# Navigating the move to IFRS

## Global insights for technology companies

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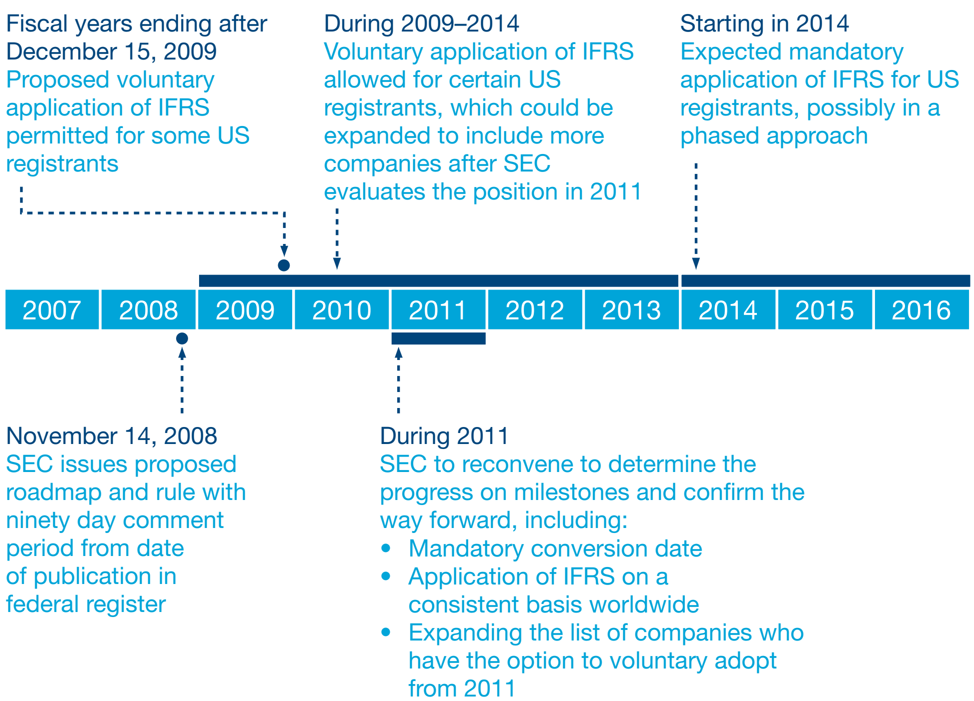
The heart of the matter

# Change is on the horizon

A majority of the world's largest capital markets already speaks to investors and stakeholders about corporate financial performance using one language—the language of International Financial Reporting Standards (IFRS). In an increasingly integrated global marketplace, it makes sense for businesses to operate under a single financial reporting framework. More than 100 countries, including the members of the European Union and parts of Asia, have already adopted or permit IFRS. The US Financial Accounting Standards Board (FASB) and the US Securities and Exchange Commission (SEC) are moving American businesses in the same direction. All signs suggest that change is on the horizon.

Technology is an industry that thrives on change. In this case, change is being ushered in by new realities in the marketplace and regulatory action to keep the US competitive with the rest of the world. The SEC recently proposed a roadmap for a transition from US Generally Accepted Accounting Principles (US GAAP) to IFRS. The preliminary plan, presented in the chart below, allows for some of the largest public companies in the United States to lead the transition to IFRS for fiscal years ending after December 15, 2009. The SEC would then reconvene to assess progress in 2011. At that time, assuming progress toward achieving certain milestones has been met, other companies would be phased in over a specific timeline beginning in 2014.

### Expected timeline for US transition




Although the deadlines are not imminent and uncertainties still exist, IFRS has gained much momentum in the United States. It would be difficult for the SEC to step back from its roadmap. When it comes to the transition from US GAAP to IFRS, the question no longer appears to be "if" but "when and how."

US companies have a rare opportunity to make time work for them. By taking action early, a company can push forward or scale back its initial assessment and subsequent conversion effort in response to market and competitive conditions. Companies will also be able to better control costs, understand and manage the challenging scope of implementation, and facilitate a smooth transition plan.

An in-depth discussion

# What does IFRS mean to the technology industry?

Key accounting topics that are most relevant to technology companies include revenue recognition, R&D, share-based payments, and income taxes.

The purpose of this publication is to help US technology companies think strategically about the financial and non-financial aspects of an IFRS conversion. In the following sections, we will present an overview of the conversion process and related considerations, including a discussion of First-time Adoption of International Financial Reporting Standards (IFRS 1). We also share lessons learned from past conversions and highlight key accounting areas that PricewaterhouseCoopers (PwC) believes are of particular interest to most technology companies.

While the impact of IFRS will vary for each company and sector, the key accounting topics that are most relevant to technology companies represent potentially complex areas of differences between US GAAP and IFRS. These areas include revenue recognition, research and development (R&D), share-based payments, and income taxes. In addition, there are a number of other accounting areas that may be relevant to all companies, regardless of their industry, which are not discussed in this guide due to their general nature. For further discussion of topics in this guide, as well as those of a more general nature, refer to PwC's publication *IFRS and US GAAP: Similarities and Differences*.

It is important to note that as US companies convert from US GAAP to IFRS they will need to apply IFRS 1, which will require the retroactive restatement of certain historical periods presented within a company's first set of IFRS-based financial statements. The application of IFRS to prior periods could generate a number of changes to a company's key metrics, bottom-line performance, and financial position. IFRS 1 further includes several optional exemptions and mandatory exceptions primarily to ease the burden of first-time adoption. In addition to the IFRS 1 discussion found in this publication, refer to PwC's publication *Preparing Your First IFRS Financial Statements: Adopting IFRS* for additional information.

It is also important to note that similar to the FASB, the International Accounting Standards Board (IASB) currently has projects in process which may result in changes to the differences discussed in this publication. Certain joint FASB-IASB projects on the active agenda include revenue recognition and financial statement presentation, among others. For a more detailed analysis of current and prospective projects, refer to the IASB's website at www.iasb.org.

While the proposed deadlines for adoption of IFRS are not immediate and uncertainties remain, one point is clear: the global factors that have been the driving force behind the move to IFRS continue to be present, despite significant turmoil in the markets. The credit crisis has highlighted the interconnected and global nature of our capital markets. While there are many challenges in the market, these issues demonstrate the need for a common accounting language. The move from US GAAP to IFRS is a reality no company should ignore.

# What can technology companies learn from previous IFRS adopters?

An IFRS conversion may have a ripple effect impacting many aspects of an organization, including underlying processes, systems, controls, and even customer contracts and interactions.

The transition to IFRS can be a long and complicated process with many challenges. Experience around the world shows that conversion projects often take more time and resources than anticipated. Historically, this has led some companies to rush the process, or outsource more work than necessary, driving up costs, increasing the risk of mistakes, and hindering the embedding of IFRS within the organization. At the same time, a conversion brings an 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 an organization, including underlying processes, systems, controls, and even customer contracts and interactions.

IFRS conversions around the world have also shown us that companies consistently underestimated the level of planning and effort needed to fully transition from local or regional GAAP to international standards. Based on these experiences, the lessons for any company planning to adopt IFRS are clear:

- Establish a clear vision and plan at the start.
- Establish the tone at the top and set up the right governance structure and clear decision-making powers.
- Plan and execute appropriately, considering impacts across the entire business.
- Develop your own IFRS resources, while leveraging the expertise of internal and external specialists—do not fully outsource the conversion process.
- Develop a conversion plan that takes into account peaks and valleys of activity, such as your quarterly reporting requirements.
- Consider how IFRS will impact key performance indicators and internal and external communication strategies.

Making strategic decisions early in the project prevents duplication of effort, changes in direction, and cost overruns at a later stage.

- Take early steps to communicate with regulators, tax authorities, and other stakeholders surrounding the impact, acceptance, and application of IFRS.
- Become knowledgeable with the standard-setting process, as IFRS will continue to evolve during implementation.
- Make the most of opportunities for other project efficiencies and understand the conversion's interaction with other business initiatives.
- Consider opportunities for rationalization and streamlining in multi-GAAP reporting, tax processes, and other areas.
- Implement changes at the business unit level using a top-down and bottom-up approach. Engage business units sooner, as opposed to later, for the most beneficial impact.
- Embed IFRS to make compliance with the reporting standards business as usual.

The experiences of companies that have already been through an IFRS conversion have demonstrated that making strategic decisions early in the project prevents duplication of effort, changes in direction, and cost overruns at a later stage. The path to a successful conversion contains pitfalls to avoid, but brings with it opportunities to improve, streamline, and standardize financial reporting and supporting business processes and systems.

# What are the key accounting differences between IFRS and US GAAP for technology companies?

IFRS generally takes a principles-based approach, which may result in significant differences from US GAAP. While many existing policies under US GAAP may be acceptable under IFRS, others may not. A thorough analysis of business practices and an understanding of potential key differences between the two frameworks can provide insight into voluntary changes that may better align the accounting with the underlying economic substance of business transactions.

In assessing the key differences between IFRS and US GAAP, the experience of foreign subsidiaries that have previously adopted IFRS and the results of foreign competitors may provide useful information. However, companies can not solely rely on this information to identify how the two frameworks vary and what the resulting impact may be. To more fully understand the impact of IFRS, companies must also draw upon resources that have an in-depth knowledge of the technology industry, financial reporting and regulatory requirements, insights into global business trends, and an overall appreciation for local practices.

The challenge for companies considering the adoption of IFRS is to identify and understand the rationale for divergence between the two frameworks. Consistent with the adoption of significant US standards, industry roundtables and discussions with peers will be useful forums for both shaping and influencing the application of specific IFRS guidance for US technology companies.

Differences upon adoption will arise due to a number of factors including accounting policies selected, the nature of a company's business, and specific transactions. Companies will also need to resist the natural bias to default to US GAAP. There is no one-size–fits-all approach, especially in areas that involve significant 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. Since IFRS is less prescriptive than US GAAP, there may be a wider range of acceptable alternatives under IFRS. For these reasons, the use of sound and well-documented professional judgment will become even more important in an IFRS reporting environment.

On the following pages, we will discuss certain key accounting considerations for technology companies in detail.

