Energy Insights:
International Financial Reporting Standards

Getting in step with IFRS*

*connectedthinking

Rapid globalization of capital markets and growth in the number of multi-national businesses is driving the worldwide adoption of International Financial Reporting Standards (IFRS). Is your company capable of making the shift away from U.S. GAAP?

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More than 100 countries around the world—including many that are home to major financial capitals and/or major trade partners to the US—have adopted or are making plans to implement a common set of accounting principles known as International Financial Reporting Standards (IFRS), some as early as 2005. Developed by the International Accounting Standards Board, IFRS provides a wide range of benefits in today's global marketplace, including more efficient access to capital for multi-national companies, reduced cost of compliance, centralized key accounting and reporting functions, improved transparency and streamlined mergers and acquisitions. For investors, IFRS ensures that financial comparisons across borders are easier, eliminating the difficulty of assessing the strengths and weaknesses of companies headquartered in different countries.

The United States is among the last to follow suit in this global shift. To date, there have been strong signals from the Securities and Exchange Commission (SEC) indicating the U.S. acceptance of IFRS. This is primarily due to the advantages IFRS provides to global companies and the requirement of the convergence process from companies operating with two different accounting systems.

Some large U.S.-based public companies are expected to voluntarily implement IFRS over the next two or three years, assuming it is approved by the SEC. And many experts predict that a formal, mandated adoption is just a matter of time, especially considering the value that IFRS brings to companies involved in competitive global industries such as energy.

While IFRS promises a wide range of benefits for U.S.-based companies, making the transition will be a challenging, resource-intensive effort. There are a number of obstacles that companies will need to overcome, from training their own accounting staff and implementing new systems and technologies to changing long-standing ways of operating to maximizing financial performance under new accounting guidelines.

Thus, given the global expected benefits of IFRS and what seems to be the inevitability of the guidelines' adoption here in the United States, it makes sense to begin studying and planning for the steps necessary to transition—while learning from the experiences of international companies that have already adopted the standards.

Yield sign versus stop light

History—International Accounting Standards Committee

International standard setting began in 1973 through an agreement reached by nine worldwide professional accountancy bodies. The agreement resulted in the formulation of the International Accounting Standards Committee (IASC) [P.4]

The IASC comprised representatives from fourteen countries and was the international standard setting body. Observer members of the International Accounting Standards Committee included: the International Organization of Securities Commissions (IOSCO); the Financial Accounting Standards Board (FASB); and the European Commission. In March 1974, the IASC issued its first exposure draft E1—Disclosure of Accounting Policies, and went on to issue a total of 68 exposure drafts, 41 International Accounting Standards (IAS) and 25 Interpretations of IAS.

In May 2000, the IASC's constitution was amended, and a group of trustees was appointed. The IASC was renamed the International Accounting Standards Board (IASB) [C.1-3] [P.1,4].

The IASB's objectives were set out in a revised constitution. The ultimate goal is the development and rigorous application of a single set of global accounting standards, which will produce high-quality financial information to help participants in the world's capital markets to make economic decisions [C.2] [P.7-10].

The principles-based approach of IFRS can have a great impact on companies in the energy industry. There are key differences in the ways companies must account for critical items such as exploration and production costs; depletion, depreciation and amortization; inventory; joint ventures; and reserves. There are also significant variables in the way that financial instruments and pension plans are treated.

Together, the differences between US GAAP and IFRS can substantially impact the way earnings are stated after the transition. For example, under IFRS guidelines, impairments should be assessed on a level as low as "by oil wells" and can be reversed, for example, in situations with upstream companies where a non-producing well was written off, it can be added back to the balance sheet if it later becomes productive. Energy companies with regulated operations are also impacted; under IFRS, companies cannot account for future increases in the value of regulatory assets, which can create a significant variable when compared to US GAAP. Experience proves that for companies involved in the energy industry, even the simplest difference between IFRS and GAAP can cause material differences in a company's financial statements.

These potential conversion disruptions make it necessary for companies preparing for IFRS to create a formalized, management-driven approach to implementing the new accounting system. Senior leadership must have a clear vision of the benefits of transition, and must commit the proper amount of time and resources to ensure that the process is well planned and well executed. The challenge in terms of organizational understanding and effort cannot be overstated.

