would require companies to obtain actuarial valuations from a plan’s inception date to compute the proper cumulative unrecognized actuarial gains and losses as of the transition date in accordance with IAS 19. IFRS 1 provides an exemption from IAS 19 by allowing companies to recognize in opening retained earnings all previously unrecognized actuarial gains and losses from inception of the plans. Such actuarial gains and losses are not subsequently recycled through profit and loss. Companies that elect this exemption are still allowed to apply the corridor approach prospectively from the IFRS transition date.

Cumulative translation differences

Retrospective application of IAS 21, *The Effects of Changes in Foreign Exchange Rates*, would require a company to determine the foreign currency translation differences in accordance with IFRS from the date on which a foreign operation was formed or acquired. The exemption allows a company to apply IAS 21 prospectively. All cumulative translation gains and losses as of the transition date are reset to zero through an adjustment to opening retained earnings. Such an adjustment to retained earnings is permanent, and gains or losses on subsequent disposals of foreign operations will

exclude translation differences that arose before the transition date. Translation differences arising after the transition date are recorded in other comprehensive income. In our experience, we would expect many US companies to elect this exemption.

Compound financial instruments

IAS 32 requires a company to split a compound financial instrument at inception into separate liability and equity components. The IFRS 1 exemption provides that if the liability component is no longer outstanding at the transition date, a first-time adopter does not have to separate it from the equity component. Any US company that has issued compound financial instruments in the past and where the liability component is not outstanding at the transition date will likely elect this exemption. If the liability component is outstanding at the transition date, companies will need to bifurcate and measure the components in accordance with IAS 32.

Key US consideration

Companies that have issued compound financial instruments (many of which are classified as debt under US GAAP) must bifurcate these instruments into their debt and equity components from inception and remeasure the debt component using the effective interest method at the transition date. This change in classification and measurement will generally result in increased interest expense in the company's income statement and may impact debt-to-equity and interest coverage ratios, which are common debt covenant requirements.

Assets and liabilities of subsidiaries, associates, and joint ventures

A parent and its subsidiaries might adopt IFRS at different dates for strategic or regulatory reasons. For example, a US parent company might prepare its first IFRS financial statements at December 31, 2014, while its nonpublic subsidiary in France might not be allowed to adopt IFRS for statutory reporting purposes until some later date. This exemption allows a subsidiary to measure its assets and liabilities either at the carrying amounts included in its parent's consolidated IFRS financial statements or on the basis of IFRS 1 as applied to its statutory financial statements at its own date of transition. When a subsidiary elects to use the carrying amounts in its parent's consolidated financial statements, those carrying amounts are adjusted, where relevant, to exclude consolidation and acquisition adjustments.

For many US parent companies, it will be common that the parent adopts IFRS for consolidated group reporting later than some of its foreign subsidiaries. When a parent adopts IFRS after a subsidiary, the parent must measure the subsidiary's assets and liabilities in the consolidated financial statements using the subsidiary's existing IFRS carrying values. Most of the IFRS 1 voluntary exemptions cannot be used on an existing IFRS-reporting subsidiary. The subsidiary's carrying values are adjusted, where relevant, to include consolidation and acquisition adjustments, but companies may not "double dip" in the pool of exemptions (i.e., a reporting entity gets only one chance to use the IFRS 1 exemptions; a subsidiary cannot use the exemptions again when its parent adopts IFRS for consolidated reporting). Parent companies may elect

different IFRS accounting policies than their subsidiaries, but they would need to conform those policies when preparing consolidated IFRS financial statements.

This scenario poses strategic considerations that companies should consider as early as possible. US parent companies whose subsidiaries have already adopted, or are in the process of adopting IFRS will want to be closely involved with their subsidiaries' IFRS policy and IFRS 1 exemption decisions. Since IFRS 1 does not allow exemptions to be applied twice, in most instances, companies with subsidiaries that have adopted IFRS will need to live with the exemption decisions made at the subsidiary level.

Example 1: Company A, a US company, has a subsidiary in Barbados that has already adopted IFRS and filed its IFRS financial statements with the Barbados taxing authority. In conjunction with its adoption, the subsidiary opted to use fair value as deemed cost for certain property, plant and equipment as allowed by the IFRS 1 optional exemptions. When Company A converts to IFRS, it must carry over the value of the Barbados subsidiary's property, plant and equipment at the depreciated deemed cost currently on the subsidiary's books. Accordingly, Company A cannot use the fair value as deemed cost exemption again for the Barbados subsidiary at its own transition date.

Example 2: Company B, a US company, has a UK subsidiary that adopts IFRS for statutory reporting purposes in 2008 with a transition date of January 1, 2007. In applying IFRS 1, the subsidiary elects the employee benefits exemption and recognizes all cumulative actuarial gains and losses in opening retained earnings at January 1, 2007. The subsidiary adopts the corridor approach for recognition of actuarial gains and losses prospectively.

Company B adopts IFRS for its consolidated financial statements in 2010 with a transition date of January 1, 2009. In applying IFRS 1, Company B also elects the employee benefits exemption to recognize cumulative actuarial gains and losses in opening retained earnings at January 1, 2009. Instead of using the corridor approach, the Parent decides to adopt a policy of recognizing actuarial gains and losses immediately in the Statement of Comprehensive Income (SOI). The UK subsidiary's cumulative actuarial gains and losses (for the period from January 1, 2007, through January 1, 2009) may not be recognized in opening retained earnings at the Parent's transition date (January 1, 2009) because the subsidiary already used that exemption. However, Company B must conform the subsidiary's IFRS accounting policies to its own and would therefore present the subsidiary's annual actuarial gains and losses in the consolidated SOI rather than deferring a portion through use of the corridor method. This difference in IFRS accounting policies will require continued tracking and consolidation adjustments going forward. In this example, Company B could have achieved greater efficiencies by managing the UK subsidiary's IFRS policy elections to ensure consistency with its own financial reporting objectives.

The criteria for when IFRS 1 should be applied, discussed in the beginning of this book, are of critical importance when assessing the impact of subsidiaries adopting IFRS. In Example 1, suppose the subsidiary in Barbados had converted to IFRS because the company anticipated that it would eventually obtain debt financing from a Barbados bank, but in the end, the parent company loaned it the necessary funds. If the IFRS statements were never provided to an external party, were not intended to be in compliance with IFRS in all respects, and if the company never had reason to explicitly represent that the statements were in compliance with IFRS, then the subsidiary could apply the optional exemptions of IFRS 1 again, as part of the parent company's conversion to IFRS.

It is crucial for US companies to understand how and why their subsidiaries converted to IFRS, whether the subsidiaries qualify for application of IFRS 1 during the parent company's conversion, and how the subsidiaries' decisions factor into the parent company's reconciliation and disclosures upon conversion. Companies will want to strategically assess and plan for IFRS adoption by subsidiaries to align with the parent's financial reporting objectives and minimize the need for consolidation adjustments (e.g., to conform IFRS policies) in the future.

Designation of previously recognized financial instruments

Entities will have to classify their financial assets and liabilities as if they had always applied IFRS. IAS 39 permits a financial instrument to be designated on initial recognition as a financial asset or financial liability at fair value through profit or loss (provided it meets certain criteria) or as available for sale. However, IFRS 1 allows an exemption from retrospective application by permitting such designations to be made at the date of transition.

For example: If an entity can document at the date of transition that a portfolio of identified financial instruments was managed together and there was evidence of a recent actual pattern of short-term profit taking, it would be permitted to designate the financial instruments at fair value through profit or loss.

Key US consideration

While FAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, allows any financial instrument to be designated under the fair value option, IAS 39 requires the designation as at fair value through profit or loss only to be used in certain prescribed situations that result in more relevant information, or for contracts that contain one or more embedded derivative. Accordingly, certain financial assets and liabilities measured at fair value under FAS 159 may not qualify for the same treatment under IAS 39 if the company is unable to document that it meets the criteria.

Share-based payment transactions

IFRS 1 provides first-time adopters certain accommodations for applying IFRS 2 to equity instruments granted before the date of transition. The following table summarizes the available options:

Award grant date	Requirements
On or before November 07, 2002 ¹	A first-time adopter is encouraged but not required to apply IFRS 2 to equity instruments granted on or before this date.
After November 07, 2002, but before the date of transition to IFRS	<p>For vested awards at transition date: A first-time adopter is encouraged but not required to apply IFRS 2. If the entity elects to apply IFRS 2, it may do so only if the entity has publicly disclosed fair value of such equity instruments determined on the <i>measurement date</i> as defined in IFRS 2.</p> <p>For unvested awards at transition date: The entity is required to apply the provisions of IFRS 2.</p>
After the date of transition to IFRS	Apply IFRS 2 to all awards.

¹The date the IASB issued the IFRS 2 exposure draft.

First-time adopters are also encouraged, but not required, to apply IFRS 2 to liabilities arising from share-based payment transactions that were settled before the date of transition to IFRS.