The proposed revenue models of the joint IASB-FASB project on revenue recognition and recent Emerging Issues Task Force (EITF) developments may move both IFRS and US GAAP closer to one another.

## Revenue recognition

Over the last decade, revenue recognition under US GAAP has evolved into a form that is highly prescriptive and rules-based with extensive industry-specific accounting. In comparison, IFRS has two primary revenue standards covering general revenue recognition and construction accounting, and three primary revenue-related interpretations covering customer loyalty programs, barter transactions involving advertising services, and agreements for the construction of real estate. The broad principles laid out in IFRS are generally applied without further guidance or exceptions for specific industries. The related interpretative guidance is often applied by analogy, broadening its scope and applicability to a wider range of transactions. The principles-based nature of IFRS provides companies with incremental flexibility in interpretation, places greater emphasis on management's judgment, and allows the ability to appropriately reflect the economics of an arrangement.

The challenge for companies in adopting IFRS is to identify and understand the rationale for divergences between the two revenue frameworks. Treatments that are allowed or possible under IFRS may not necessarily be compatible with US GAAP. Conversely, strict application of US GAAP in certain circumstances may not comply with IFRS. As companies look to the impact of these potential changes, consideration will need to be given to both the operational challenges and opportunities that will need to be addressed upon conversion. Additionally, current developments in IFRS and US GAAP will require companies to continually consider how the two models converge. In particular, the proposed revenue models of the joint IASB-FASB project on revenue recognition and recent Emerging Issues Task Force (EITF) developments may move both IFRS and US GAAP closer to one another.

### Primary revenue recognition criteria

IFRS and US GAAP are broadly consistent in nature, but present subtle differences that can result in significantly different timing in the recognition of revenue and related costs.

| IFRS | US GAAP |
|---|---|
| • The entity has transferred to the buyer the significant risks and rewards of ownership of the goods<br>• The entity does not retain either continuing managerial involvement to the degree usually associated with ownership or effective control over the goods sold<br>• The amount of revenue can be measured reliably<br>• It is probable that the economic benefits associated with the transaction will flow to the entity<br>• The costs incurred or to be incurred in respect of the sale can be measured reliably<br>• The stage of completion can be reliably measured (for sale of services only) | • Persuasive evidence of an arrangement exists<br>• Delivery has occurred or services have been rendered<br>• The seller's price to the buyer is fixed or determinable<br>• Collectability is reasonably assured |

Technology companies should not miss this opportunity to perform a clean-sheet-of-paper analysis of how best to structure transactions for the business and the company's stakeholders.

### Key observations and insights

With the conversion to IFRS, technology companies have an important opportunity to re-evaluate not just their accounting, but actual business practices. Even where a company's existing US GAAP policies are acceptable under IFRS, a thorough analysis may suggest that voluntary changes better align accounting policies with economic objectives or substance and better support how management portrays the business to key stakeholders. Before finalizing their IFRS revenue recognition policies, technology companies should not miss this opportunity to perform a clean-sheet-of-paper analysis of how best to structure transactions for the business and the company's stakeholders.

Change will not come without challenge. Lack of prescriptive guidance surrounding revenue and potential increased use of management judgment will present a significant challenge in ensuring consistency in application. This challenge could potentially place higher demands on an organization, including allocation of revenue recognition resources, development of new systems and processes, and necessary incremental levels of training both internally and for key stakeholders.

For example, companies entering into multiple element arrangements involving software must perform an analysis to determine the following under US GAAP:

- Whether arrangements contain incidental or more-than-incidental software
- Whether software elements need to be separated from non-software elements
- Whether services being provided are essential to the functionality of the software
- Whether the company has Vendor-Specific Objective Evidence (VSOE) for all elements or all undelivered elements of the arrangement

Under IFRS, accordingly, companies will need to focus their analysis on management's judgment of the economic substance of the arrangement, including an assessment of the ability to separate components of a multiple element arrangement. While both GAAPs take into account the customer's perspective of the transaction, IFRS places particular emphasis on this consideration. Incremental flexibility in determination of fair value may require development of new systems and processes to capture data that historically has not been tracked. Incremental training of finance, legal and sales resources will be required to ensure appropriate accounting for transactions.

In performing an objective analysis of a company's existing revenue recognition policies, there are several potential areas of differences between the two reporting frameworks that management will need to assess, including (but not limited to):

- Persuasive evidence of an arrangement
- Determination of fair value
- Multiple element arrangements
- Use of contract accounting, including service arrangements
- Cost deferral
- Right of return
- Principal versus agent

While not an exhaustive list of potential revenue recognition differences between the reporting frameworks, these may be common potential issues that technology companies will need to address in conversion.

### Persuasive evidence of an arrangement

Under US GAAP, revenue cannot be recognized unless persuasive evidence of an arrangement exists. US GAAP rules state that where customary practice is to obtain an executed contract, no revenue may be recognized until a final contract has been signed by both parties. Conversely, there is no explicit requirement for persuasive evidence of an arrangement under IFRS. IFRS requires that revenue and costs be measured reliably and the inflow of economic benefits is probable prior to recognizing revenue. To the extent that a contract is still under negotiation, it will generally be difficult for a company to reliably estimate the revenues and costs related to all explicit and implied obligations under the agreement. However, it is also conceivable that, although total agreement has been reached, a contract may not yet have been signed for a reason independent of the negotiations between the parties.

So while rare in practice, there may be certain circumstances in which a company may have met the criteria for recognition of revenue under IFRS without having obtained all required signatures to a contract. Even though the contract has technically not been signed, the company may still be able to support that it had met the recognition criteria by (a) providing evidence that agreement of all explicit and implicit obligations had actually been reached, (b) the company has the ability to reasonably and reliably estimate revenue and all costs to be incurred, and (c) that there is a legally enforceable claim on the receivable. Accordingly, it may be inappropriate at times to delay revenue recognition under IFRS due to lack of a signed agreement.

## Example 1. Can a company recognize revenue if a master agreement has not been signed?

It may be common practice for a technology company to sign a master agreement setting out the general legal terms and conditions of transactions between the parties, with the customer issuing a separate purchase order for each product. Under US GAAP, the revenue for each transaction could not be recognized if the master agreement had not been signed. However, sales are often made before the master agreement is finally signed (or renegotiated, if it is being renewed). Indeed, delivery may have occurred (based on a purchase order), payment may already be due, and the company may have a legally enforceable right to collect its receivable. Under IFRS, in this situation a company may regard the transfer of probable future economic benefits as having occurred in advance of the signature of a master agreement, assuming the company can demonstrate that it has considered all explicit and implied obligations.

### Determination of fair value

As mentioned above, the determination of fair value for the purpose of allocating revenue to separate components of a transaction is more flexible under IFRS and should generally follow the economic substance of the underlying arrangement. Under US GAAP, fair value determination for units of accounting follows a strict hierarchy that varies depending on the industry. If these measures are not available or are inconclusive, US GAAP generally requires that revenue be deferred and recognized over the longest delivery period of the elements in the arrangement. In the software guidance, fair value is determined based on the price charged when the product is sold separately. For a product not yet being sold separately, it must be probable that the price, once established by management having the relevant authority, will not change before the separate introduction of the product into the marketplace. This is vendor-specific objective evidence (VSOE). Where software is not a part of the arrangement or is incidental, comparisons to similar goods or services sold by competitors may be used to determine fair value of elements (Verifiable Objective Evidence or VOE). If these measures do not exist, the element does not qualify to be accounted for separately under US GAAP, and revenue must be deferred.

Prescriptive rules for establishing fair value of deliverables in an arrangement do not exist under IFRS. Rather, IFRS has a broader definition of fair value as being the exchange price between two willing parties in an arm's-length transaction. Accordingly, there may be acceptable alternatives for both software and non-software arrangements in determining fair value. In addition to VSOE and VOE, which are both acceptable measures under IFRS, a company may also determine fair value using cost plus a reasonable margin. Cost plus a reasonable margin would represent the anticipated cost incurred by a company for a product or service together with its estimation of a reasonable profit margin. As a result, it will be less frequent under IFRS for a company to conclude that revenue cannot be recognized solely because fair value cannot be measured.

## Example 2. Upgrading from Version 3.0 to 3.5: What is the revenue recognition treatment of this future obligation?

Company A is selling version 3.0 of its software for $1,000, plus the right to receive version 3.5, which is due to be released in six months. Under US GAAP, Company A determined that it does not have VSOE of fair value for version 3.5 because it is has never been sold separately. Accordingly, all of the $1,000 would be deferred until delivery of version 3.5. Under IFRS, it may be possible to support the fair value of the version 3.5 upgrade based on factors such as pricing of similar rights by Company A's competitors, or use of a cost plus a reasonable margin approach. In this case, Company A could use relative fair value or the residual method to recognize revenue related to version 3.0 up-front.

The flexibility offered by IFRS in the determination of fair value may have an impact on associated systems, processes, and controls. During a conversion assessment, companies should consider the various options in the determination of fair value in the structuring of their sales transactions. Where sales transactions may have been historically structured to achieve a certain accounting result under US GAAP, IFRS may provide companies with more flexibility in the negotiation of sales arrangements and allow the accounting to follow the underlying economic substance of the arrangement. As companies seek to operationalize under IFRS, they need to weigh the benefits of this flexibility with the robust control mechanism and level of discipline in pricing and sales discounts that currently exist. Consider the example below.

## Example 3. Flexibility in determination of fair value: The potential business impact of moving to other measures of fair value

Company A currently uses VSOE to support fair value of its software product under US GAAP. During its preliminary conversion assessment, the company evaluated the options for determining fair value. In its assessment, management confirmed that, with sufficient systems investment, it could use cost plus a reasonable margin as a measure of fair value. Due to the highly specialized nature of its product, it would be unable to use VOE to establish fair value for IFRS. Company A noted that use of VSOE as a measure of fair value provided the company with rigidity and discipline in pricing and discounting and gave it additional control over its sales force. Accordingly, under IFRS, Company A may be able to continue using VSOE to support fair value, and, not a cost plus a reasonable margin approach as long it can demonstrate that VSOE of fair value best captures the economics of the arrangement. However, companies should also be careful not to select this fair value measure to purely align its IFRS model to existing US GAAP practices.

