



# International Financial Reporting Standards:

*Considerations for  
Power & Utilities*

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# Table of Contents

Chart the Course .....	1
Timing is Everything .....	2
Which Approach Will Work for You? .....	3
Technical Accounting Issues for Power & Utilities Companies ....	3
More Than Accounting and Financial Reporting .....	8
The European Experience.....	9
Smoothing the Transition .....	10
Getting It Right .....	10
Resources & Contacts.....	11

# International Financial Reporting Standards:

## Considerations for Power & Utilities

Decibel levels continue to rise on the subject of International Financial Reporting Standards (IFRS), with frequent communications from many sources. As the volume increases, you may find yourself asking: How will IFRS impact my company? What triggering events would compel us to move more quickly to adopt IFRS? What obstacles might stand in our way?

IFRS appears inevitable and will likely be the final destination for public companies in the U.S. and for most companies around the globe. Still unsettled, however, is the pace of the trip. Some companies may perceive benefits in embarking immediately. Others may adopt a more measured approach. Still others may choose to closely examine the roadmap before they take any steps.

Power and utilities (P&U) companies have significant investments in property, plant and equipment and often make extensive use of derivative instruments. Many US P&U companies also operate subject to governmental regulatory bodies that set the rates charged to customers, and have many global peers who already report under IFRS.

Like companies in other industries, P&U companies have multiple capital market considerations and complex organizational structures. It is possible that rate-regulated companies, already subject to regulatory accounting differences from U.S. GAAP, may be required to continue using historical regulatory accounting rules based on U.S. GAAP beyond the time that it becomes mandatory to use IFRS for shareholder reporting purposes.

Of course, like any significant business decision, determining the timing and pace of an IFRS conversion requires an understanding of the potential costs and benefits. Regardless of your ultimate conversion plan, it is important to make an informed decision based on a thorough analysis.

Such analysis and planning is important, since a successful conversion will not happen overnight. Indeed, companies that have already converted to IFRS have found that the initiative can span several years, due to the surprisingly wide scope of the effort. A successful IFRS conversion project will involve not only technical accounting and financial reporting, but also issues around internal processes and controls; regulatory, statutory, and management reporting; technology infrastructure; as well as organizational issues, including tax, treasury, legal and contracts, compensation and human resources, and communication.

Suffice it to say, conversion involves much more than reshuffling the chart of accounts.

## Chart the Course

If you take only one action after reading this document, we suggest it be this: Develop an IFRS implementation roadmap. To kick off this effort, ask yourself and your team a few preliminary questions to gauge the potential impact of IFRS on your company:

- Have we inventoried our current IFRS reporting requirements, if any?
- How many local GAAP do we currently report under?
- How many of our business units already prepare IFRS financial statements?
- How might our access to capital be impacted by an IFRS conversion?
- How many of our peers have converted to IFRS? (See chart, "Competitive Landscape," page 2.) Is there an expectation that they would switch to IFRS, if given the choice in the U.S.?
- Do we have a major Enterprise Resource Plan (ERP) or finance transformation project in the works?
- Are we involved in or considering a major acquisition?

### Key Impacts of IFRS Implementation

Technical Accounting	Process and Statutory Reporting	Technology Infrastructure	Organizational Issues
<ul style="list-style-type: none"> <li>• Overall approach to IFRS implementation</li> <li>• First-time adoption policy considerations, including reporting dates and use of exemptions</li> <li>• Ongoing policy considerations, including alternatives and approach to "principles"</li> </ul>	<ul style="list-style-type: none"> <li>• Internal controls and processes, including documentation and testing</li> <li>• Management and internal reporting packages</li> <li>• Global reporting packages</li> <li>• Statutory reporting, including "opportunities" around IFRS adoption</li> </ul>	<ul style="list-style-type: none"> <li>• General ledger and chart of accounts structure, including performance metrics</li> <li>• Global consolidation</li> <li>• Sub-system issues related to configuration and data capture</li> <li>• Capabilities to manage multiple GAAP accounting during transition</li> </ul>	<ul style="list-style-type: none"> <li>• Tax structures</li> <li>• Treasury and cash management</li> <li>• Legal and debt covenants</li> <li>• People issues, including education and training, compensation structures</li> <li>• Internal communications</li> <li>• External and shareholder communications</li> </ul>

- What is the level of IFRS knowledge within the company, both domestically and globally?
- What would be the impacts on our company of required IFRS application in the U.S.?
- Have we assessed the costs and benefits of adopting IFRS?