Key US consideration

Although the quantity of unvested, pre-November 2002 grants at the transition date is likely to be low, most US companies with such grants would have measured and disclosed the fair value of those share-based payments in accordance with FAS 123 or FAS 123R, and therefore could, in most cases, present such grants in opening retained earnings at the transition date. Alternatively, US companies with unvested, pre-November 2002 grants could apply the transition provisions of IFRS 2 as written in that standard and avoid recognizing stock compensation expense for the unvested portion of those grants. However, because the reported results would not be comparable, detailed disclosures regarding those grants would be required in the notes to financial statements.

Insurance contracts

Companies that issue insurance contracts need not restate comparatives for IFRS 4, *Insurance Contracts*. This exemption is available only to companies that have an adoption date before January 1, 2006. Accordingly, it is unlikely that many US companies will use this exemption.

Key US consideration

Under US GAAP, multiple pronouncements and related interpretations have been issued to prescribe accounting for specific industries. In contrast, IFRS intentionally avoids industry-specific standards where possible, asserting that the underlying principles in the standards should generally be fit for application in all industries. This difference in approach causes numerous industry-specific accounting topics to appear un- or underrepresented in IFRS. Industries such as insurance, extractive, healthcare, and others will likely encounter more challenges in the near term than other industries because IFRS may not currently address specific accounting in these highly specialized industries. Though it is unlikely IFRS will ever have as much industry-specific guidance as US GAAP, the IASB has acknowledged that certain industries have unique accounting concepts that require different or additional guidance, and it is working to catch up to the identified needs.

In the meantime, companies should use the guidance in IAS 8 to determine the most appropriate method of accounting for areas where they believe IFRS guidance is limited. In addition, companies should recognize that any industry-specific reporting requirements dictated by regulatory agencies are generally incremental to IFRS financial reporting and are still required unless otherwise indicated by the regulator (e.g., federal banking and state insurance regulators).

Changes in existing decommissioning, restoration, and similar liabilities included in the cost of property, plant and equipment

International Financial Reporting Interpretations Committee (IFRIC) 1, *Changes in Existing Decommissioning, Restoration, and Similar Liabilities*, requires any changes in decommissioning liabilities (commonly known in the United States as “asset retirement obligations” or “AROs”) to be added or subtracted from the carrying value of the related asset and depreciated over the remaining life of the asset. IFRS 1 allows first-time adopters to apply a shortcut method for measuring the ARO and related depreciated asset cost at the transition date. Companies can elect to measure the ARO at the transition date in accordance with IAS 37 and then “back into” the amount of the ARO that would have been included in the cost of the related asset at the time the liability first arose by discounting the liability to that date using historic risk-adjusted rates. The company would then calculate the accumulated depreciation on that discounted amount as of the transition date using the current estimate of the useful life and the depreciation policy adopted under IFRS.

Key US consideration

The accounting for AROs can differ between IFRS and US GAAP in terms of both initial recognition and subsequent measurement. IFRS (IAS 16, IAS 37, and IFRIC 1) requires a provision to be recorded when there is a present obligation (legal or constructive) as a result of constructing or acquiring a long-lived asset. The ARO is discounted using a pretax discount rate reflecting current market assessments of the time value of money and risks specific to the liability. Future cash outflows and the discount rate are adjusted if necessary each balance sheet date to reflect current conditions.

US GAAP (FAS 143, *Accounting for Asset Retirement Obligations*) recognizes AROs resulting from a legal obligation and specifies use of a credit-adjusted, risk-free rate for discounting purposes. Different discount rates are used for subsequent adjustments depending on whether there are increases or decreases to the expected future cash outflows. US companies will need to reassess the recognition and measurement of AROs under IFRS at the transition date and will likely elect this exemption to streamline the measurement exercise.

Leases

IFRIC 4, *Determining Whether an Arrangement Contains a Lease*, requires an assessment of whether a contract or arrangement contains a lease. The assessment should be carried out at the inception of the contract or arrangement. First-time adopters must apply IFRIC 4, but can elect to make this assessment as of the date of transition based on the facts at that date, rather than at inception of the arrangement.

Example: The owner of a co-generation facility and a natural gas provider entered into a natural gas supply contract. The parties to the contract will need to analyze the arrangement under IFRIC 4 to determine whether the arrangement should be accounted for as a single element—that is, a natural gas supply contract—or whether there is an embedded lease within it; for example, a lease of (1) the pipeline used to transport the natural gas to the cogeneration facility and/or (2) the underlying land. Under US GAAP, EITF 01-08, *Determining Whether an Arrangement is a Lease*, provides guidance on determining whether an arrangement contains a lease. The EITF grandfathered any arrangements that were entered into prior to June 2003 and have not been modified or extended subsequent to that date. Using the lease exemption, companies can choose to perform the embedded lease assessment either at the date of transition or at the arrangement inception date for those contracts that were grandfathered under the US rules.

Fair value measurement of financial assets and financial liabilities at initial recognition

The current guidance in IAS 39 states the transaction price of a financial instrument is generally the best evidence of fair value, unless fair value is evidenced by comparison with other observable current market transactions in the same instrument or based on a valuation technique whose variables include only data from observable markets.

At initial recognition, a company may recognize as a gain or loss on the difference between this fair value measurement and the transaction price (i.e., “day one” gain or loss) only if the measurement of fair value is based entirely on observable market inputs without modification. Otherwise, IAS 39 does not allow the recognition of a day one gain or loss and forces initial recognition at the transaction price, which is considered the best evidence of fair value. Subsequent measurement and recognition would follow the guidance as defined IAS 39.

IAS 39 originally required only retrospective recognition of the day one gain or loss. The standard was amended in December 2004 to allow a company, including a first-time adopter, to measure these financial instruments at initial recognition either:

- Prospectively for transactions entered into after October 25, 2002 (the date when the equivalent US GAAP requirements became effective and hence IFRS and US GAAP were converged in this area), or
- Prospectively for transactions entered into after January 1, 2004 (which roughly corresponds with the date the amended IAS 39 standard was published)

It is unlikely that many US companies will apply the exemption because of the early dates it is available.

Key US consideration

The recognition criteria for a day one gain or loss under US GAAP was subsequently changed with the issuance of FAS 157, *Fair value Measurement*. FAS 157 allows the measurement of fair value using a valuation technique and the recognition of an initial gain or loss even if the measure of the fair value is based on a valuation model that uses significant entity-specific inputs. As a result, more companies are recognizing day one gains or losses since the adoption of FAS 157 than are currently permitted under IFRS. This will be a measurement difference at the date of transition regardless of how the exemption is applied (i.e., full retrospective application or prospective application as of the specified dates).

Service concession arrangements

IFRIC 12, *Service Concession Arrangements*, applies to contractual arrangements in which a private sector operator participates in the development, financing, operation, and maintenance of infrastructure for public sector services. First-time adopters may elect to use the transitional provisions of IFRIC 12 rather than full retrospective application. When it is impractical for a company to apply IFRIC 12 retrospectively to the start of the earliest period presented, the IFRIC 12 transition provisions allow a company to:

- Recognize financial and intangible assets that existed at the start of the earliest period presented.
- Use the previous carrying amounts as the carrying amount at that date (no matter how they were previously classified).
- Test the financial and intangible assets recognized at that date for impairment.

Borrowing costs

IFRS first-time adopters may apply IAS 23, *Borrowing Costs*, using the following guidelines:

- If the accounting treatment for capitalized interest required by IAS 23 is different from the company's previous accounting policy, the company should 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.
- Alternatively, companies can designate any date before January 1, 2009, and apply the standard to borrowing costs relating to all qualifying assets capitalized on or after that date.

Key US consideration

IAS 23 was recently converged with FAS 34, *Capitalization of Interest Cost*, making the IFRS treatment of capitalized interest similar to US GAAP. Therefore, it is unlikely that many US companies will need to use this exemption.

Investments in subsidiaries, jointly controlled entities and associates

In separate financial statements (i.e., stand-alone, unconsolidated parent-company-only financial statements) IAS 27R requires a company to account for its investment in subsidiaries, jointly controlled entities and associates either at cost or at fair value in accordance with IAS 39. In the opening IFRS balance sheets of their separate financial statements, first-time IFRS adopters can measure their investment in one of the following manners:

- At cost, determined in accordance with IAS 27R
- At deemed cost, which is defined as:
 - Fair value (determined in accordance with IAS 39) at the company's IFRS transition date, or
 - Previous GAAP carrying amount at the IFRS transition date.

Because US companies generally are not required to prepare such separate financial statements, it is unlikely that many US companies would use this exemption.

Summary of optional exemptions

As seen in the preceding paragraphs, 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 previously described elections available to companies under IFRS 1.