## Multiple element arrangements

Differences involving the separation of multiple element arrangements into components and the allocation of consideration between those components may significantly impact the timing of revenue recognition.

The IFRS separation guidance is based primarily on analyzing the substance of the arrangement from the customer's perspective and concluding how best to reflect the commercial effect of the transaction. It is more subjective and judgmental than US GAAP. Under US GAAP, the separation and allocation approach for multiple element arrangements is more regimented and requires the determination of standalone value and measurement of fair value using a stricter fair value hierarchy such as VSOE or VOE.

The measurement of the fair value and allocation of revenue to components under IFRS is more flexible than US GAAP as there are more fair value measures (e.g. cost plus a reasonable margin) that may be used and there is no prescribed hierarchy for how to apply these measures. Accordingly, this judgment-based determination, combined with differences in the fair value thresholds, may make it easier to separate components using IFRS, possibly leading to earlier revenue recognition.

Once elements in an arrangement have been assessed for separation, IFRS contains allocation models that are consistent with US GAAP providing, by analogy, allocation methods for multiple element arrangements based upon relative fair value(s) or use of the residual method.

From a conversion perspective, management will need to assess any areas under US GAAP where revenue is being deferred (e.g. where it has historically been unable to separate elements in multiple element transactions or establish fair value based upon an inability to meet a higher threshold such as VSOE). For those identified areas requiring specific analysis under the IFRS framework, management should evaluate the IFRS treatment. The outcome of this exercise may identify areas where revenue recognition would have been accelerated under IFRS. Accordingly, existing deferred revenue balances may have to be recast upon the date of transition to IFRS. This may result in lost or deferred revenue that will be reflected as an opening balance adjustment to retained earnings upon transition, and not recognized in future periods under IFRS. Technology companies should look to identify potential areas of 'lost revenue', consider amending existing contractual arrangements to mitigate concerns, or plan the process of educating key stakeholders where such change is unavoidable.

The FASB's issuance of the proposed EITF 08-1, *Revenue Arrangements with Multiple Deliverables*, may lead to greater use of another fair value threshold (e.g. the residual method utilizing estimated selling prices) enabling separation of multiple element arrangements into more units of accounting. The EITF may allow companies to unbundle more elements in an arrangement due to the ability to use a lower fair value threshold. Companies can use estimated selling price to determine fair value only using the residual method that is broadly consistent with the concept of cost plus a reasonable margin under IFRS. This is likely to narrow the differences in the ability to separate and determine fair value for technology companies who are outside the scope of the software guidance. While the proposed EITF's lower fair value threshold does not apply to software arrangements, it is anticipated that future guidance will address the interaction of EITF 08-1 and software arrangements.

### Use of contract accounting, including service arrangements

Under US GAAP, use of the percentage-of-completion method is generally precluded unless the transaction is within the scope of contract accounting. Under IFRS, the application of percentage-of-completion accounting is primarily driven by the nature of the underlying activity and includes arrangements for the rendering of services. Accordingly, a broader scope of transactions will qualify for percentage-of-completion accounting under IFRS. Conversely, certain industries where use of percentage-of-completion was mandated under US GAAP may not be permitted to use percentage-of-completion under IFRS.

Under IFRS, a construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. IFRIC 15, *Agreements for the Construction of Real Estate*, further clarifies the scope of IAS 11, *Construction Contracts*, by analogy. Under IFRIC 15, an agreement to construct an asset is within the scope of percentage-of-completion accounting when the buyer is able to specify the major structural elements of the design or where risks and rewards clearly transfer over time. Where the buyer is unable to specify structural elements or risks and rewards do not transfer over time, percentage-of-completion accounting is not permitted.

Service arrangements (except those directly related to the construction of an asset that is scoped into IAS 11) are required to follow the revenue recognition provisions of IAS 18, *Revenue*. IAS 18, however, allows companies to use the percentage of completion guidance contained in IAS 11 but does not allow companies to use all of the provisions of IAS 11. Accordingly, service arrangements should be recognized using the percentage-of-completion method (which involves the performance by an entity of a contractually agreed task over an agreed period of time). Where there is no discernible pattern of delivery or an indeterminate number of acts, services are recognized on a straight-line basis.

In the application of percentage-of-completion accounting, IFRS and US GAAP prescribe different treatment in the event that costs or progress toward completion cannot be reliably estimated. In such circumstances, US GAAP prescribes a completed contract method. Under IFRS, the use of the completed contract method is prohibited. The zero-profit method is required when the final outcome cannot be estimated reliably (e.g. revenue is recognized only to the extent of contract costs incurred that are expected to be recovered). This may impact a company's gross margin.

Technology companies will need to assess the applicability of percentage-of-completion to their business upon transition to IFRS. The broader scope of the guidance could potentially result in incremental revenue streams being accounted for using percentage-of-completion. The ability to measure and track costs is an incremental component of the ability to use percentage-of-completion accounting. Accordingly, in advance of conversion to IFRS, technology companies should look to system capabilities and data availability to both facilitate and substantiate use of percentage-of-completion accounting.

### Example 4. Agreement to provide hardware to a customer's specification

A company contracts to deliver 1,000 computers under a fixed price arrangement. The customer provides specifications for processing speed, graphics chips, and memory capacity based on the company's standard menu of options and enhancements for its line of PCs. The contract does not have the attributes of a construction contract as the customer's influence over the design of the product is limited to the selection of pre-existing components marketed to the general public. As such, revenue would be recognized under the provisions of IAS 18 (sale of product) versus IAS 11 (construction accounting).

In situations where the attributes of the arrangement are more similar to a construction contract (i.e. where the buyer specifies structural elements), IAS 11 may be more appropriate.

These types of arrangements should be evaluated using IFRIC 15 to determine whether IAS 11 or IAS 18 is applicable.

#### Cost deferral

Under IFRS, costs associated with performing revenue activities may only be deferred if they meet the recognition and measurement criteria of an asset (such as inventory; property, plant, and equipment; or an intangible asset). Since the definition of an asset may differ under IFRS (for example, in the case of internally generated intangible assets), technology companies will need to re-evaluate the nature of their costs and related accounting policies and practices.

#### Right of return

IFRS lacks the extensive prescriptive guidance of US GAAP, focusing its requirements on the ability to make a reliable estimate of future returns based on prior experience. In the basic framework, the application of IFRS and US GAAP should not differ. The SEC provides incremental prescriptive guidance in SAB 104, *Revenue Recognition*, and other interpretative guidance surrounding rights of return. While none of these prescriptive factors exist under IFRS, they may be used as a reference to provide directional guidance in making reasonable and reliable estimates. However, failure to meet any of the factors would not automatically preclude revenue recognition under IFRS. These factors would be considered in any assessment of a company's ability to both make a reliable estimate and meet the general revenue recognition criteria.

Upon conversion to IFRS, management should be prepared to substantiate any changes to existing revenue recognition policies. GAAP differences could potentially arise due to the existence of specific US GAAP or SEC guidance that does not exist in IFRS. However, it is important to remember that the underlying principles for both US GAAP and IFRS are similar, so differences purely based on the form and substance of an arrangement will be rare in practice.

### Principal versus agent

A determination of whether a company should recognize revenue based on the gross amount billed to a customer because it has earned revenue from the sale of the goods or services or the net amount retained because it has earned a commission or fee is a matter of judgment that depends on the relevant facts and circumstances. US GAAP requires an assessment of specific indicators, with certain indicators carrying higher weight in the analysis. IFRS contains the concepts of principal and agent, but is not as prescriptive as the guidance provided by US GAAP.

The IASB's 2008 Improvements to IFRSs propose the following features that bring the definition of a principal closer to US GAAP:

- Primary responsibility for providing the goods or services to the customer or for fulfilling the order
- The entity has inventory risk
- The entity has discretion in establishing prices
- The entity bears the customer's credit risk

As IFRS does not provide any weighting of factors, there potentially could be some application differences. However, in practice it is quite rare to have any GAAP differences on gross versus net presentation matters.

Technology companies may also need to further evaluate potential differences surrounding the classification of costs such as out-of-pocket expenses, sales taxes, and shipping and handling fees that are addressed by specific guidance under US GAAP. IFRS does not provide similar prescriptive guidance and, as a result, technology companies may need to re-evaluate the classification within the broader principles of IFRS as well as any new gross versus net indicators.

### IASB and FASB joint project

In the currently proposed revenue model by the joint IASB-FASB project, revenue should be recognized on the basis of increases in a company's net position in a contract (an agreement between two or more parties that creates enforceable obligations) with a customer. When a company becomes a party to a contract with a customer, the combination of the rights and the obligations in that contract gives rise to a net contract position. Whether that net contract position is a contract asset or a contract liability depends on the measurement of the remaining rights and obligations in the contract.

In the currently proposed model, revenue is recognized when a contract asset increases or a contract liability decreases (or some combination of the two). This occurs when a company performs by satisfying an obligation in the contract. A company's performance obligation is a promise (explicit or implicit) in a contract with a customer to transfer an asset (such as a good or a service) to that customer.

A company satisfies a performance obligation and, thus, recognizes revenue when it transfers a promised asset (such as a good or a service) to the customer. The company has transferred the promised asset when the customer obtains control of it.

Performance obligations initially should be measured at the transaction price—the customer's promised consideration. If a contract comprises more than one performance obligation, an entity would allocate the transaction price to the performance obligations on the basis of the relative standalone selling prices of the goods and services underlying those performance obligations.

Subsequent measurement of the performance obligations should depict the decrease in the entity's obligation to transfer goods and services to the customer. When a performance obligation is satisfied, the amount of revenue recognized is the amount of the transaction price that was allocated to the satisfied performance obligation at contract inception. Consequently, the total amount of revenue that a company recognizes over the life of the contract is equal to the transaction price.

The proposed single, contract-based revenue recognition model, while designed to improve financial reporting and provide consistency in reporting regardless of the industry in which a company operates, may have far reaching impacts on most revenue recognition models.

### Other practical considerations

As revenue recognition models change due to additional options and flexibility under IFRS, technology companies should also consider the impact on compensation and incentive programs as well as current controls in place for the sales force. Operation and implementation assessments, particularly those related to sales force behaviors and incentives, should be performed prior to any IFRS policy elections being made.