Of course, your IFRS implementation roadmap will be significantly more detailed than merely addressing these few questions. Given the far-reaching scope of IFRS, the roadmap may assess the impact on each department in your organization, including finance, human resources, tax, legal, information technology, and investor relations. Other stakeholders may also be involved, including the board, audit committee, shareholders, regulatory commissions and your external auditor.

A carefully designed roadmap may empower your company to convert on its own terms. By taking a measured and informed approach, you increase the likelihood of identifying value in an exercise that otherwise may be reactive and solely compliance driven. The value may show itself in the form of reduced costs of implementation, standardization and centralization of statutory reporting activities and related controls, greater consistency of accounting policy application, and possibly core finance transformation. Through your roadmap, you can independently validate perceptions and dispel misconceptions. And you can justify your decisions before your board, shareholders, other stakeholder groups, and the financial analyst community.

#### Competitive Landscape: Power & Utilities Companies by Accounting Standard

Company	Market Cap (in millions)	Country	Accounting Standard
EDF Group	170.81	France	IFRS
E.ON	126.22	Germany	IFRS
Suez Group	83.56	France	IFRS
Iberdrola	72.78	Spain	IFRS
RWE Group	68.19	Germany	IFRS
ENEL	67.00	Italy	IFRS
Gaz de France	56.73	France	IFRS
Exelon	49.49	USA	US GAAP
UES of Russia	47.09	Russia	Local GAAP
CEZ	43.86	Czech Republic	IFRS
Veolia Environment	42.78	France	IFRS
NTPC	41.57	India	Local GAAP
Fortum	37.29	Finland	IFRS
National Grid	37.29	UK	IFRS
Tokyo Electric Power	34.93	Japan	Local GAAP
Gas Natural Group	27.32	Spain	IFRS
Southern Co.	26.41	USA	US GAAP
Scottish & Southern	25.42	UK	IFRS
FPL Group	24.56	USA	US GAAP
Reliance Power	24.32	India	Local GAAP

Data as of February 29, 2008.

Source: [http://www.forbes.com/lists/2008/18/biz\\_2000global08\\_The-Global-2000\\_Rank.html](http://www.forbes.com/lists/2008/18/biz_2000global08_The-Global-2000_Rank.html)

## Timing is Everything

IFRS adoption increasingly appears to be inevitable. In late August 2008, the U.S. Securities and Exchange Commission (SEC) announced that it would issue a proposed IFRS “roadmap” that would include a timetable and appropriate milestones for mandatory transition to IFRS starting for fiscal years ending on or after December 15, 2014. Before evaluating whether to mandate adoption, specific proposed rule changes would provide a limited number of U.S. issuers an option of using IFRS in their financial statements for fiscal years ending on or after December 15, 2009. (For the latest news and information on IFRS, visit [www.deloitte.com/us/ifrs](http://www.deloitte.com/us/ifrs).)

If you think the year 2014 gives you plenty of breathing room, think again. A conversion effort that is both sane (in the sense of avoiding the firedrill type atmosphere that characterized compliance with Sarbanes-Oxley and the Y2K issue) and successful (one that can stand up to the scrutiny of regulators, analysts, and your independent auditor) will require a lengthy runway. Consider also that comparative financial statements will also be required. At least one year of comparative information is required under IFRS, and the recently announced SEC roadmap would require presentation of a second comparative year. Since the “opening balance sheet” date will be as of January 1 of the earliest year presented, the real IFRS conversion date is at least two years earlier than December 31, 2014, and possibly three years, depending on what is ultimately required by the SEC.



## Which Approach Will Work for You?

Generally speaking, two approaches to IFRS conversion predominate: all-in and tiered. The former is characterized by a relatively short timeframe; simultaneous conversion of all reporting entities; dedicated project teams; and commitment of significant resources. The latter is conducted over a more extended period; with phased conversion of reporting entities; with at least some personnel retaining their “day job” duties; and with a spreading out of project costs.