Exemption	Choice	Exemption applies to all items? [†]
Business combinations	<p>For all transactions qualifying as business combinations under IFRS 3R, a company can choose to:</p> <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
Fair value as deemed cost	<p>For property, plant and equipment, a company can choose to measure the value using:</p> <ul style="list-style-type: none"> • Cost in accordance with IFRS. • Fair value at the date of transition as deemed cost. • A revaluation carried out at a previous date (such as an IPO) as deemed cost, subject to certain conditions. <p>This exemption 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 exemption may not be used for any other assets or for liabilities.</p>	No
Employee benefits	<p>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.</p>	Yes
Cumulative translation differences	<p>The cumulative translation reserve may be reset to zero.</p>	Yes
Compound financial instruments	<p>A compound financial instrument does not need to be bifurcated if the liability component is not outstanding at the transition date.</p>	No
Assets and liabilities of subsidiaries, associates and joint ventures	<p>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.</p> <p>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.</p>	No
Designation of previously recognized financial instruments	<p>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.</p>	No
Share-based payment transactions	<p>A company may choose (but is not required) to apply IFRS 2 to any equity instruments that were granted 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.</p> <p>In addition, a company may choose (but is not required) to apply IFRS 2 to a liability relating to a cash-settled share-based payment that was settled prior to the date of transition to IFRS.</p>	Yes

Exemption	Choice	Exemption applies to all items? [†]
Insurance contracts	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
Changes in existing decommissioning, restoration (AROs), and similar 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 <i>after</i> October 25, 2002. • Prospectively for all transactions entered into <i>after</i> January 1, 2004. 	No
Service concession arrangements	Companies may elect to apply the transitional provisions of IFRIC 12, rather than full retrospective application.	No
Borrowing costs	If the accounting treatment for capitalized interest required by IAS 23 is different than a company’s previous accounting policy, the company should 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. Alternatively, companies can designate any date before January 1, 2009 and apply the standard to borrowing costs relating to all qualifying assets capitalized on or after that date.	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, or • Deemed cost, defined as previous GAAP carrying amount at the IFRS transition date. 	No

[†] 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 in detail 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	Assets classified as held for sale and discontinued operations
Noncontrolling interests	

Hedge accounting

This exception requires companies to recognize hedging relationships in the opening balance sheet (i.e., at the transition date) if the hedging instrument is of a type that would qualify for hedge accounting under IFRS. However, hedge accounting can be applied to those hedging relationships subsequent to the transition date only if all of the IAS 39 hedge accounting criteria are met.

Companies should first consider whether their hedges under previous GAAP are of a type that qualify for hedge accounting under IAS 39. If they qualify, companies must follow the detailed guidance in IFRS 1 to recognize the hedging instrument and the hedging relationship in the opening balance sheet at the transition date. Hedge accounting after the transition date may be applied only if all the IAS 39 hedge accounting criteria are met. If the criteria are not met (e.g., documentation does not exist because the shortcut method for hedge effectiveness testing was used under US GAAP), the company should apply IAS 39 guidance for discontinuing hedge accounting until the criteria are met.

If hedges are of a type that do not qualify for hedge accounting under IAS 39, the hedging relationship must not be reflected in the opening balance sheet at the transition date. For example, a hedging relationship in which a company combines a purchase option and a written option with a different counterparty is not allowed to be designated as a hedging relationship under IFRS but allowed under US GAAP. Instead, the related derivatives must be recognized at fair value with a corresponding adjustment to retained earnings.

Example: Company A holds a plain vanilla interest rate swap to fix the interest on its variable-rate debt. The company concluded the swap was of a type that qualifies for hedge accounting under IAS 39. Therefore, the company should retrospectively apply IAS 39 to the swap at the transition date and reflect the hedging relationship in its opening balance sheet. Under US GAAP, the swap qualified for the shortcut method for hedge effectiveness testing; therefore, the company did not test for and document effectiveness annually. Because IAS 39 does not allow the shortcut method and requires contemporaneous documentation (i.e., documentation in place as of the transition date) of retrospective and prospective effectiveness testing, the swap would not meet the criteria for hedge accounting under IFRS after the

transition date and the guidance for discontinuing hedge accounting must be applied. Hedge accounting would be applied prospectively only from the date that the hedge relationship is fully designated and documented as required by IAS 39.

Key US consideration

US companies that have significant hedging activities, particularly those that currently use the shortcut method, should assess their hedging instruments and strategies using IAS 39 criteria sufficiently in advance of their conversion to IFRS. By ensuring the necessary designations and documentation are prepared contemporaneously—even prior to adoption of IFRS—a company can mitigate the risk that the hedge accounting treatment will need to be discontinued under IAS 39 during first-time adoption of IFRS.

The decision tree on the opposite page outlines the application of the hedge accounting exception.

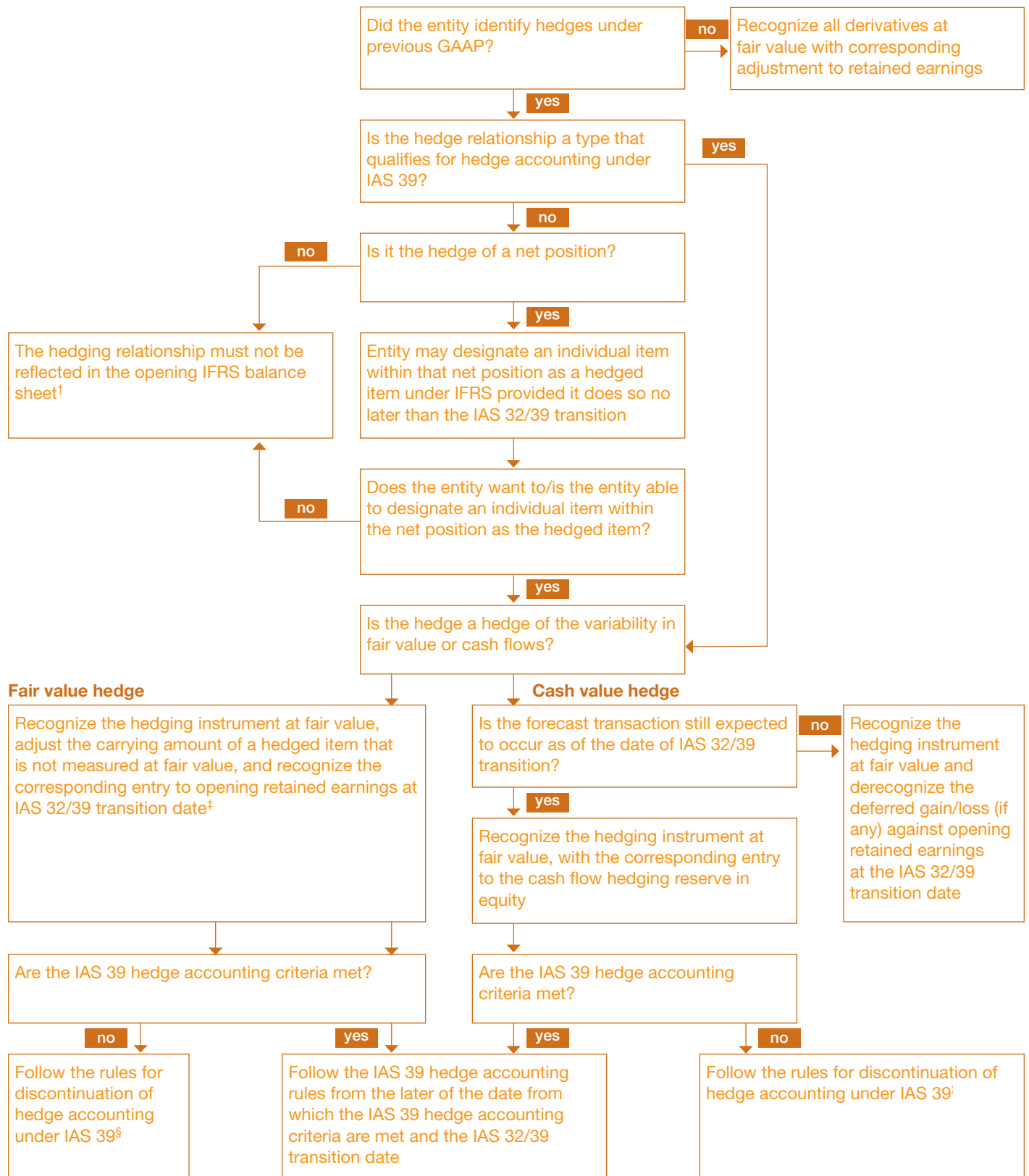
Notes to decision tree

[†] The only entries recognized in the opening balance sheet at the transition date should be the derivative at fair value and the hedged item measured in accordance with the normal IFRS measurement rules for that type of asset/liability. Any adjustments are recognized against opening retained earnings.

[‡] The carrying amount of the hedged item is adjusted by the lesser of a) that portion of the cumulative change in the fair value of the hedged item that reflects the designated hedged risk and was not recognized under previous GAAP, and b) that portion of the cumulative change in the fair value of the hedging instrument that reflects the designated hedged risk and, under previous GAAP, was either i) not recognized or ii) deferred in the balance sheet as an asset or liability.

[§] For example, for a financial asset, the adjustment made to the carrying value of the hedged item is amortized to profit or loss. The amortization is based on a recalculated effective interest rate at the date amortization begins and should be amortized fully by maturity.

[¶] The net cumulative gain/loss included in equity remains in equity until a) the forecast transaction subsequently results in the recognition of a nonfinancial asset or liability, b) the forecast transaction affects profit and loss, or c) circumstances subsequently change and the forecast transaction is no longer expected to occur, in which case, any related net cumulative gain/loss that had been recognized directly in equity is recognized in profit or loss.