Any changes in revenue recognition under IFRS may need to be assessed for potential conformity with local tax rules and associated tax accounting method changes. These changes could impact a company's transfer pricing, state and local income tax apportionment factors, and directly affect cash and deferred income taxes.

## Research and development

Under US GAAP, research and development (R&D) costs are expensed as incurred, except for certain software and website development costs. Depending on whether software development activities are intended for internal or external use, technology companies may be required to capitalize certain costs based on one of two accounting models. Website development costs are accounted for pursuant to a model similar to the framework for internal use software development costs.

IFRS has a single standard for all internally generated intangible assets. Similar to US GAAP, costs incurred in the research phase are expensed. Development activities are required to be identified and then assessed to determine whether an internally generated intangible asset has been created. However, the relevant scope of development activities is not limited to software or website efforts; the guidance is applicable across industries and all types of development activities, such as development of hardware solutions. Once certain criteria have been demonstrated, development costs are required to be capitalized until the project moves into production or use.

In general, we expect to see increased capitalization of development costs under IFRS.

In general, we expect to see increased capitalization of development costs under IFRS. Technology companies will need to carefully understand and monitor the various stages of their product life cycle for all development activities and identify the point from which expenditures potentially meet the capitalization requirements under IFRS. This will involve significant management judgment and may not always permit reliable peer comparison. Many technology companies also currently lack the systems to separately identify and track internal costs with the level of transparency or accuracy required to initiate the implementation of this accounting thereby creating a significant challenge upon conversion. Furthermore, the requirement to track detailed time and labor activities could potentially impact the culture in a company's R&D function and will require careful communication and rollout from management.

A majority of technology companies do not currently capitalize software development costs under US GAAP because the costs incurred between the establishment of technological feasibility and general availability of external use software are often not significant. Technology companies will need to reassess this determination and establish appropriate capitalization thresholds in accordance with IFRS, the criteria of which differs from US GAAP and is discussed below. This could potentially result in different capitalization milestones than those previously used under US GAAP. An additional consideration for technology companies will be a potential impact to gross margin as certain capitalized development costs are required to be amortized to cost of sales. Communication of this impact to stakeholders will be a key consideration for management during the conversion to IFRS.

Another significant challenge for companies surrounds the determination of the opening balance sheet amount for development costs upon IFRS adoption. Technology companies will be required to track development activities for a period in advance of their date of transition to IFRS dependent upon their elected useful lives for internally generated intangible assets. For example, consider a company with an initial reporting date of December 31, 2014, and a useful life of three years for internally developed intangible assets. Assuming a two-year comparative reporting period requirement upon transition, all development activities subsequent to January 1, 2009, would have to be assessed for capitalization. Accordingly, the urgency of addressing this issue for technology companies should not be underestimated.

It is important that each company perform and document an analysis that supports its accounting for development costs under IFRS.

### Key observations and insights

While we expect global practice in this area to evolve as business models mature, it is important that each company perform and document an analysis that supports its accounting for development costs under IFRS. Even companies that ultimately do not capitalize development efforts will need sufficient evidence that none of the costs incurred in the development phase meet the capitalization requirements. This could result in as much work and analysis as it would to support capitalization.

Under IFRS, costs in the development phase should be capitalized when all of the following criteria are demonstrated:

- The technical feasibility of completing the intangible asset so that it will be available for use or sale
- The intention to complete the intangible asset and use or sell it
- The entity's ability to use or sell the intangible asset
- How the intangible asset will generate future economic benefits – that is, the entity should demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if for internal use, the usefulness of the intangible asset
- The availability of adequate technical, financial, and other resources to complete the development and to use or sell the intangible asset
- The entity's ability to measure reliably the expenditure attributable to the intangible asset during its development

These are requirements and not an accounting policy election that a company may choose to ignore. If the criteria for capitalization are met, the entity must record the intangible asset.

While the criteria for capitalization of development costs under IFRS appear to be similar to US GAAP, it is important to understand the subtle differences. For example, the term “technical feasibility” under IFRS is not defined, as opposed to the prescriptive US GAAP guidance for external use software, which defines “technological feasibility” in the context of two models: detailed program design or working model. Accordingly, technology companies may determine that technical feasibility under IFRS is reached at a different point in time when compared to technological feasibility under US GAAP. On a practical level, the trigger point for capitalization under IFRS typically may be determined to be a point on a company’s development lifecycle prior to the production of a working model as defined under US GAAP. Similarly, technology companies may determine that technical feasibility for internal use software is reached at a different point in time than the application development stage under US GAAP. Both of these assessments will require specific analysis based on the facts and circumstances of each company and significant management judgment. Depending upon the significance of capitalized development costs to a company’s results, IFRS may require disclosure of these judgments as a component of both the critical accounting estimates and assumptions and significant judgments sections of a company’s financial statements.

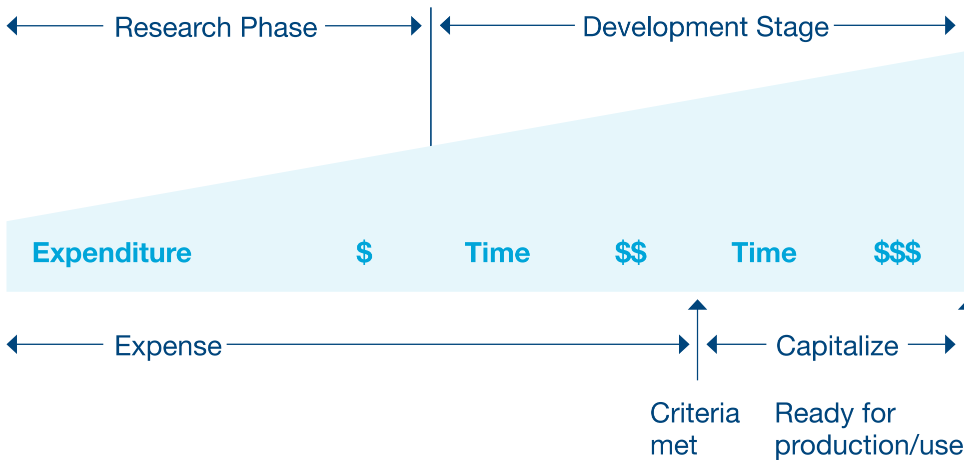
The scenario below illustrates how a company could potentially assess the capitalization criteria during its transition from US GAAP to IFRS.

### Example 5. Determination of the relevant point of capitalization under IFRS

Company B is innovative and annually makes significant investments in R&D activities to develop software that enables it to remain competitive and responsive to evolving customer needs. Historically, Company B has not capitalized any development costs under US GAAP as the period between the point of achieving technological feasibility and product release is usually relatively short and, as a result, the potential costs are not significant.

Under IFRS, Company B re-evaluated its product life cycle to determine at what stage the criteria for cost capitalization is met. Company B concluded that it could make this determination at a point during the validation stage of its product development lifecycle resulting in an earlier capitalization milestone than the working model approach under US GAAP.

It is also important to note that not all development costs are capitalized, only those that meet the specific criteria for capitalization. The following illustrates a potential milestone for capitalization of development costs within an R&D lifecycle:




Once the criteria for capitalization have been achieved, an indefinite-lived intangible asset is recorded until the development project moves into production or use. During this period, the asset will need to be monitored and assessed, both annually and on a triggering event basis, in accordance with a company's impairment testing policy under IFRS. Where a development project is impaired during this intervening period, the impairment charge is recorded as a component of R&D expense in the income statement.

Once the project is ready for production or use, the asset is reclassified as a finite-lived intangible asset, amortized over the asset's expected useful life, and tested for impairment upon triggering events. Capitalized development costs for internal use are amortized to the appropriate function or nature expense categories that benefit from the underlying asset. Capitalized development costs for external use are required to be amortized to cost of sales, impacting gross margin. Technology companies will need to educate stakeholders regarding the ongoing incremental impact on gross margin and potential for one-time impairments impacting gross margin within a discrete reporting period.

Supporting the accounting for development costs may require significant systems and process changes.

Supporting the accounting for development costs may require significant systems and process changes that allow robust tracking and analysis, visibility to underlying activities, and identification of associated expenses. Companies should consider exploring existing project and time and labor functionality within their ERP solution to address data-gathering requirements. Process and controls changes will also have to be considered from an internal controls perspective. These changes could represent a significant adjustment in workplace culture, especially for employees who perform R&D roles. Employees who had previously worked without stringent monitoring and tracking may now be required to complete detailed time and activity sheets.

Management will also have to carefully message and control the rollout of any changes to existing systems and processes in order to manage expectations of affected employees. Incremental impairment monitoring and testing processes will also have to be established surrounding indefinite and finite lived intangible assets relating to development efforts. However, with the adoption of FAS 141R, *Business Combinations*, and the related requirement to capitalize in-process R&D, many companies may have an existing monitoring process to leverage in their assessment of capitalized development costs under IFRS.

These changes will not be without benefit for an organization. If implemented properly, enhanced tracking of R&D costs may enable companies to better measure their return on investment from R&D activity. The resulting incremental transparency may also enable companies to become more agile in their ability to control R&D spending and be able to expand or contract efforts in response to market and competitive conditions.

### Potential tax impacts

The potential increased capitalization of development costs for book purposes under IFRS may result in incremental scrutiny from tax authorities in the corresponding detailed positions taken on tax returns. The substantial documentation often required under IFRS for the appropriate accounting of development costs may also provide tax authorities with an increased ability to assess and potentially challenge the character of expenditures eligible for tax credits.

While progress has been made toward convergence in this area, there are still significant differences between US GAAP and IFRS that will present unique challenges for technology companies.

## Share-based payments

Many technology companies use share-based payments as a key component of their compensation programs in order to attract, retain, and motivate employees. Share-based payment plans and their related record keeping systems have evolved as the accounting rules under US GAAP have changed, culminating with the adoption of FAS 123R, *Share-Based Payment*. While progress has been made by the FASB and IASB toward convergence in this area, there are still a number of significant differences between the two frameworks that will present unique challenges for many technology companies upon conversion. These differences could potentially impact reported earnings, analyst estimates and projections, a company's effective tax rate, financial statement classification, and cash flows upon adoption of IFRS.