When the European Union converted to IFRS in 2005, it was, for most companies, an all-in effort driven by the tight timelines imposed by the European regulators. Without the luxury of time to convert on a staggered basis, most companies were forced to rush through the process, leading to inevitable inefficiencies and ineffectiveness.

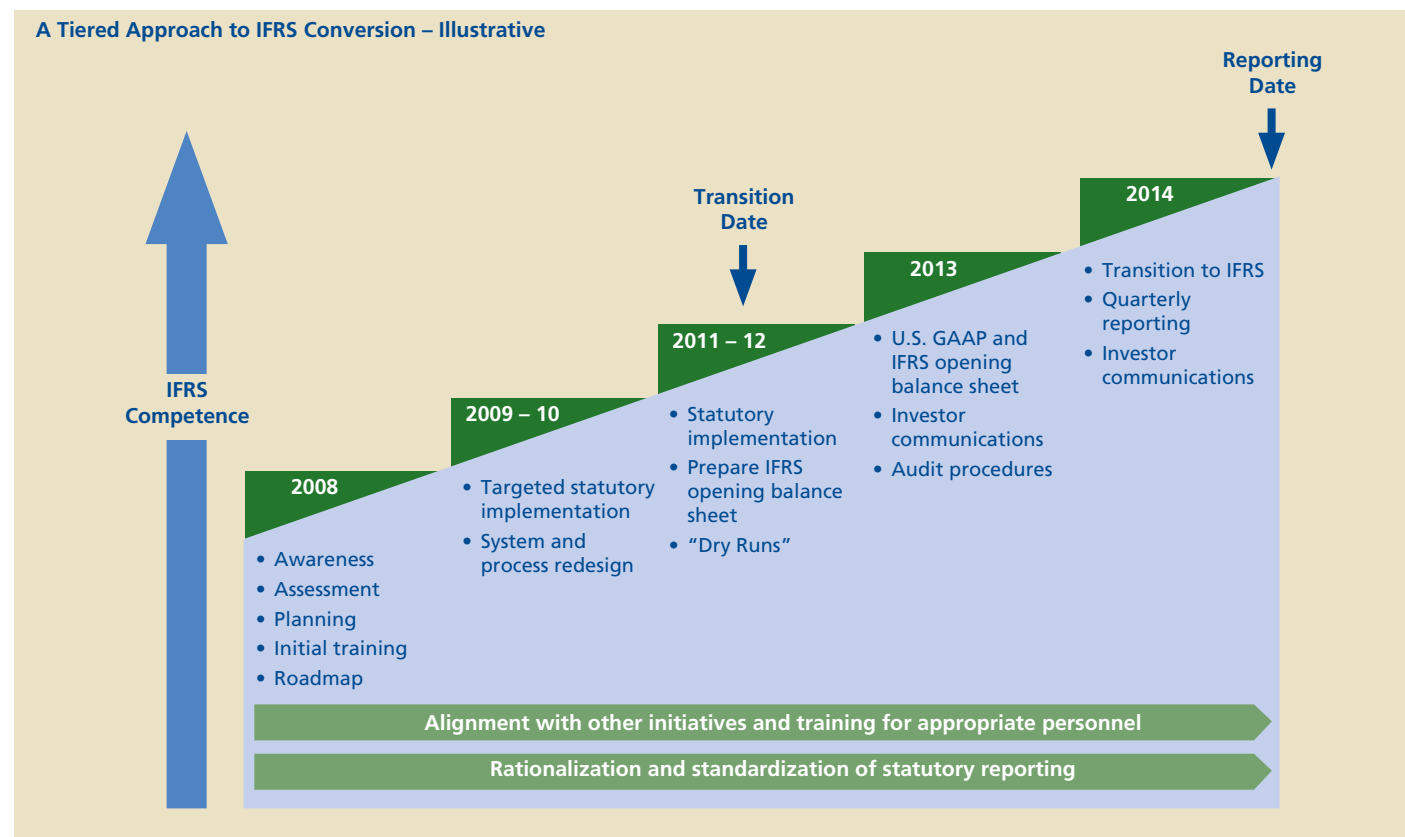
A tiered approach – staged, rational, and measured – to IFRS conversion will likely provide better results. This comes with a seemingly self-contradictory caveat: You’ll have to act fast if you want to go slow. That is, if you want to reap the potential benefits of phasing in your conversion, you’ll need to start planning soon.