Estimates

IFRS 1 prohibits the use of hindsight to adjust estimates made under previous GAAP unless there is objective evidence of an error. A company should adjust the estimates made under previous GAAP only when the basis of calculation does not comply with IFRS.

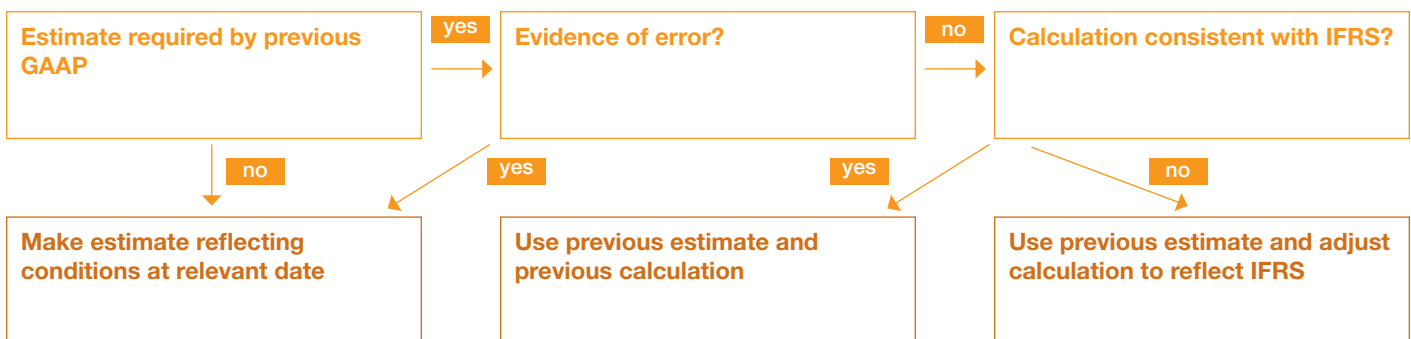
IFRS 1 requires the following for estimates made under a previous GAAP:

- Estimates made at the same date under the previous GAAP should be used for the opening IFRS balance sheet, unless there is objective evidence of an error.
- Estimates made under previous GAAP should be revised if necessary to comply with IFRS, but they should reflect conditions present at the date of transition.
- An entity may need to make estimates under IFRS at the date of transition to IFRS that were not required at that date under previous GAAP. To achieve consistency with IAS 10, *Events after the Reporting Period*, those estimates under IFRS shall reflect conditions that existed at the date of transition to IFRS. In particular, estimates at the date of transition to IFRS should reflect current market conditions for items such as market prices, interest rates and foreign exchange rates.

For example: A constructive liability that was not recognized under US GAAP should be included in the opening IFRS balance sheet using the estimates for the expected future cash outflows and discount rates that existed at that time.

The requirements of IFRS 1 in connection with estimates are summarized in the following chart:

Estimates



Example: Company A, a US registrant, is converting to IFRS with a transition date of January 1, 2011. At December 31, 2011, in accordance with FAS 5, *Accounting for Contingencies*, and FIN 14, *Reasonable Estimation of the Amount of a Loss—an interpretation of FAS 5*, the company had a \$2 million liability for an ongoing lawsuit where the loss was probable, and a range of loss had been identified as between \$2 million and \$8 million, with no specific amount more likely than any other.

As the company identified its US GAAP to IFRS conversion adjustments in the third quarter of 2012, it settled the case for \$8 million. Under the provisions of IFRS 1, the company is required to measure the liability in accordance with IAS 37 using the information available at the transition date. Thus, the settlement of the obligation cannot be a factor in measurement at the transition date. Under IAS 37, the company would be required to record the midpoint of the estimated range (as opposed to the low end of the range under FIN 14). Therefore, in the IFRS opening balance sheet, the company would reflect a \$5 million liability for the lawsuit. The difference between the US GAAP liability and IFRS liability of \$3 million would be recorded in opening retained earnings. In its 2012 IFRS financial statements, when the settlement of \$8 million was agreed to, the company would increase the liability by \$3 million to reflect the change in estimate in 2012 with the additional expense recognized in the income statement.

Noncontrolling Interests

IAS 27R requires certain amounts to be allocated between owners and noncontrolling interests. This exception for first-time adopters requires prospective application from the date of transition to IFRS for the following requirements of IAS 27R:

- a. the requirement that total comprehensive income is attributed to the owners of the parent and to the noncontrolling interests;
- b. the requirements for accounting for changes in the parent's ownership interest in a subsidiary that do not result in a loss of control; and
- c. the requirements for accounting for a loss of control over a subsidiary.

Similar to the business combination exemption, this exception provides relief from requiring companies to gather information and calculate allocations between owners and noncontrolling interests under IFRS for transactions in periods prior to the transition date. However, if a first-time adopter elects to apply the business combination standard retrospectively to past business combinations, it must also apply the IAS 27R requirements from that date forward.

Assets classified as held for sale and discontinued operations

This mandatory exception is applicable only for companies with IFRS adoption dates before January 1, 2006, so it is unlikely to apply to most US companies. Therefore, first-time adopters in the United States will need to retrospectively apply IFRS 5, *Non-Current Assets Held for Sale and Discontinued Operations*, to the transition date.

Key US consideration

IFRS 5 requires that a discontinued operation:

- Represent a separate major line of business or geographical area of operations,
- Is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, or
- Is a subsidiary acquired exclusively with view to resale

The requirement that a discontinued operation be a “separate major line of business or geographical area of operations” is a higher threshold than under US GAAP. This may mean that certain components (as defined in FAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*) that met the discontinued operations criteria of FAS 144 will not receive discontinued operations presentation under IFRS 5.

Derecognition of financial assets and financial liabilities

The IFRS guidance dealing with derecognition of financial assets and financial liabilities should be applied only to transactions that occurred on or after January 1, 2004. However, a company may apply the derecognition requirements in IAS 39 retrospectively from a date of the company’s choosing, provided that the information required by IAS 39 was obtained at the date of those transactions.

Disclosures and other considerations

The first IFRS financial statements should provide all of the disclosures IFRS requires, in addition to the specific disclosures required by IFRS 1, to explain the impact of the transition to IFRS. There are no exemptions from the disclosure requirements of any standards except for certain aspects of IFRS 6, *Exploration for and Evaluation of Mineral Resources*, and IFRS 7, *Financial Instruments: Disclosures*. However, because of the effective dates applicable to the exemptions in those standards, it is unlikely US companies will be allowed to use them, so they are not discussed in detail here.

Reconciliations in the first IFRS financial statements

The first IFRS financial statements should include a reconciliation of:

- Equity from previous GAAP to IFRS at the transition date and at the end of the latest period presented in the company's most recent annual financial statements under previous GAAP.
- Net profit from previous GAAP to IFRS for the last period in the company's most recent annual financial statements under previous GAAP.

The reconciliations should give sufficient detail to enable users to understand the material adjustments to the balance sheet and income statement and to distinguish changes in accounting policies from the correction of errors identified during transition. A sample reconciliation footnote is included at the end of this guide.

Key US consideration

A conversion to IFRS may lead to the identification of errors in the previous GAAP financial statements. IFRS 1 requires errors to be disclosed separately from adjustments because of accounting policy changes in the reconciliation from previous GAAP to IFRS. US registrants will need to be particularly mindful of such findings because of the regulatory requirements governing the identification and disclosure of errors.

Other disclosures in the first IFRS financial statements

The disclosures required by IAS 36 should be provided when impairment losses are recognized in the opening IFRS balance sheet. These disclosures are substantial and include (among others):

- The amount and financial statement line items impacted by the impairment.
- The impairment amount recorded for each reported segment.
- For material impairments:
 - The events leading to the recognition of the impairment.
 - A description of the asset or cash-generating unit.
 - What constitutes the remaining recoverable amount of the asset or cash-generating unit.
 - The discount rates used in the impairment analysis.
- Significant assumptions used in the impairment analysis.
- The amount of any unallocated goodwill and the reasons it is unallocated.

In addition, when fair value is used as deemed cost, the aggregate fair values and the aggregate adjustment to the previous carrying amounts should be disclosed for each line item. Finally, a company should also explain material adjustments to the cash flow statement.

A company that applies the optional exemption to classify a financial asset or financial liability as “at fair value through profit or loss” must disclose:

- The fair value of the item.
- The carrying amount under previous GAAP.
- The classification under previous GAAP.

Challenges for US companies in providing IFRS disclosures

Although the level of disclosures required by US GAAP and the SEC are significant, the disclosures required in a set of IFRS financial statements are even more extensive in certain areas. Aside from the IFRS 1 disclosures described above, which are required only in the first year of IFRS adoption, annual IFRS financial statements require ongoing disclosures that can be more voluminous, and in some cases more challenging, than disclosures under US GAAP.

The greater use of management judgment in establishing accounting policies in an IFRS framework will require companies to pay special attention to ensure disclosures of those policies are sufficient. Disclosure of management’s judgments is critical to the transparency and overall quality of IFRS financial reporting. The challenge in providing some of the annual IFRS disclosures is not necessarily in their complexity, but in the level of judgment that must be applied when deciding what to disclose and in gaining comfort with disclosing the level of detail required by some IFRS standards.