### Key observations and insights

In addressing the impact on a company's existing share-based payment plans, there are several areas of differences between the two reporting frameworks that management will need to assess, including but not limited to:

- Graded vesting
- Tax consequences—recognition and changes in share price
- Withholding tax obligations
- Timing of recognition of social charges
- Arrangements with non-employees
- Cash flow statement—classification of excess tax benefits

Several of these differences may already be familiar to multinational technology companies due to statutory reporting requirements for subsidiaries already reporting under IFRS. Given the relative complexity of the application of IFRS at a subsidiary level, the difficulty of the application of the IFRS guidance at a parent level should not be underestimated.

There are many other detailed areas of application where the treatment under the two frameworks differs. This may impact the classification, attribution, or measurement of specific share-based payments, particularly those with performance or market conditions, restrictions or any that are subject to modifications.

## Graded vesting

Under US GAAP, companies have an accounting policy choice regarding expense recognition of an award that has a graded vesting schedule with a service condition. A company can elect to recognize compensation expense either over the requisite service period for each separately vesting portion of the award as if the award was in substance multiple awards, or on a straight-line basis over the requisite service period for an entire award. Most companies elected the latter option primarily due to its relative simplicity in application. However, IFRS requires a company to treat each installment of a graded vesting award as a separate grant. This requires separately measuring and attributing expense to every tranche of an award at each reporting date (for example, quarterly), thereby accelerating the overall expense recognition.

The example below demonstrates the differences in attribution of expense between the straight-line and graded vesting method.

**Table A.**
**Illustrative expense recognition for a graded vesting award under IFRS**

| | Recognized expense | | | |
|---|---|---|---|---|
| **Tranche** | **Year 1** | **Year 2** | **Year 3** | **Year 4** |
| 1—100 shares | 100 | | | |
| 2—100 shares | 50 | 50 | | |
| 3—100 shares | 33 | 33 | 34* | |
| 4—100 shares | 25 | 25 | 25 | 25 |
| Total | 208 | 108 | 59 | 25 |
| | 52% | 27% | 15% | 6% |

* rounded for simplicity

## Example 6. What's the difference between the straight-line and graded vesting methods?

Company A grants an employee options to purchase 400 shares of common stock. The grant vests in four equal tranches of 100 shares per year over four years. Under the straight-line method, total compensation cost is recognized on a straight-line basis over the four year vesting period, resulting in the recognition of expense relating to 100 options per year.

Under the graded vesting method, the total compensation cost of the option grant is divided into the four separate vesting tranches of 100 shares, each of which are valued and recognized over their respective vesting periods of one, two, three, and four years.

While the expense related to the one-year tranche of 100 shares is recognized in the first year, so is half of the second-year tranche, one-third of the third-year tranche, and one-fourth of the fourth-year tranche.

**Chart A.**
**Comparison of straight-line versus graded vesting annual expense recognition**

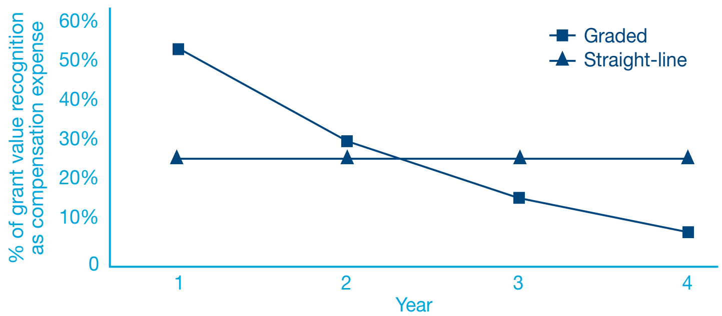
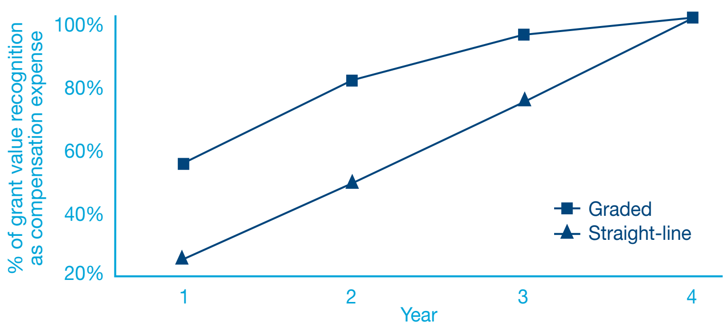



**Chart B.**
**Comparison of straight-line versus graded vesting cumulative expense recognition**



In addition to separately attributing each award, IFRS requires measurement of each tranche separately. Consider an example where management grants a four-year award with a one-year cliff and then monthly ratable vesting. Under US GAAP, this would be measured as a single award. Under IFRS, this would result in 37 separate awards (a single one-year cliff award and 36 separate monthly awards). The difference in valuation is primarily driven by the expected term of each award which, dependent upon the number of tranches in an award and employee exercise behavior, could dramatically impact its valuation.

Additionally, companies using the straight-line method under US GAAP will have to recast unvested options upon conversion to reflect graded vesting. This will lead to accelerated recognition of a portion of previously unrecognized shared-based compensation directly to equity upon transition.

Upon conversion to IFRS, technology companies should ensure that their internal record keeping system or third-party equity ledger contains the functionality to both separately attribute and measure individual tranches of graded vesting awards. Given the relative complexity of the application of graded vesting under IFRS, companies should be cautious in using manual workarounds such as spreadsheet solutions, especially in a Sarbanes-Oxley 404 certification environment.

IFRS will result in additional tax expense volatility and create significant incremental record keeping demands as the deferred tax asset must be tracked for each individual grant and remeasured at each reporting period.

### Tax consequences—recognition and changes in share price

Both US GAAP and IFRS require recognition of a deferred tax asset for the deductible temporary difference that arises due to recognition of book expense related to share-based payments that are expected to result in tax deductions upon exercise or vesting. The two frameworks require different measurement of the deferred tax asset over the life of the award and ultimately upon triggering of the taxable event. IFRS may result in additional tax expense volatility and creates significant incremental record keeping demands as the deferred tax asset must be tracked for each individual grant and re-measured at each reporting period to reflect the expected tax deduction if the award was exercised at the reporting date.

Typically, companies receive a tax deduction under US Federal Income Tax rules upon the exercise of a non-qualified stock option or upon vesting of restricted stock or restricted stock unit. The amount of the deduction will be based on the value received by the employee on that date—that is, the intrinsic value of an option or the value of a share of common stock for restricted stock or restricted stock unit less any exercise price paid by the employee. The following discussion is based on a tax deduction that is expected to result under US Federal income tax rules upon exercise of a non-qualified stock option.

Under US GAAP, a deferred tax asset is recorded as an entity recognizes book compensation expense and the corresponding deferred tax benefit in the income statement. That deferred tax asset is not adjusted to reflect the expected tax deduction—such deduction would be based on the intrinsic value of the grant—until the option is exercised and the taxable event occurs. When the taxable event occurs, the tax effect of any excess deduction over the accumulated deferred tax asset (the "tax windfall") is recognized as a credit to additional paid-in capital. If the tax effect of the deduction is less than the accumulated deferred tax asset at the date of exercise, the amount by which the deferred tax asset exceeds the tax effect of the deduction (the "tax shortfall") first reduces previously recognized windfalls in additional paid-in capital to the extent they have not been previously reduced and then any remaining shortfall is recognized as tax expense.

Under IFRS, the deferred tax asset at each reporting period should reflect the amount of the future reduction in taxes payable anticipated due to the deduction that is expected to result upon exercise. As such, the deferred tax asset is adjusted each reporting period until exercise to reflect the amount of the expected future tax deduction based on the intrinsic value of the options at the reporting date. The deferred tax benefit related to the expected deduction is recognized in the income statement up to the amount of the tax benefit attributable to book compensation expense recognized for that grant. To the extent that the expected deduction exceeds book compensation expense recognized for that grant, a credit is recorded in equity. Future reductions in the expected tax deduction reduce the credits recognized in equity for that grant only to the extent that they have not been previously reversed. Further decreases in the expected tax deductions beyond the amount recognized in equity are recognized as an increase of tax expense for the period in which they occur.

Consequently, for stock options granted with an exercise price that equals or exceeds the fair market value of the shares, no deferred tax asset is recognized under IFRS unless there is an increase in the underlying share price because no inherent tax deduction is present in the award. Tax benefits are only recorded as, and to the extent, the stock price rises. This will typically trail, often by a considerable length of time, the recorded compensation expense. Under IFRS, a company will have to revise the deferred tax asset each balance sheet date for the entire life of the award on an employee-by-employee and grant-by-grant basis. Decreases in deferred tax assets (i.e. shortfalls) are only recorded against equity to the extent the same equity award had resulted in a windfall in a prior period. IFRS does not include a windfall pool concept. As a result, the future changes in the company's stock price will result in potentially significant volatility to the effective tax rate.

Upon conversion to IFRS, technology companies should ensure that their internal record keeping system or third-party equity ledger contains the capability to calculate deferred tax adjustments at each reporting period. Such a calculation should incorporate the ability to track on a grant-by-grant basis changes in share price; vesting, forfeiture and exercise activity; cumulative share-based payment expense; and recognized tax windfalls, in order to correctly measure and recognize tax benefits over the life of share-based payment award.

Technology companies may need to reassess the administration of their equity compensation plans and consider changes to their broker-assisted exercise process.

### Withholding tax obligations

Share-based compensation plans often include arrangements to settle option and share grants within statutory withholding limits, for example, a broker-assisted exercise process for options. Under US GAAP, a company may withhold shares upon settlement of the award to satisfy the employee's share of withholding taxes and continue to classify the award as equity-settled, provided that the withholdings do not exceed statutory minimums. This enables companies to avoid liability accounting for these awards.