Resources are key

At its core, transitioning to IFRS is much like any other enterprise-wide change process. It requires a commitment from the C-suite; trained, knowledgeable professionals; extensive resources of time and human capital; realistic planning and implementation timelines; and thorough communication.

The experience of companies who have already made the transition has been universal—the primary challenge is the lack of skilled personnel who are "bilingual;" that is, fluent in both their existing accounting system and IFRS and able to appropriately judge the impact that changes will have on existing operations. Companies can begin to overcome this skill deficit by ensuring that their senior and mid-level accounting and financial reporting personnel receive training on IFRS, beginning as soon as possible. For IFRS conversion to be successful, resources with the right knowledge is critical; however, those skilled resources are in short supply.

This knowledge-gathering phase should include the company's chief financial officer, chief accounting officer, controller and other financial executives and managers, and eventually involve as many staff as possible. The degree of information will vary by level but education is necessary at all levels.

The reality is that it is difficult to educate your accounting staff and handle the conversion at the same time, so building institutional knowledge is critical in the coming years. US companies that currently have overseas operations will likely have in-house expertise on IFRS that can be drawn upon to at least begin the process of educating others.

It is also critical to begin understanding the costs and resource requirements of the transition, and begin planning for those contingencies.

The final actions before beginning the transition process include integrating your statutory tax and external reporting activities across business units and possibly even centralizing those activities.

Steps in the process

Most multi-national companies transitioning to IFRS can count on the process taking between 18 and 24 months, depending on the complexity of the business and/or structure.

The first distinct phase (“Phase 1”) involves assessing the key areas of impact and making policy decisions based on their long-term impacts. Under IFRS, for example, research and development expenses can be capitalized rather than expensed; how will that impact future earnings or govern budgeting considerations?

Phase I typically takes about three to six months to uncover potential problems for future study. Some companies find as many as 15-20 potential significant differences between US GAAP and IFRS that could have a substantial bearing on future financials. The transition teams then determine how these changes will affect debt covenants, taxes, earnings and other financial mechanisms.

These differences and their potential impacts are brought to the management team leading the transition effort and policy decisions are made based upon the findings. The quality of decisions made in Phase I will greatly influence enabling the next effort to go smoothly.

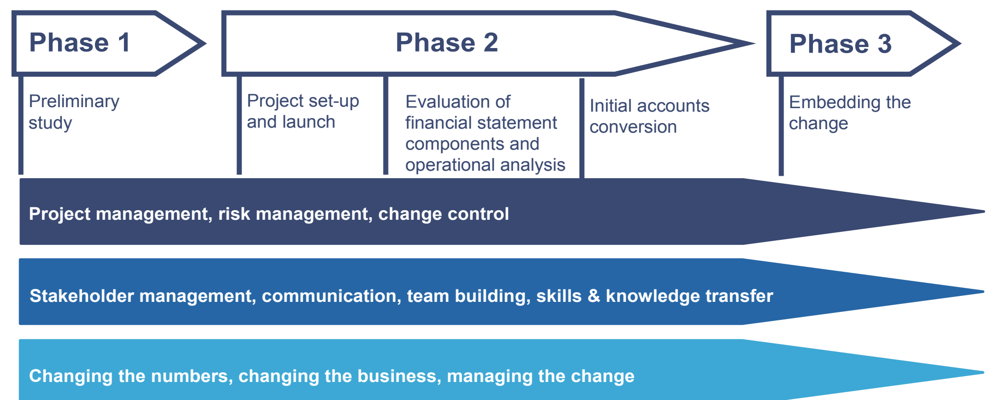
The second distinct phase (“Phase II”) involves dedicated teams using the policy decisions made earlier to pull data, run analyses and review contracts, leases and joint venture arrangements. The goal is to move towards a full calculation of the transition adjustment and other adjustments to historical data necessary post transition.

It is important to remember that IFRS is not just a finance function. The guidelines and reporting standards impact operations and strategic decisions across the board—and require changes to many long-standing “ways of doing business.” Just as US GAAP had been, IFRS needs to be embedded deeply into the organization in order to maximize its benefit.