Some examples of IFRS disclosure requirements that are more significant than current US GAAP disclosures include:

- **Summary of significant accounting policies**—These familiar US GAAP note disclosures may need to be even more descriptive under IFRS. IAS 1, *Presentation of Financial Statements*, focuses on clear disclosure of the measurement bases used in preparing the financial statements (e.g., historical cost, current cost, fair value, net realizable value, or recoverable amount), as well as any other policies used that are relevant to an understanding of the financial statements.
- **Judgments used in applying accounting policies**—IAS 1 also specifically requires disclosure of the judgments management has made that can significantly affect the amounts recognized in the financial statements. For example:
 - factors considered in determining whether certain ownership interests constitute control and require consolidation rather than associate (i.e., equity method) accounting;
 - factors considered in determining whether an available-for-sale financial asset is impaired under IAS 39;
 - judgments made in determining when the significant risks and rewards of ownership have transferred to a buyer for purposes of recognizing revenue
- **Sources of estimation uncertainty**—IAS 1 requires detailed disclosure about the assumptions and other major sources of estimation uncertainty that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. For applicable assets and liabilities, the financial statement notes must include details on their nature and carrying amount at the end of the period. This disclosure is intended to address estimates that require management's most difficult, subjective or complex judgments; the greater the number of variables and assumptions affecting the future resolution of the uncertainty, the greater the potential for a material adjustment to the amount of the assets and liabilities and the greater need for transparent disclosure. Typical areas involving significant estimation uncertainty include impairment testing, income tax provisions, and fair value measurement for derivatives and other financial instruments. Examples of the types of disclosures an entity might make are:
 - the nature of the assumption or other estimation uncertainty;
 - the sensitivity of carrying amounts to the methods, assumptions, and estimates including the reasons for the sensitivity;
 - the expected resolution of an uncertainty and the range of possible outcomes with the next financial year; and
 - an explanation of changes made to past assumptions if the uncertainty remains unresolved.
- **IFRS 7, Financial Instruments: Disclosures**—IFRS 7 requires detailed qualitative and quantitative disclosures about the nature and extent of risks arising from financial instruments including credit, liquidity and market risks and how management manages those risks. Such disclosures include detailed sensitivity analysis for each type of market risk to which the company is exposed at the end of the reporting period. US registrants will be prepared to provide some of these disclosures because they are similar to the liquidity disclosures required in Management's Discussion and Analysis (MD&A) under SEC Regulation S-K. However, the IFRS 7 disclosures are more comprehensive and may require the capture of new data.

- **Capital risk management strategy and ratios**—A company is required to disclose its objectives, policies and processes on managing capital. IAS 1 requires the following disclosure based on information provided internally to the entity’s key management personnel:
 - Qualitative information about the entity’s objectives, policies and processes for managing capital, including:
 - A description of what the entity manages as capital
 - When an entity is subject to externally imposed (for example, by regulators) capital requirements, the nature of those requirements, and how those requirements are incorporated into the entity’s management of its capital
 - How the entity is meeting its objectives for managing capital
 - Summary quantitative data about what the entity manages as capital
 - Whether there have been any changes in the above from the previous period
 - Whether the entity has complied with any externally imposed (for example, by regulators) capital requirements to which it is subject and, if not, the consequences of such noncompliance
- **Rollforwards of balance sheet accounts**—In some instances, companies were required to provide rollforwards of certain balance sheet accounts (e.g., valuation allowances) as part of the financial statement schedules in the Form 10-K. However, the IFRS requirement for rollforwards covers more balance sheet accounts and requires inclusion of the rollforwards in the notes to the financial statements. For example, detailed rollforwards are required for: property, plant and equipment (gross and accumulated depreciation), intangible assets (gross and accumulated amortization), deferred tax assets and liabilities, and provisions.
- **Disclosure of expenses by nature**—IAS 1 allows the presentation of expenses in the income statement based on either their nature or function, whichever provides information that is reliable and more relevant. Companies that elect a functional presentation of expenses within the income statement are required to separately disclose the nature of the expenses in the notes to the financial statements (including depreciation, amortization, and employee benefits expense).
- **Key management compensation**—Companies are required to disclose compensation for “key management personnel” (as defined within IAS 24, *Related Party Disclosures*) by the following categories:
 - Short-term employee benefits
 - Post-employment benefits
 - Other long-term benefits
 - Termination benefits
 - Share-based payments

This list is not all-inclusive but provides a sample of the types of additional financial statement disclosures required by IFRS. Please refer to the PwC publication *Illustrative Corporate Consolidated Financial Statements* for a more extensive example of IFRS financial statements and notes.

Key US consideration

Some of the IFRS disclosures discussed above may already be required for US registrants under the SEC's integrated disclosure system, but may be made outside the audited financial statements. Examples include critical accounting policies and liquidity and capital resources in MD&A, valuation and qualifying accounts in Financial Statement Schedule II to the Annual Report on Form 10-K and executive compensation disclosures in proxy statements. The disclosures required under IFRS must be made in the financial statements and are covered by the independent auditor's opinion. Additionally, inclusion of this information in the notes to financial statements removes the safe harbor protection previously available.

IFRS 1 and the publication of interim financial information

IFRS, including IFRS 1, does not require interim reporting, but provides guidance on what a company should report when it publishes interim financial information. IAS 34, *Interim Financial Reporting*, allows companies preparing interim reports the option of presenting either full IFRS financial statements or condensed interim financial information. IAS 34 sets out the minimum contents of condensed reporting. A company that publishes interim financial information for a period covered by the first IFRS financial statements must also follow the additional requirements of IFRS 1 (e.g., disclosure of the reconciliation from previous GAAP to IFRS and other IFRS 1 disclosures) if that interim financial information is prepared in accordance with IFRS.

Publication of condensed interim financial information

A company may find that the first published financial information under IFRS is in the form of interim financial statements. For example, a company whose first annual IFRS reporting date is December 31, 2014, may decide to report its interim March 31, 2014, financials using IFRS. Therefore, the interim statements would become the first IFRS financial statements. The interaction of the reconciliation requirements of IFRS 1 and the requirement of IAS 34 to present all information "material to an understanding of the current interim period" may require the production of extensive interim financial statements.

IFRS 1 requires the reconciliation of equity and the profit and loss under previous GAAP at the end of the comparable interim period, as well as the reconciliations expected for the first full IFRS financial statements. It does not require the company to publish a full set of financial statements as a first interim financial statement.

IAS 34 sets out the concept of an "interim financial report," which allows the primary financial statements to be condensed and keeps accounting policies and disclosures to a minimum. Entities are permitted to reduce disclosures and condense line items in an interim financial report because they would have made "full disclosures" in their previously published annual financial statements. Traditional interim financial statements focus on the operational and financial changes of the reporting entity since the last full set of financial statements. The requirements of IAS 34 could therefore be more burdensome than companies realize.

What happens if the detailed information implied by “full disclosures” is not available? The financial statements published under US GAAP may use recognition and measurement criteria that are different from IFRS, or may not provide all the information that must be disclosed in full IFRS financial statements or all of the same line items.

The interim financial report must bridge the gap between the information published under previous GAAP and the information that will appear in the first complete set of IFRS financial statements. A company must include either all necessary information in the interim financial report, or cross-references to another document that includes the necessary information.

Neither IFRS 1 nor IAS 34 includes a checklist of required information. Disclosure depends on the company’s specific circumstances. Companies making the transition to IFRS for the year ended December 31, 2014 that have published annual financial statements under previous GAAP for year-end 2013 may have to report a great deal of additional information to avoid misleading users of the IFRS interim financial statements. Also, the more complex the business or organization, the more disclosures are required. Companies may have to include additional line items or subtotals in the financial statements to communicate significant changes in figures.

Interim reconciliation requirements of IFRS 1

IFRS financial reports published for interim periods covered by the first IFRS financial statements should include two additional reconciliations: net income for the comparative interim period and equity at the end of that period. The first IFRS interim report published for interim periods covered by the first IFRS financial statements must also include the same reconciliations that will be included in the first annual IFRS financial statements.

The diagram below illustrates the reconciliations that must be made in the quarterly interim IFRS financial report for the three months ended March 31, 2014, by an entity adopting IFRS for its December 31, 2014, financial statements, assuming only one year of comparatives is required.



Historical summaries

A company may elect to present a summary of historical data for periods prior to the IFRS transition date. IFRS 1 does not require such information to be presented in accordance with IFRS. A company can also elect to present additional comparative information under the previous GAAP. When historical summaries or comparative information under a previous GAAP is presented, the information should be labeled clearly as not complying with IFRS, and the nature of the main adjustments to comply with IFRS should be described.

Amendments to IFRS 1

Amendments to other standards commonly impact IFRS 1. It is reasonable to expect that additional amendments may be made in the future as more countries adopt IFRS and as new standards and interpretations are published. Companies should monitor developments in this area as they proceed through their conversion projects.