IFRS provides no such exception for withholding limits, as classification of an award generally follows the settlement mechanism. As a result, any portion of an award that may be net-settled to satisfy withholding taxes must be separated and accounted for as a cash-settled award causing it to be remeasured at each reporting period. In order to maintain classification as an equity-settled award, shares issued by the company would be required to be sold on the open market to generate the cash necessary to satisfy withholding obligations. Accordingly, technology companies may need to reassess the administration of their equity compensation plans and consider changes to their broker-assisted exercise process.

### Timing of recognition of social charges

Under US GAAP, a liability for employee payroll taxes or social charges on employee stock-based compensation should be recognized on the date of the event triggering the measurement and payment of the tax to the taxing authority. This generally occurs on the exercise date for options and the vesting date for restricted stock, although this may vary in some territories.

Under IFRS, social charges are expensed when the related compensation expense associated with a share-based payment transaction is recognized in the income statement. Since this obligation is considered a cash-settled transaction, it is remeasured at each reporting period to reflect the value of the underlying grant through the date of exercise. This will result in a record keeping requirement to track the underlying obligation for each relevant grant by jurisdiction and applicable tax rate over the life of a share-based payment instrument.

### Arrangements with non-employees

US GAAP contains a very strict legal definition of an employee based on US common law and an Internal Revenue Service ruling. Share-based payments to non-employees are measured at the earlier of the completion of performance and the performance commitment date and are based on either the fair value of the instruments issued or the fair value of the goods or services received, whichever is more reliably measurable. In most cases, the fair value of the instruments issued is preferred under US GAAP.

IFRS focuses on the nature of the services provided and treats awards to employees and other individuals providing employee-type services similarly, regardless of whether they meet the legal definition of an employee. Awards for goods from vendors or for non-employee-type services are treated differently. Share-based payments for non-employee-type services are measured at the dates that the goods are received or services are rendered and are based on the fair value of the goods or services received. However, if the consideration received appears to be less than the fair value of the equity instruments granted or liability incurred, this indicates that other consideration (such as unidentifiable goods or services) has been received. In this case, incremental compensation cost would be recognized for the difference.

### Cash flow statement: classification of excess tax benefits

Under US GAAP, excess tax benefits, such as windfalls, associated with share-based payment transactions are classified, under both the direct and indirect methods of reporting cash flows, as cash inflows from financing activities. The amount shown in the financing section of the statement of cash flows is equal to the sum of the gross windfall tax benefits. Under the indirect method, any shortfalls resulting from the write-off of deferred tax assets are included in net income (or loss) and reflected in the change in the deferred tax asset in the operating section of the statement of cash flows.

Under IFRS, all cash flows from excess tax benefits, such as windfalls, associated with share-based payment transactions are presented as cash flows from operating activities in the statement of cash flows. Upon conversion, technology companies will need to communicate this change to their stakeholders as this will have the effect of increasing operating cash flows impacting free cash flow analyses.

## Income taxes

The implications of adopting IFRS go well beyond the potential impact on a company's effective tax rate or income tax-related disclosures in a company's financial statements. The move to IFRS has broad tax implications for a technology company; potentially impacting global cash tax obligations, international tax planning and underlying systems, processes and controls. The book financial accounting aspects of IFRS have a myriad of tax method accounting considerations. Accordingly, it is essential that tax executives be part of the IFRS conversion process. Proper assessment of the tax impact of each potential accounting change not only requires insight into the applicable tax rules and regulations in various tax jurisdictions, but also knowledge of the detailed differences between US GAAP, IFRS, and local statutory accounting, where applicable.

A company's tax function will need to understand and analyze each change to book accounting policies and methods in all applicable jurisdictions.

### Key observations and insights

In addition to applying differences between the tax standards in IFRS and US GAAP to the accounting for income taxes, a company's tax function will need to understand and analyze each change to book accounting policies and methods in all applicable jurisdictions. There are a significant number of potential differences between IFRS and US GAAP that could materially affect pre-tax accounting income, some of which have been discussed in the preceding sections of this document. In the US, tax methods of accounting do not necessarily follow a company's book method of accounting. As a result, a conversion to IFRS will require an analysis of each new accounting policy for its related tax implications, including a determination as to whether it is permissible or advisable to conform the related tax method of accounting to the new book accounting method. A tax accounting method also frequently does not automatically change because the book accounting method changes. Rather, the company may need to obtain consent of the respective taxing authority. Each jurisdiction may have a different process to obtain such consent and address the transition effects in various ways. For example, in the US a tax liability arising from a change in accounting method can often be paid over four years.

Certain other jurisdictions, with increasing frequency, measure a company's taxable profits mainly in accordance with its financial accounts and permit or require adoption of IFRS at the legal entity level. In such cases, the adoption of IFRS will likely have a direct impact on a company's cash tax position and more attention will need to be focused on the cash tax implications of the various financial accounting policy decisions made during the conversion to IFRS.

For US companies, systems, processes, and controls used within the tax department have been primarily designed to deliver information to meet the financial statement reporting requirements of US GAAP, along with various tax compliance and reporting requirements. Recent developments in tax and financial reporting have increased the importance of these systems and processes. Companies have sought to automate and enhance their tax processes to reduce risk and increase efficiency. A change in the underlying basis of accounting to IFRS will require tax departments to perform a review of their systems and processes for gathering tax-related data. Systems and processes that have been used to track or compute book-tax differences, record the tax treatment of stock-based compensation, or calculate the tax provision will need to change. Transfer pricing documentation, as well as agreements with tax authorities and tax rulings that may have been based on US GAAP or local statutory accounting, may need to be recast onto an IFRS basis.

The adoption of IFRS by tax jurisdictions and IFRS as a common accounting language throughout the enterprise may also provide opportunities for increased efficiencies in the tax function. Tax departments may no longer have to reconcile many different statutory accounts to the financial accounts and other tasks may be addressed more centrally.

Although the US GAAP and IFRS frameworks share many fundamental principles such as a balance sheet approach, they are at times interpreted and applied in different manners. The following represent some of the more significant differences between the two standards, taking into consideration the expected proposals by the IASB for a replacement of IAS 12, *Income Taxes*:

- **Uncertain tax positions:** The IASB is expected to require a probability-weighted-average approach to recognize and measure uncertain tax positions without considering a recognition threshold. This will likely lead to an increased level of effort under IFRS than the current FIN 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*, processes, as all possible outcomes have to be identified and likely more positions will need to be assessed. However, disclosure requirements are expected to be generally less onerous under IFRS for uncertain tax positions.
- **Unrealized intragroup profits:** Under US GAAP, any income tax effects resulting from intragroup profits are deferred by the seller and recognized upon sale to a third party or depreciation/amortization of the transferred asset. IFRS requires the recognition of the seller's tax consequences and the recording of deferred taxes based on the buyer's tax rate at the time of the initial transaction. The net effect of recognizing the seller's tax consequence and the buyer's deferred tax asset requires multinational entities to consider the location of their cross-border inventories at the balance sheet date because the location of the inventory could result in a significant impact to recorded tax assets. For enterprises with significant fluctuations in inventory levels between periods or significant property transfers, this difference could also affect the effective tax rate.
- **Non-monetary assets:** For subsidiaries with a functional currency different than the local currency, the relevant book basis of non-monetary assets is determined at historical exchange rates. IFRS requires the recognition of deferred taxes on the difference arising between the local currency tax basis and the book basis at historical exchange rates, even though such difference is not affecting pre-tax income. US GAAP prohibits the recognition of such deferred taxes and accordingly the conversion to IFRS will result in additional volatility in the effective tax rate.

# First-time adoption: Where do technology companies begin?

IFRS 1 is the relevant guidance applied during a company's first-time adoption of IFRS and preparation of its first IFRS financial statements. As a general principle, IFRS 1 requires the opening balance sheet to be prepared and presented as if IFRS had always been applied, with full retrospective application of all standards that are effective as of the first IFRS reporting date. In other words, a company's first set of IFRS financial statements should be presented as if it had always used IFRS as its basis of accounting. Successive versions of the same standard are not applied in different periods. Full retrospective application can be extremely challenging given that information may not be readily available and data gathering can be extremely onerous. Given these facts and circumstances, IFRS 1 provides a number of exemptions and exceptions from this general principle that provide potential relief.

## Key definitions under IFRS 1

Before we begin our discussion of first-time adoption, it is important to define certain key terms that apply to the preparation of a company's first IFRS financial statements. These dates are the transition date, the adoption date, and the reporting date.

- The transition date is identified as the beginning of the earliest period for which full comparative information is presented in accordance with IFRS. IFRS standards require an opening balance sheet be prepared and presented as part of the first IFRS financial statements.
- The date of adoption, although not defined in the standard, is commonly understood as the beginning of the fiscal year for which IFRS financial statements are prepared.
- The reporting date is defined as the closing balance sheet date for the first IFRS financial statements. A company may apply an IFRS standard that has been issued as of the reporting date, even if it is not mandatory, as long as the standard permits early adoption.

### What does first-time adoption entail?

The key principle of IFRS 1 is full retrospective application of all IFRS standards that are effective as of the closing balance sheet or reporting date of the first IFRS financial statements. These are the first financial statements to contain an explicit and unreserved statement of compliance with IFRS. Companies are required 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 them 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 opening IFRS balance sheet is the starting point for all subsequent accounting under IFRS and is prepared at the date of transition, which is the beginning of the earliest period for which full comparative information is presented in accordance with IFRS. IFRS 1 requires that the opening IFRS balance sheet:

- Recognize assets and liabilities required under IFRS.
- Derecognize assets and liabilities that IFRS does not permit.
- Classify assets, liabilities and equity in accordance with IFRS.
- Measure all items in accordance with IFRS.

These general principles are followed except where one of the optional exemptions or mandatory exceptions does not require or permit recognition, classification, or measurement in accordance with IFRS.

## Retroactive application exemptions and exceptions

Exemptions are designed to ease the burden of retrospective application. Use of exemptions is entirely elective. IFRS 1 is generally updated upon issuance of new standards. Accordingly, companies should continue to monitor the impact of new pronouncements upon their first adoption of IFRS.