Companies that choose a tiered strategy should consider staggering their conversions on a country-by-country or region-by-region basis. As each group moves through the stages (see graphic, “A Tiered Approach to IFRS Conversion,” below), the processes developed and lessons learned are applied to the next group.

## Technical Accounting Issues for Power & Utilities Companies

IFRS and U.S. GAAP differ in key ways, including their fundamental premise. At the highest level, U.S. GAAP is more of a rules-based system, whereas IFRS is more principles-based. This distinction may prove more vexing than it initially appears, because most accounting and finance professionals in the U.S. have been schooled in the rules of U.S. GAAP. The overriding lesson from their years of study and work is this: If you have an issue, look it up. Under U.S. GAAP, voluminous guidance attempts to address nearly every conceivable accounting problem that might arise. And if that guidance doesn’t exist, it generally is created. On the other hand, IFRS is a far shorter volume of principles-based standards, and consequently requires more judgment than American accountants are accustomed to applying.

Beyond the issue of rules versus principles, IFRS also can pose particular technical accounting challenges to P&U companies. The table “Technical Accounting Issues” on page 4 and the discussion that follows explains some of these challenges.



## Technical Accounting Issues

Potential Differences	Potential Implications		
	Financial Statements	Process/IT	Other Issues
Property, Plant & Equipment	IFRS requires componentization approach; costs eligible for capitalization may also differ; revaluation at fair value is an option.	Systems modifications may be necessary to track components and separate depreciation amounts.	May cause potential difficulty in initial componentization exercise depending on age of assets, previous acquisitions. Will also have potentially significant tax recordkeeping implications.
Regulatory Assets & Regulatory Liabilities	No IFRS equivalent to SFAS 71; regulatory items may only be recorded if they meet the IFRS definition of assets or liabilities.	May require additional analysis and assessment processes to determine whether specific items can be recorded on the balance sheet.	Amounts previously deferred on the balance sheet based on SFAS 71 may now impact current income and consequently lead to earnings volatility.
Asset Impairments	Differing impairment assessments (e.g., one-step approach under IFRS) exist; IFRS impairments may be reversed.	Will require changes in impairment analysis and more likely requirements to measure impairment amounts.	Will lead to increased focus on periodic assessments and financial statement disclosures.
Income Taxes	No specific guidance related to uncertain tax positions in IFRS.	Tax accounts and processes for deferred taxes and uncertain tax liabilities may change; additional temporary differences are likely.	Taxable income that is typically based on reported book earnings will change; record-keeping requirements are likely to increase.
Derivative Instruments	U.S. GAAP guidance is more prescriptive than IFRS, particularly in core businesses that have significant contractual activities on a forward basis.	May lead to potential policy changes and related changes to derivatives database and valuation systems/processes.	Differing definitions will necessitate a review of contracts.
Asset Retirement Obligations	Both standards have similar initial treatments, but IFRS amounts are adjusted for discount rate changes.	May need changes to systems to incorporate discounting impacts.	May need increased monitoring of valuation inputs and their effects
Leases	Lease classifications may differ; no bright line tests in IFRS; IFRS lease definition applies to the right to use any asset (more than just PP&E and land).	May have potential changes to lease revenue systems/processes; all contracts existing at transition will have to be evaluated to determine if they are leases under IFRS.	Will require review of existing contracts
Inventories	IFRS does not permit LIFO.	Need to adopt an alternative inventory method with potential changes to associated systems.	If non-LIFO method is recognized for rate recovery, cash flows will be adversely impacted.
Environmental Liabilities	U.S. GAAP has more specific recognition rules than IFRS.	May have a reduction of U.S. GAAP-specific recognition parameters and increased focus on economic, legal factors.	Specific rules are replaced by enhanced reliance on judgment, making standardized processes more difficult.
Joint Ventures	IFRS differentiates between jointly controlled assets and operations versus jointly controlled entities/ventures.	Systems modifications to manage differing consolidation processes.	Proposed IFRS standard likely to remove proportionate consolidation option; potentially change evaluation of joint assets and operations.