Early adoption of IFRS

The SEC may propose allowing certain US registrants to adopt IFRS voluntarily, in advance of an eventual mandatory adoption date for all US registrants. A number of companies may find an early move to IFRS advantageous, especially those that embody some combination of the following characteristics:

- Operates internationally, with a heavy physical or business presence overseas.
- Competes in an industry where many competitors already use IFRS.
- Plans a major system conversion or implementation in the next five years.
- Prefers to seek capital from outside the United States.
- Anticipates significant strategic acquisitions or divestitures internationally in the next few years.
- Seeks to be a directional leader in its industry or in the US market.
- Desires flexibility in its conversion time-frame to avoid “working under the gun.”
- Has limited resources available internationally to produce US GAAP financial statements.

Companies that adopt IFRS early may recognize some or all of the following benefits:

- Better access to limited IFRS-knowledgeable resources.
- Earlier realization of cost efficiencies generated by using a common financial reporting language.
- More flexibility in designing a conversion plan and integrating IFRS into business processes and systems.
- Enhanced access to global capital and potentially lower cost of capital.
- Increased comparability to competitors and peers using IFRS.
- Enhanced ability to influence regulators and standard-setters on IFRS matters over companies not yet using IFRS.

Though the benefits of early adoption may outweigh the risks, companies should be aware of some challenges they may face by adopting early. For example, the FASB and IASB have ambitious agendas, and companies should expect both standard-setters to issue significant new standards as well as amendments to previously issued standards. Though many are joint projects and therefore should result in fairly similar standards, companies converting to IFRS early will likely need to learn and apply both the US and international standards concurrently (US standards for existing reporting prior to their first IFRS financial statement filing and international standards for properly converting their opening IFRS balance sheet).

A related issue with new standard setting is timing relative to a company's IFRS transition date. Consider, for example, a company that decides to early adopt and plans to issue its first IFRS financial statements for the year ended December 31, 2012. This company's date of adoption is January 1, 2012, and its date of transition (assuming that two years of comparatives are required by the SEC) will be January 1, 2010. If the IASB issues a new standard in 2011 that is effective for annual periods beginning after December 31, 2011, the company will need to apply that new standard to its opening balance sheet effective January 1, 2010. Such timing issues make for a moving target, since the company would likely have identified its necessary opening balance sheet conversion adjustments well before the effective date of the new standard, and it would need to go back and adjust all periods to reflect the new standard.

Appendix: Sample IFRS reconciliation note for first interim financial statements

This Appendix presents an illustrative example of the reconciliation disclosures required by IFRS 1 using a fictional company, ABC Co. (“the Company”). The example assumes the Company’s first IFRS financial statements are for the year ended on December 31, 2014, with a transition date of January 1, 2013 (only one year of comparative financial information is required). The Company’s first interim financial report under IFRS is for the quarter ended March 31, 2014. ABC Co. prepared US GAAP annual financial statements for the year ended December 31, 2013, and prepared quarterly reports throughout 2013.

The intent of the example is to illustrate the periods to be reconciled and the type of disclosures required to explain the related adjustments. The example is not comprehensive and is not intended to reflect all possible accounting entries that would be necessary for a first-time adopter.

Note 5. Transition to IFRS

5.1 Basis of transition to IFRS

5.1.1 Application of IFRS 1

The Company’s financial statements for the year ended December 31, 2014, will be the first annual financial statements that comply with IFRS. The Company has applied IFRS 1 in preparing these consolidated interim financial statements.

The Company’s transition date is January 1, 2013. The Company prepared its opening IFRS balance sheet at that date. The reporting date of these interim consolidated financial statements is March 31, 2014.

In preparing these interim consolidated financial statements in accordance with IFRS 1, the Company has applied the relevant mandatory exceptions and certain optional exemptions from full retrospective application of IFRS.

5.1.2 Exemptions from full retrospective application—elected by the Company

The Company has elected to apply the following optional exemptions from full retrospective application.

(a) Business combinations exemption

The Company has applied the business combinations exemption in IFRS 1. It has not restated business combinations that took place prior to the January 1, 2013, transition date.

(b) Fair value as deemed cost exemption

The Company has elected to measure certain items of property, plant and equipment at fair value as at January 1, 2013. The application of this exemption is detailed in Note 5.2.2(b).

(c) Cumulative translation differences exemption

The Company has elected to set the previously accumulated cumulative translation adjustments to zero at January 1, 2013. This exemption has been applied to all subsidiaries in accordance with IFRS 1. The application of this exemption is detailed in Note 5.2.2(f).

(d) Employee benefits exemption

The Company has elected to recognize all cumulative actuarial gains and losses at January 1, 2013. The application of this exemption is detailed in Note 5.2.2(g).

The remaining optional exemptions are not applicable to the Company.

5.1.3 Exceptions from full retrospective application followed by the Company

The Company has applied the following mandatory exceptions from retrospective application.

(a) Hedge accounting exception

Management has claimed hedge accounting from January 1, 2013, only if the hedge relationship meets all the hedge accounting criteria under IAS 39. The application of this exemption at the opening balance sheet date of January 1, 2013, is detailed in Note 5.2.2(h).

(b) Estimates exception

Estimates under IFRS at January 1, 2013, are consistent with estimates made for the same date under US GAAP.

All other mandatory exceptions in IFRS 1 were not applicable because there were no significant differences in management's application of US GAAP in these areas.

5.2 Reconciliations between IFRS and US GAAP²

The following reconciliations provide a quantification of the effect of the transition to IFRS. The first reconciliation provides an overview of the impact on stockholders' equity of the transition at January 1, 2013, March 31, 2013, and December 31, 2013. The following five reconciliations provide details of the impact of the transition on:

- stockholders' equity at January 1, 2013 (Note 5.2.2)
- stockholders' equity at March 31, 2013 (Note 5.2.3)
- stockholders' equity at December 31, 2013 (Note 5.2.4)
- net income March 31, 2013 (Note 5.2.5)
- net income December 31, 2013 (Note 5.2.6)

² IFRS 1.40 requires an explanation of the material adjustments to the statement of cash flows as a result of transition to IFRS if a statement of cash flows was presented under previous GAAP. Such explanations have been omitted in this illustrative example

5.2.1 Summary of stockholders' equity						
(in millions of \$)	Jan. 1, 2013	Note	Mar. 31 2013	Note	Dec. 31, 2013	Note
Total stockholders' equity reported under US GAAP	14,850		15,750		16,650	
Restatement of inventory costing method from the LIFO method to the FIFO method	400	5.2.2 (a)	500	5.2.3 (a)	370	5.2.4 (a)
Consolidation of inventory of subsidiary	50	5.2.2 (a)	50	5.2.3 (a)	50	5.2.4 (a)
Elimination of investment in associate	(35)	5.2.2 (a)	(35)	5.2.3 (a)	(35)	5.2.4 (a)
Recognition of noncontrolling interest [†]	(15)	5.2.2 (a)	(15)	5.2.3 (a)	(15)	5.2.4 (a)
Restatement of the XYZ PPE to fair value at transition	750	5.2.2 (b)	729	5.2.3 (b)	667	5.2.4 (b)
Recognition of impairment provisions using the guidance in IAS 36	(500)	5.2.2 (b)	(488)	5.2.3 (b)	(450)	5.2.4 (b)
Goodwill adjustments	200	5.2.2 (c)	200	5.2.3 (c)	200	5.2.4 (c)
IPR&D related adjustments	1,125	5.2.2 (d)	1,031	5.2.3 (d)	750	5.2.4 (d)
Cumulative translation adjustment [†]	300	5.2.2 (f)	300	5.2.3 (f)	300	5.2.4 (f)
Pension adjustment [†]	(100)	5.2.2 (g)	(100)	5.2.3 (g)	(100)	5.2.4 (g)
Discontinuance of hedge accounting [†]	-	5.2.2 (h)	(50)	5.2.3 (h)	(75)	5.2.4 (h)
Deferred tax and other noncurrent liability adjustments	(1,250)	5.2.2 (e)	(1,300)	5.2.3 (e)	(1,220)	5.2.4 (e)
Total adjustments	925		822		442	
[†] Total adjustments above were reclassified within equity	(185)		(135)		(110)	
Total stockholders' equity reported under IFRS	15,590		16,437		16,982	

5.2.2 Reconciliation of stockholders' equity at January 1, 2013				
(in millions of \$)	Note	US GAAP	Effect of transition to IFRS	IFRS
Assets				
Cash and cash equivalents		5,000	-	5,000
Short-term securities		2,000	-	2,000
Accounts receivable less allowances		5,000	-	5,000
Inventories	(a)	4,500	450	4,950
Other current assets, including deferred taxes		3,500	-	3,500
Total current assets		20,000	450	20,450
Property, plant and equipment	(b)	15,000	250	15,250
Goodwill	(c)	2,000	200	2,200
Other intangible assets, net of accumulated amortization	(d)	500	1,125	1,625
Investments in associates	(a)	500	(35)	465
Other assets including deferred taxes		4,000	-	4,000
Total assets		42,000	1,990	43,990
Current liabilities				
Trade accounts payable		1,600	-	1,600
Accrued expenses		6,400	-	6,400
Accrued taxes		2,000	-	2,000
Total current liabilities		10,000	-	10,000
Noncurrent liabilities				
Long-term debt		13,000	-	13,000
Pension liabilities		500	-	500
Accrued postretirement benefits other than pensions		1,500	-	1,500
Other noncurrent liabilities, including deferred taxes	(e)	2,150	1,250	3,400
Total noncurrent liabilities		17,150	1,250	18,400
Stockholders' equity				
Share capital		500	-	500
Cumulative translation adjustment	(f)	300	(300)	-
Retained earnings	(i)	14,250	925	15,175
Noncontrolling interests	(a)	-	15	15
Accumulated other comprehensive loss	(g), (h)	(200)	100	(100)
Total stockholders' equity		14,850	740	15,590
Total liabilities and stockholders' equity		42,000	1,990	43,990

Explanation of the effect of the transition to IFRS

The following explains the material adjustments to the balance sheet and income statement.