Based upon our IFRS conversion experience and our knowledge of companies reporting under IFRS, the most relevant exemptions that may apply to technology companies are as follows:

| Exemption | Impact |
| --- | --- |
| Business combinations | An election to not retroactively apply IFRS 3R, *Business Combinations*, to transactions prior to the transition date. However, if management elects to restate a business combination that precedes the transition date, this becomes management's effective date of adoption of the standard. Accordingly, all subsequent combinations have to be restated and re-evaluated from that point forward. |
| Cumulative translation differences | An election to recalculate cumulative translation differences and set corresponding translation differences to zero on the date of transition, reflected as an adjustment to retained earnings. |
| Share-based payments | An election to not retrospectively apply IFRS 2, *Share-Based Payment*, to awards granted before November 7, 2002, or those vested as of the transition date. Where the exemption is elected, the date of transition becomes management's effective date of adoption of IFRS 2 for all unvested share-based payments. |

| | |
|---|---|
| Fair value or revaluation as deemed cost | An election to apply fair value at the transition date as deemed cost for property, plant and equipment or investment property. IFRS 1 enables companies a one-time option to apply a different measurement basis to discrete assets at the transition date. The exemption may be applied on an asset-by-asset basis or to an entire class of assets. When the exemption is applied, a company is not required to revalue in subsequent periods unless it elects the revaluation option prospectively for that entire class of assets. |
| Assets and liabilities of subsidiaries, associates, and joint ventures | Where a parent adopts IFRS subsequent to its subsidiaries, the company, in its consolidated financial statements, must measure the assets and liabilities of the subsidiary at the same carrying amounts recorded in the subsidiary's IFRS financial statements, adjusting for normal consolidation entries and uniform accounting policies. In other words, subsidiaries who previously adopted IFRS cannot re-apply exemptions or exceptions during a parent's adoption of IFRS. In the event that a subsidiary adopts IFRS later than the parent, it can elect to use:<br>• The carrying amounts included in the parent's consolidated financial statements; or,<br>• The carrying amounts required under IFRS 1, based on the subsidiary's date of transition to IFRS. |

There are also mandatory exceptions to full retrospective application of IFRS. Exceptions are mandatory and prohibit the retrospective application of some IFRS guidance. Based upon our IFRS conversion experience and our knowledge of companies reporting under IFRS, the most relevant exceptions that may apply to technology companies are as follows:

| Exception | Impact |
| --- | --- |
| Hedge accounting | Upon the transition date, a company is required to recognize hedging relationships in its opening balance sheet where the hedging instrument is of a type that would qualify for hedge accounting under IFRS. Hedge accounting can only be applied to those hedging relationships subsequent to the date of transition (e.g. day 1) only if all hedge accounting criteria under IAS 39 are met. In other words, on day one, hedge relationships recognized in the opening balance sheet that do not qualify under IAS 39 have to be de-designated until all IAS 39 criteria are met. |
| Estimates | Estimates are an area where full retrospective application of IFRS would be inappropriate. The key principle driving this exception is that hindsight should not be used upon transition to IFRS to adjust estimates made under previous GAAP unless there is objective evidence of an error. A company should adjust estimates made under previous GAAP only when the basis of calculation does not comply with measurement and recognition provisions of IFRS. |

The exceptions and exemptions provide limited relief for first-time adopters, potentially easing the burden in areas where the information needed to apply IFRS retrospectively may be most challenging to obtain. There are, however, no exemptions from the incremental disclosure requirements of IFRS and companies may experience challenges in collecting new information and data for retrospective footnote disclosures.

### Key observations and insights

The transition to IFRS can be a long process with many complex issues to address and critical decisions to be made. Here are some important considerations related to the preparation of a company's first IFRS financial statements:

- **Data gaps:** Preparation of the opening IFRS balance sheet and new disclosures may require information that was not collected or calculated under US GAAP. Technology companies should plan their transition and identify the differences between IFRS and US GAAP early so all of the information required can be collected and verified in a timely manner.
- **Additional entities:** IFRS consolidation principles differ from those of US GAAP and those differences may cause some companies to consolidate entities that were not consolidated under US GAAP. Subsidiaries or other entities that were previously excluded from the consolidated financial statements are to be consolidated as if they were first-time adopters on the same date as the parent. Technology companies will also have to consider the potential data gaps of investees to comply with IFRS informational and disclosure requirements.
- **Accounting policy choices:** A number of IFRS standards allow companies to choose between alternative accounting policies. Technology companies should carefully select the policies to be applied to the opening balance sheet and have a full understanding of the implications for current and future periods. Companies should resist the temptation of taking the path of least resistance—choosing accounting policies most similar to US GAAP policies—and, instead, take this opportunity to approach IFRS accounting policies with a clean-sheet-of-paper mindset. Although many accounting policies under US GAAP will be acceptable under IFRS, and therefore not require change, companies should not overlook the opportunity to explore alternative IFRS accounting policies and voluntary changes that may better align the accounting with the economic substance of business transactions.

Technology companies with a multinational presence should inventory the jurisdictions where their subsidiaries may already be reporting under IFRS for statutory filing purposes.

- **Subsidiaries adopting prior to parent:** Technology companies with a multinational presence should inventory the jurisdictions where their subsidiaries may already be reporting under IFRS for statutory filing purposes. By considering this in the early stages of a company's assessment, management will be able to gain insight regarding the conversion process and IFRS accounting policies already adopted by the subsidiary. The subsidiary's accounting policy choices may influence the IFRS accounting policies adopted by the parent company. Otherwise, to the extent that IFRS policy differences between a parent and subsidiary remain, such differences will have to be eliminated in consolidation through adjusting entries. As a result, a company will continue working in a less streamlined reporting environment and may not achieve the full efficiencies of having consistent accounting policies across the organization.

It is advantageous for all organizations to take a systematic, thoughtful, comprehensive approach to the IFRS transition, whether they are large companies potentially eligible for early IFRS adoption, or medium-sized companies with smaller market capitalizations and longer timelines for implementation.

For more information about IFRS 1, refer to PwC's publication *Preparing Your First IFRS Financial Statements: Adopting IFRS*.

What this means for your business

# Where do technology companies go from here?

Moving from US GAAP to IFRS involves more than just an accounting change. The transition will likely touch on every facet of your business: your systems, processes, and people.

**Changing numbers**

Addition of another GAAP and/or change in primary GAAP

| Changing people | Changing processes | Changing systems |
|---|---|---|
| • Communication<br>• Training | • Existing processes to be enhanced<br>• New processes created<br>• Budgeting & forecasting<br>• Internal controls revisited | • Data availability and system requirements<br>• New systems components<br>• Re-alignment of management information systems<br>• Multi-GAAP solutions<br>• Primary GAAP changeover |

**Changing business**

Performance management to be embedded across:

- Performance measure/KPIs
- Management accounts
- Remunerations/bonuses
- Budgeting/forecasting
- Financial and business impact analysis
- Different valuations

Successful conversion efforts are characterized by a thorough strategic assessment, creation of a robust step-by step plan, alignment of resources, and smooth integration of the change into normal business operations. The bottom line: An IFRS conversion should establish sustainable processes a company can repeat and should produce meaningful information long after the conversion takes place.

As technology executives assess the impact of IFRS and begin determining a conversion strategy, they should consider this checklist as a starting point:

### Sales models

- ☐ Are there opportunities to revisit sales practices
    - In order to bring the form and substance of sales transaction more in line?
    - To take a fresh look at contracting methods, which provide evidence of an arrangement?
- ☐ Have we considered the potential impact of IFRS on our customers? Should we make changes to our product and service offerings?
- ☐ Should we reconsider how we deliver and price the components of our multiple element arrangements?

### R&D function

- ☐ Have we considered how our product development cycle aligns with IFRS?
- ☐ Do our current R&D processes capture the data necessary for evaluation of development costs under IFRS?
- ☐ Are there opportunities to increase the efficiency of our R&D organization as we move forward with our IFRS conversion efforts?

### Human resources

- ☐ Have we identified and leveraged the IFRS knowledge and skills of our finance organization in our non-US locations?
- ☐ How will the different accounting rules for employee benefits and share-based payments affect our compensation plans?

### Business combinations

- ☐ Have we incorporated sufficient consideration of IFRS in our due diligence?
- ☐ Do our acquisition models appropriately reflect the new business combination rules?
- ☐ Have we thought about incorporating our evaluation of IFRS into our integration plans?
- ☐ Have we considered how the new business combination rules may influence acquisition negotiations and deal structures?

### Financing and other considerations

- [ ] Have we considered the impact of IFRS on our long-term contracts?
- [ ] Have we considered whether any of our financing arrangements contain features that would require bifurcation into debt or equity components as a result of IFRS?
- [ ] What is the impact of accounting under IFRS on our debt covenants?
- [ ] How will IFRS affect the key performance indicators we use to manage the business and reward our employees?

### IT and change management

- [ ] Have we identified or considered the impact of IFRS on any current or planned IT projects or initiatives?
- [ ] Have we considered the impact of IFRS on projects or initiatives in other parts of our organization such as accounting, finance, or legal?
- [ ] Are there any statutory reporting implications to consider?

### Statutory reporting

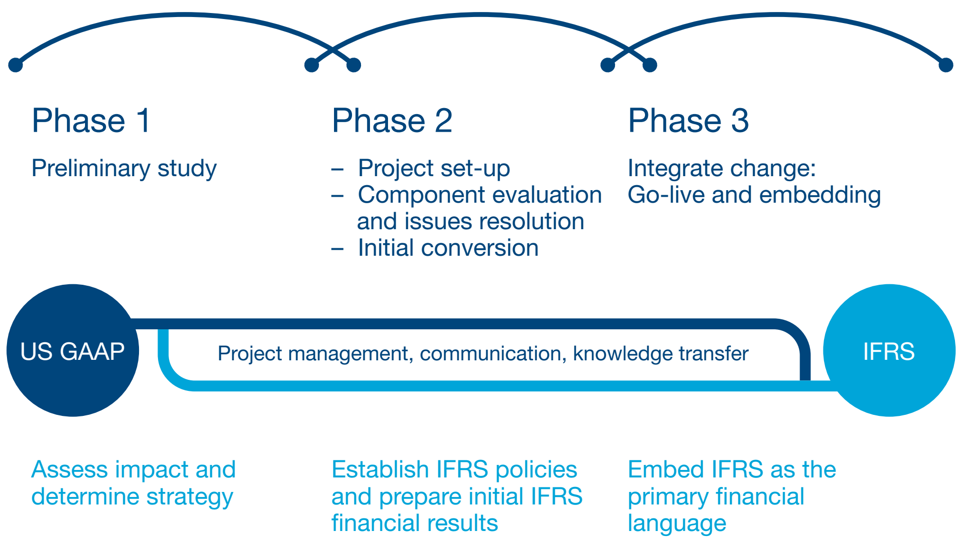
- [ ] In which areas are we currently reporting under IFRS?
- [ ] Do we operate in countries where IFRS adoption is imminent? Are we involved in the policy selection process?