Companies that have made the transition and experienced the most return on their investment in time and effort are those that approached the process as an opportunity to position their organization for future operational and financial success, rather than as just another way of reporting results. They viewed the transition to IFRS as a catalyst for more effective day-to-day management of their companies.

Embedding IFRS in an organization after the transition requires building on the initial work to create sustainable and efficient processes that enable effective management of the business. It requires the necessary organizational structure, systems, data capabilities and people to succeed.

IFRS conversion methodology



Augment with experienced resources

Because of the detailed nature of the transition process—and the strict requirements for highly skilled, knowledgeable financial professionals—many companies are well served by seeking advice from external sources with IFRS and energy experience.

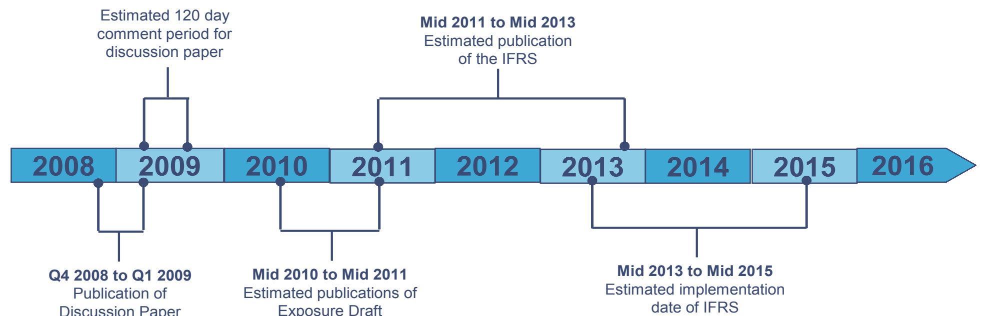
While it is critical that company leadership drive the transition to IFRS and that in-house staff be directly involved in all facets of the process, outside support can bring key learnings and expertise to bear in two key areas:

- Process/project management–Preparing for and planning an 18– to 24–month change management process can be daunting for internal staffs already stretched to the limit with existing work. The commitment in terms of management time and attention and staff requirements are substantial; some companies estimate that as much as 50 percent of their senior financial managers' time was dedicated to IFRS transition issues over the program's 18–to 24–month implementation. A firm with extensive experience in both change management and IFRS transition programs can help provide the framework for the company's activities and ensure that the effort will remain on track.
- Understanding and comparing/contrasting individual differences between US GAAP and IFRS–This is where the most time-consuming and difficult work takes place, and it requires a fluency in both standards that is beyond the easy reach of most in-house accounting staff. Because IFRS is more guideline-based than rule-based, it also helps to have knowledgeable assistance in terms of setting company policy.

In summary

Companies in the energy industry have characteristics that make transitioning to IFRS beneficial from a financial and operational perspective. Enhancing global competitiveness and access to capital is a critical component to long term vitality in the industry. Although the hurdle is high, IFRS conversion is in the long term best interests of companies operating on a global basis.

The initial IFRS conversion will come at a one-time cost to companies, an expenditure of time and money that will depend in large part on the size and operating structure of their individual operations. However, with the proper planning and resource allocation, the long-term benefits—a common accounting and financial reporting language that can be applied consistently and rigorously around the world—will make the effort worthwhile.



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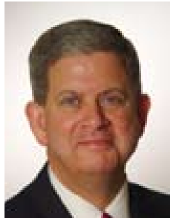
John is a Houston partner with over 18 years of experience in servicing clients in the energy industry. John is a certified public accountant licensed to practice in both Texas and Louisiana.

John has considerable international experience with, among others, Royal Dutch Shell, Saudi Aramco and Motiva Enterprises LLC. John's experience includes working closely with group auditors and global audit teams servicing clients around the world.

John has considerable IFRS experience and is the U.S. Energy IFRS transition leader.

If you'd like more information on preparing and planning for IFRS implementation or what IFRS can mean for your organization, contact PricewaterhouseCoopers at IFRSHouston@us.pwc.com.

U.S. Energy Leadership Team



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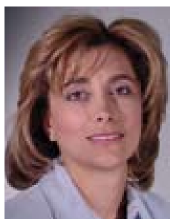

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