(a) Inventory and consolidation

- i. Under US GAAP, the Company applied the LIFO method of inventory measurement for both book and tax purposes. Under IFRS, LIFO is not an acceptable inventory costing method. Accordingly, the Company has restated its opening balance sheet retrospectively assuming that the first-in, first-out (FIFO) inventory costing methodology had been applied. The impact of this change in inventory valuation was an increase of \$400 million at January 1, 2013.
- ii. In addition, one subsidiary had been excluded from consolidation under US GAAP because the Company determined that it was not the primary beneficiary of the entity's activities. However, the Company has a currently exercisable purchase option to purchase a controlling interest in the assets of the entity, which consisted entirely of inventory. This entity was consolidated under IFRS. Inventory related to this entity totaled \$50 million.

The total increase to inventory as a result of IFRS differences was \$450 million.

As a result of the consolidation, the company recorded entries described above to consolidate the previously unconsolidated entity, eliminate the investment in the associate, and record the related noncontrolling interest.

(b) Property, plant and equipment

- i. Management has applied the fair value as deemed cost exemption with respect to certain plant machinery, buildings and land of its XYZ subsidiary. The valuation of the property performed at January 1, 2013, assessed its fair value as \$1.75 billion, an increase of \$750 million from its carrying amount under US GAAP of \$1.0 billion.
- ii. Impairment

Information on impairment losses recognized at January 1, 2013

The impairment charge of \$500 million arose in the manufacturing CGU “Factory Blue,” which is the Company’s manufacturing plant in Any State, USA, following a decision to reduce the manufacturing output allocated to the operation. This was a result of a redefinition of the Company’s allocation of manufacturing volumes across all CGUs to benefit from advantageous market conditions. The Company reassessed the depreciation policies in the CGU and estimated that the useful lives and residual values of property, plant and equipment will not be affected following this decision.

The recoverable amount of this CGU was estimated based on value-in-use calculations as this was determined to be higher than fair value less costs to sell. These calculations use cash flow projections based on financial budgets approved by management covering a five-year period. Cash flows beyond the five-year period are extrapolated using the estimated growth rates stated below. The growth rate does not exceed the long-term average growth rate for the manufacturing business in which the CGU operates. The following are key assumptions used in the value-in-use calculation.

Gross margin [†]	30.0%
Growth rate [‡]	1.8%
Discount rate [§]	10.5%

[†] Budgeted gross margin

[‡] Weighted average growth rate used to extrapolate cash flows beyond the budget period

[§] Pretax discount rate applied in cash flow projections.

Management determined the budgeted gross margin based on past performance and its expectations for the market development. The weighted average growth rates used are consistent with the forecasts included in industry reports. The discount rates used are pretax and reflect specific risks in relation to the relevant CGU.

A change in management’s gross margin estimate by 10% would increase the impairment by \$50 million. If management reduces the growth rate by 10%, impairment would increase by \$3 million. An increase in the discount rate by 10% would also increase impairment by \$5 million.

This CGU was not considered impaired under US GAAP because the estimated cash flow projections on an undiscounted basis exceeded the carrying amount of the CGU.

As a result of the adjustments described in (b)(i) and (ii) to the opening IFRS balance sheet, total PP&E increased by \$250 million.

(c) Goodwill

One special-purpose entity previously unconsolidated under US GAAP, because the Company concluded that it was not the primary beneficiary of the entity's activities, has been consolidated under IFRS. Goodwill related to this entity totaled \$200 million.

Goodwill had been tested for impairment at January 1, 2013.

Goodwill was allocated to CGUs for the purpose of impairment testing. Each of those CGUs represented the Company's investment in each country of operation. No impairment was identified at January 1, 2013.

A segment-level summary of the goodwill allocation is presented below.

As at January 1, 2013

<i>(in millions of \$)</i>	Segment A	Segment B	Total
US	800	600	1,400
UK	200	300	500
Other	100	200	300
	1,100	1,100	2,200

The recoverable amount of this CGU was estimated based on value-in-use calculations as this was determined to be higher than fair value less costs to sell. These calculations use cash flow projections based on financial budgets approved by management covering a five-year period. Cash flows beyond the five-year period are extrapolated using the estimated growth rates stated below. The growth rate does not exceed the long-term average growth rate for the business in which the CGU operates.

Key assumptions used for value-in-use calculations

	Segment A			Segment B		
	US	UK	Other	US	UK	Other
Gross margin [†]	29.0%	30.0%	26.0%	36.0%	28.0%	27.0%
Growth rate [‡]	1.8%	1.8%	1.9%	1.3%	1.1%	1.4%
Discount rate [§]	10.0%	10.7%	12.8%	11.0%	11.8%	13.5%

These assumptions have been used for the analysis of each CGU within the business segments.

[†] Budgeted gross margin

[‡] Weighted average growth rate used to extrapolate cash flows beyond the budget period

[§] Pretax discount rate applied to the cash flow projections

Management determined the budgeted gross margin based on past performance and its expectations for market development. The weighted average growth rates used are consistent with the forecasts included in industry reports. The discount rates used are pretax and reflect specific risks relating to the relevant segments.

(d) Other intangible assets

As part of the acquisition of ABC Technologies in 2012, the Company recorded at fair value and then immediately expensed \$1.5 billion of in process research and development under US GAAP. The amount of \$1.125 billion has been recognized, net of \$375 million accumulated amortization, as other intangible assets in the IFRS opening balance sheet to properly reflect the net unamortized balance of the costs as of the transition date.

(e) Deferred tax adjustments (other noncurrent liabilities)

The change in deferred taxes represents the deferred tax effects on the adjustments necessary to transition to IFRS.

(f) Cumulative translation adjustment

As allowed by IFRS, the company reset its cumulative translation adjustment account to zero at January 1, 2013.

(g) Pension adjustment

The Company has elected to apply the IFRS 1 employee benefits exemption. Accordingly, cumulative net actuarial losses totaling \$100 million recorded in accumulated other comprehensive loss under US GAAP were recognized in opening retained earnings at January 1, 2013.

(h) Hedge accounting exception

The company held interest rate swaps at the transition date related to variable rate debt instruments. Under US GAAP, the swaps qualified for hedge accounting with changes in fair value recorded in other comprehensive income. The hedging relationship was carried over in the opening balance sheet because it is of a type that qualifies for hedge accounting under IFRS. However, because management had used the shortcut method, it did not have sufficient documentation at the transition date to continue hedge accounting under IAS 39. As a result, the company has discontinued hedge accounting and will record future changes in the fair value of the hedging instrument directly in profit and loss.

(i) Retained earnings

Other than for reclassification items, all of the above adjustments were recorded against the opening retained earnings at January 1, 2013.

5.2.3 Reconciliation of stockholders' equity at March 31, 2013				
(in millions of \$)	Note	US GAAP	Effect of transition to IFRS	IFRS
Assets				
Cash and cash equivalents		4,700	-	4,700
Short-term securities		2,500	-	2,500
Accounts receivable less allowances		6,000	-	6,000
Inventories	(a)	5,000	550	5,550
Other current assets, including deferred taxes		2,500	-	2,500
Total current assets		20,700	550	21,250
Property, plant and equipment	(b)	14,500	241	14,741
Goodwill	(c)	2,000	200	2,200
Other intangible assets, net of accumulated amortization	(d)	475	1,031	1,506
Investments in associates	(a)	525	(35)	490
Other assets including deferred taxes		4,500	-	4,500
Total assets		42,700	1,987	44,687
Current liabilities				
Trade accounts payable		2,100	-	2,100
Accrued expenses		6,400	-	6,400
Accrued taxes		500	-	500
Total current liabilities		9,000	-	9,000
Noncurrent liabilities				
Long-term debt		13,100	-	13,100
Pension liabilities		525	-	525
Accrued postretirement benefits other than pensions		1,600	-	1,600
Other noncurrent liabilities, including deferred taxes	(e)	2,725	1,300	4,025
Total noncurrent liabilities		17,950	1,300	19,250
Stockholders' equity				
Share capital		500	-	500
Cumulative translation adjustment	(f)	300	(300)	-
Retained earnings	(i)	15,200	822	16,022
Noncontrolling interests	(a)	-	15	15
Accumulated other comprehensive loss	(g), (h)	(250)	150	(100)
Total stockholders' equity		15,750	687	16,437
Total liabilities and stockholders' equity		42,700	1,987	44,687

Explanation of the effect of the transition to IFRS

The following explains the material adjustments to the balance sheet at March 31, 2013.	(in millions of \$)
<i>(a) Inventory</i>	
Restatement of inventory costing method from LIFO to FIFO	500
Consolidation of subsidiaries previously excluded from US GAAP consolidation	50
Total impact—increase to inventory	550
<i>(b) Property, plant and equipment</i>	
Restatement of XYZ property, plant and equipment to fair value	750
Impact of impairment losses recognized under IFRS	(500)
Additional depreciation on net property, plant and equipment adjustments	(9)
Total impact—increase to property, plant and equipment	241
<i>(c) Goodwill</i>	
Consolidation of subsidiaries previously excluded from US GAAP consolidation resulted in the recognition of additional goodwill of \$200 million. See Note 5.2.2(c).	