Technology companies that address these questions early and adopt a thoughtful approach to their IFRS conversion will increase their chances of an effective transition.

## The PwC methodology

We have significant experience helping companies convert from one accounting framework to another. Our involvement in large-scale accounting conversions began more than a decade ago, building a global practice with hundreds of full-time conversion specialists. PwC staff train together, use a common methodology, and regularly collaborate on projects all over the world, sharing best practices learned from work with thousands of companies.

Our three-phase approach to conversions outlined below is based on the experiences of these conversion experts. The PwC methodology has been a critical factor in performing well controlled implementations of IFRS. It is flexible and scalable, enabling it to work effectively in organizations of any size. Although each company's timeline will vary, a well-planned IFRS conversion project may take as long as three years from start to finish. But, the first phase, a preliminary study, can take less than a few months, can be performed at any time, and allows a company to assess the IFRS impact and gather necessary information to decide next steps. It is an ideal place to start.



# Appendices

# Appendix A

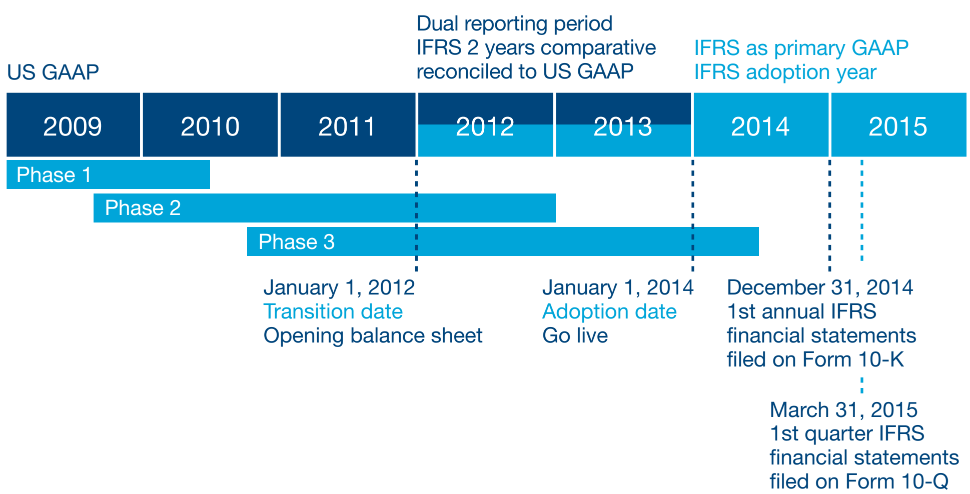
## Current SEC proposed timeline for adoption and related reporting requirements

On November 14, 2008, the SEC published its roadmap for the potential use of IFRS in the US. While the roadmap contains some unanswered questions and may change in response to public comments, it reaffirms the SEC's focus on moving toward a single set of high quality global accounting standards.

Key provisions of the plan include:

- The SEC will reconvene in 2011 to make a decision on the mandatory use of IFRS by US issuers. In making that decision, the SEC will evaluate progress against several specific milestones.
- Assuming a decision is made in 2011 to mandate IFRS for US issuers, the proposed roadmap contemplates a phased-in transition to IFRS beginning in 2014 for large accelerated filers, 2015 for accelerated filers, and 2016 for remaining public companies.
- An issuer that either elects or is required to file IFRS financial statements may only begin reporting using IFRS in an Annual Report on Form 10-K containing three years of audited financial statements, though the SEC is seeking comment on this topic. As currently proposed, an issuer would not be able to file IFRS financial statements with the SEC for the first time in a quarterly report, Securities Act or Exchange Act registration statement, or proxy or information statement.
- The proposed roadmap provides an opportunity for certain qualifying issuers to adopt IFRS as early as fiscal years ending on or after December 15, 2009. To qualify for this option, a company must be one of the 20 largest companies within its industry (as measured by market capitalization) and IFRS must be used more than any other basis of accounting among those 20 largest companies. Issuers that satisfy both criteria and wish to early adopt must apply for and receive a 'Letter of No Objection' from the SEC.

The chart below highlights some of the SEC's concepts in the most recent plan as of the publication of this guide. Assume that SEC registrants are preparing IFRS financial statements for the year ending December 31, 2014, with two years of additional comparatives. In this timeline, companies would have an adoption date of January 1, 2014, a reporting date of December 31, 2014, and a date of transition of January 1, 2012. That would also be the date of the opening IFRS balance sheet, which would be required to be prepared and presented as part of the first IFRS financial statements. The diagram also presents the various phases of a conversion and how they would factor in to the reporting timeline.




*Note: As the roadmap is subject to a public comment period, parts of the proposal may change.*

Although the exact transition timing will be the subject of considerable debate, PwC continues to believe the ultimate change to IFRS is inevitable and the mandatory phased in transition dates beginning in 2014 are reasonable and attainable. Companies should continue to closely monitor regulatory developments.

# Appendix B

## Additional resources

### PwC IFRS websites

- PwC's US IFRS website is your gateway to a wealth of information about the financial standards, geared toward US companies that will soon begin planning for their own transitions. www.pwc.com/usifrs
- PwC's global IFRS website boasts distinctive resources, perspectives, and planning tools from around the world. www.pwc.com/ifrs

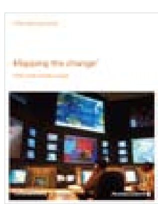
### PwC publications on IFRS

PwC continues its position as a thought leader on IFRS through ongoing publications on IFRS-related topics that are relevant to you. In addition to the sample of broader IFRS publications listed below, PwC is also dedicated to providing thought leadership tailored to the technology industry. In addition to this publication, refer to the following publications for further discussion of IFRS topics:

### IFRS readiness series

*IFRS and US GAAP: Similarities and differences*
Much more than a simple comparison, this revision provides insight as to the actual impact of key differences between IFRS and US GAAP as well as context of how conversion to IFRS has ramifications far beyond the accounting department.

*Preparing your first IFRS financial statement: Adopting IFRS*
This paper outlines how US companies should address 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.

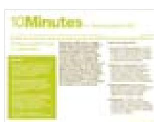


*Mapping the change: IFRS implementation guide*
This guide is intended to jumpstart strategic thinking about an IFRS conversion, providing an outline for a suggested IFRS conversion approach, highlighting objectives, timelines, key considerations, and insights.

## Other featured publications

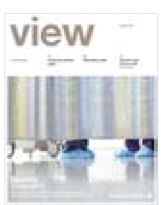
*A shifting software revenue recognition landscape? Insights on potential impacts of IFRS and US GAAP convergence*
In this paper, the PwC global software practice examines certain situations in which adopting IFRS may require a reconsideration of revenue recognition policies and practices that were driven by US GAAP compliance.

*Stock option awards under IFRS: An analysis of the potential impact*
PwC developed this publication to assist you in understanding the impact of IFRS on existing and new share-based payment plans. The consequences of a move to IFRS will be important as the move may affect cash taxes and will certainly significantly impact financial reporting, systems and processes.




*10Minutes on transitioning to IFRS*
This paper delivers a high-level overview of IFRS to the C-Suite. In it, we emphasize why it's important for senior executives and directors to start weighing and preparing for the implications of transition, even if their business isn't among those qualifying for voluntary adoption in 2009. With sufficient lead time, companies will be in a better position to reap the benefits of IFRS.


*Navigating the multi-GAAP reporting maze*
This paper explains why it's critical to begin planning early for an IFRS conversion so you can understand how changing your financial reporting language will require changes in your processes, systems and organization.




*One global flavor: How leading companies are getting ready for IFRS*
It is not an overstatement to say that a financial reporting revolution is now under way. Increasingly, International Financial Reporting Standards (IFRS) is how most of the world talks to investors and other stakeholders about corporate performance. Anticipating that the US will soon join the rest of the world by allowing or mandating a move to IFRS, PwC offers this publication to explain IFRS and provides guidance on how to move to IFRS.

*IFRS: The right move toward convergence: What IFRS will mean to US tax executives*

This paper can assist you in understanding the related tax considerations and discussing IFRS with other functional leaders within your company.


*Do you speak IFRS? Why the new accounting language matters for private equity investors*

IFRS is rapidly becoming the world's global financial reporting language with China and Canada recently announcing their intent to adopt these standards. With a substantial portion of the world committed to using IFRS, US private equity funds that operate globally can no longer afford to ignore its impact. Differences between IFRS and US GAAP treatments will affect deal structuring, due diligence and post-acquisitions analysis.


*Got control? Really, what did you expect?*

The tension between management's desire to present financial results in their most positive light, and investor and regulator demands for more transparency didn't begin with Enron. But after Enron's demise, regulators took a hard look at rules previously used to determine who controls (and should consolidate) an entity. Our purpose here is to highlight key differences in US GAAP and IFRS consolidation rules, and how recent changes to both can affect your deals.


*Keeping current on IFRS*

This publication highlights the impact IFRS can have on transactions, financial reporting and operations, with important information for CFOs involved in cross-border deals or for those who have to report under IFRS.


*Why CFOs need to know about IFRS*

International Financial Reporting Standards (IFRS) are the accounting rules all public companies in the European Union must follow, with another 100 countries either implementing or considering them. So why should this concern a US company? This paper explores seven good reasons.

PwC is here to help you navigate the move to IFRS. To have a deeper conversation about how the transition will affect your business, please contact:

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pwc.com

PwC is committed to helping technology companies with the conversion from US GAAP to IFRS. The following IFRS and technology industry leaders are dedicated to this effort within our firm:


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