(d) Other intangible assets

As part of the acquisition of ABC Technologies in 2012, the Company recorded at fair value and then immediately expensed \$1.5 billion of IPR&D under US GAAP. The amount of \$1.125 billion has been recognized as other intangible assets in the IFRS balance sheet and will be amortized over its remaining useful life of 3 years.

For the three-month period ended March 31, 2013, the Company recognized \$94 million of IPR&D amortization in cost of sales.

(e) Deferred tax adjustments and other noncurrent liabilities adjustments.

The change in deferred taxes represents the deferred tax adjustments on the adjustments necessary to transition to IFRS.

(f) Cumulative translation adjustment

The cumulative translation adjustment account was reset to zero at January 1, 2013. There were no additional changes in the CTA account for the three months ended March 31, 2013.

(g) Pension adjustment

The Company has elected to recognize all cumulative actuarial gains and losses as of January 1, 2013. For the period ended March 31, 2013, the Company recognized \$100 million in retained earnings related to cumulative net actuarial losses, which had been recorded in accumulated other comprehensive loss under US GAAP.

(h) Hedge accounting exception

Management had applied the “shortcut” method for hedge effectiveness testing for its existing interest rate swaps on variable rate debt instruments under US GAAP. All changes in fair value were recorded in accumulated other comprehensive income. Under IFRS, although the hedging relationship was reflected on the opening balance sheet, it did not qualify for hedge accounting prospectively because of differences in documentation requirements. As a result, an additional \$50 million in unrealized losses were recognized in the income statement under IFRS during the period ended March 31, 2013.

(i) Retained earnings

Other than for reclassification items, all of the above adjustments were recorded against the opening retained earnings at January 1, 2013, or reflect the income and retained earnings impact for the three-month period ended March 31, 2013.

5.2.4 Reconciliation of stockholders' equity at December 31, 2013

(in millions of \$)	Note	US GAAP	Effect of transition to IFRS	IFRS
Assets				
Cash and cash equivalents		5,000	-	5,000
Short-term securities		3,000	-	3,000
Accounts receivable less allowances		5,000	-	5,000
Inventories	(a)	4,500	420	4,920
Other current assets, including deferred taxes		2,000	-	2,000
Total current assets		19,500	420	19,920
Property, plant and equipment	(b)	13,000	217	13,217
Goodwill	(c)	2,000	200	2,200
Other intangible assets, net of accumulated amortization	(d)	400	750	1,150
Investments in associates	(a)	600	(35)	565
Other assets including deferred taxes		4,000	-	4,000
Total assets		39,500	1,552	41,052
Current liabilities				
Trade accounts payable		1,500	-	1,500
Accrued expenses		5,500	-	5,500
Accrued taxes		2,500	-	2,500
Total current liabilities		9,500	-	9,500
Noncurrent liabilities				
Long-term debt		10,200	-	10,200
Pension liabilities		450	-	450
Accrued postretirement benefits other than pensions		1,550	-	1,550
Other noncurrent liabilities, including deferred taxes	(e)	1,150	1,220	2,370
Total noncurrent liabilities		13,350	1,220	14,570
Stockholders' equity				
Share capital		500	-	500
Cumulative translation adjustment	(f)	300	(300)	-
Retained earnings	(i)	16,125	442	16,567
Noncontrolling interests	(a)	-	15	15
Accumulated other comprehensive loss	(g), (h)	(275)	175	(100)
Total stockholders' equity		16,650	332	16,982
Total liabilities and stockholders' equity		39,500	1,552	41,052

Explanation of the effect of the transition to IFRS

The following explains the material adjustments to the balance sheet at December 31, 2013.	(in millions of \$)
<i>(a) Inventory</i>	
Restatement of inventory costing method from LIFO to FIFO	370
Consolidation of subsidiaries previously excluded from US GAAP consolidation	50
Total impact—increase to inventory	420
<i>(b) Property, plant and equipment</i>	
Restatement of XYZ property, plant and equipment to fair value	750
Impact of impairment losses recognized net of depreciation expense	(500)
Additional depreciation on net property, plant and equipment adjustments	(33)
Total impact—increase to property, plant and equipment	217
<i>(c) Goodwill</i>	
Consolidation of subsidiaries previously excluded from US GAAP consolidation resulted in the recognition of additional goodwill of \$200 million. See Note 5.2.2(c).	
<i>(d) Other intangible assets</i>	
Opening retained earnings adjustment related to IPR&D acquired as part of the Company's acquisition of ABC Technologies in 2012	1,125
Amortization for the year ended December 31, 2013	(375)
Net other intangible adjustment	750
<i>(e) Deferred tax adjustments and other noncurrent liabilities adjustments.</i>	
The change in deferred taxes represents the deferred tax adjustments on the adjustments necessary to transition to IFRS.	
<i>(f) Cumulative translation adjustment</i>	
The cumulative translation adjustment account was reset to zero at January 1, 2013. There were no additional changes in the CTA account for the year ended December 31, 2013.	

(g) Pension adjustment

The Company has elected to recognize all cumulative actuarial gains and losses as of January 1, 2013. On January 1, 2013, the Company recognized \$100 million in retained earnings related to actuarial losses recorded in US GAAP accumulated other comprehensive loss.

(h) Hedge accounting exemption

Management had applied the “shortcut” method for its existing interest rate swaps on its variable rate debt instruments under US GAAP. All changes in fair value were recorded in accumulated other comprehensive income. Under IFRS, although the hedging relationship was not adjusted on the opening balance sheet, it did not qualify for hedge accounting going forward due to different documentation requirements. As a result, an additional \$75 million in unrealized losses were recorded under IFRS during the year ended December 31, 2013.

(i) Retained earnings

Other than for reclassification items, all of the above adjustments were recorded against the opening retained earnings at January 1, 2013, or reflect the income and retained earnings impact for the year ended December 31, 2013.

5.2.5 Reconciliation of net income for three months ended March 31, 2013				
(in millions of \$)	Note	US GAAP	Effect of transition to IFRS	IFRS
Sales		7,500	-	7,500
Cost of sales	(a)	5,000	3	5,003
Gross profit		2,500	(3)	2,497
Other operating income		(100)	-	(100)
Selling and marketing costs		500	-	500
Administrative expenses		200	-	200
Other operating expenses		100	-	100
Operating profit/(loss)		1,800	(3)	1,797
Finance costs—net	(b)	(150)	(50)	(200)
Share of profit of associates		25		25
Profit before tax		1,675	(53)	1,622
Income tax expense (benefit)	(c)	725	(14)	711
Profit from ordinary activities after tax		950	(39)	911
Profit for the period		950	(39)	911

(a) Costs of sales were impacted by:

(i) Inventory costing method change—quarterly change in LIFO reserve	(100)
(ii) Additional depreciation on net adjustments to PPE	9
(iii) Amortization of IPR&D	<u>94</u>
Net decrease to cost of sales	3

(b) Interest expense on interest rate swaps for which the shortcut method was applied under US GAAP

(c) Tax impacts of adjustments

5.2.6 Reconciliation of net income for year ended December 31, 2013				
(in millions of \$)	Note	US GAAP	Effect of transition to IFRS	IFRS
Sales		27,000	-	27,000
Cost of sales	(a)	20,000	439	20,439
Gross profit		7,000	(439)	6,561
Other operating income		(100)		(100)
Selling and marketing costs		2,000		2,000
Administrative expenses		600		600
Other operating expenses		500		500
Operating profit/(loss)		4,000	(439)	3,561
Finance costs—net	(b)	(700)	(50)	(750)
Share of profit of associates		100		100
Profit before tax		3,400	(489)	2,911
Income tax expense (benefit)	(c)	1,525	(196)	1,329
Profit from ordinary activities after tax		1,875	(293)	1,582
Profit for the period		1,875	(293)	1,582

(a) Costs of sales were impacted by:

(i) Inventory costing method change—quarterly change in LIFO reserve	30
(ii) Additional depreciation on net adjustments to PPE	33
(iii) Amortization of IPR&D	<u>376</u>
Net decrease to cost of sales	439

(b) Interest expense on interest rate swaps for which the shortcut method was applied under US GAAP

(c) Tax impacts of adjustments

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