### Property, plant and equipment (PP&E)

**Asset componentization:** IAS 16, Property, Plant and Equipment, requires the different components of an asset to be identified and depreciated separately if they have differing patterns of benefits and are significant relative to the total cost of the item. This components approach means that different depreciation periods will be used for each component of a fixed asset. For example, a power plant is comprised of separate components with different useful lives (turbine rotor, turbine blades, boiler, electronic equipment, and so on), so its total book value will have to be allocated to these separate components. These individual components would then be depreciated over their respective useful lives. Significant parts of an asset that have similar useful lives and pattern of consumption can, however, be grouped together.

Entities that currently recognize plant assets as one overall item depreciated over a single 20- or 30-year useful life may find componentization to be a challenging process, especially if the PP&E ledger under U.S. GAAP is not sufficiently detailed or lacks certain key data necessary to specifically identify components. This is particularly true for old plants, plants owned by joint ventures (where data access may be limited), or in the case of acquired assets where legacy pre-acquisition data may be limited. Consequently, you may need to involve plant managers and engineers to review the available asset data, including overhaul and replacement schedules, in order to complete the componentization process.



Other potentially significant impacts of asset componentization include: (1) group depreciation methods that are commonly used by power and utility companies will not be permitted, requiring all gains and losses on retirements to be recognized in earnings and (2) assets related to planned major maintenance activities need to be identified as separate components if they meet the asset recognition requirements in IAS 16. For example, estimated major maintenance or overhaul costs that would typically be expensed under U.S. GAAP that is scheduled to be performed every five years would need to be identified as a separate component upon acquisition of an asset and depreciated separately rather than depreciating the entire cost of the asset over the longer useful life of the asset. When the major maintenance is performed that component would be retired and the major maintenance cost incurred would be capitalized as a new component.

**Revaluation option:** IFRS provides companies a choice of accounting for PP&E under either the historical cost model (which is the required model under U.S. GAAP) or a revaluation model. Although the revaluation model is not widely used under IFRS, if elected, it does require companies to re-measure PP&E at fair value and record the change in value directly to equity (to the extent that a net revaluation surplus remains) on a recurring basis. Companies must have a consistent accounting policy for all assets within a particular asset class. When the revalued asset is disposed of, the revaluation surplus in equity remains in equity and is not reclassified to profit or loss. However, under this model, depreciation is recorded from the revalued amount, typically resulting in a higher depreciable basis and higher depreciation expense.

**Costs eligible for capitalization:** Under IFRS, costs that are directly attributable to bringing the asset to working condition for its intended use are able to be capitalized. Directly attributable costs do not include administrative and other general overhead costs, which may have historically been capitalized under U.S. GAAP as part of guidance received from regulators (e.g., Federal Energy Regulatory Commission or state commissions).

### **Regulatory assets and liabilities**

IFRS does not provide specific guidance on regulatory assets and liabilities or on the recognition of revenues and expenses covered by future increases and decreases in regulated tariffs. Instead, under IFRS costs should be charged to the income statement when incurred, and recoveries from customers should be recognized when receivable.

During its discussions on service concessions, the IFRIC considered the accounting treatment under IFRS of regulated assets and liabilities. No firm conclusion was reached except that entities applying IFRS should recognize only assets that qualify for recognition in accordance with the IASB's Framework for the Preparation and Presentation of Financial Statements and relevant accounting standards, such as IAS 11, Construction Contracts; IAS 18, Revenue; IAS 16, Property, Plant and Equipment; and IAS 38, Intangible Assets. In other words, an entity should recognize regulatory assets and liabilities to the extent that they meet the criteria to be recognized as assets and liabilities in accordance with existing IFRS. P&U companies should consider whether the regulatory assets or liabilities permitted under U.S. GAAP from deferred fuel clause revenues or the securitization of storm costs would meet the IFRS definition of assets or liabilities. In practice U.S. GAAP regulatory assets or liabilities have not been recognized under IFRS.

The absence of specific guidance similar to SFAS 71, Accounting for the Effects of Certain Types of Regulation, has impacts that extend beyond the typical regulatory asset and liability accounts. For example, SFAS 71 permits the capitalization of an Allowance for Funds Used During Construction (AFUDC) which permits companies to capitalize the cost of financing construction projects including the cost of both debt and equity financings. Under existing IFRS, capitalization of financing costs would be limited to borrowing costs as defined by IAS No. 23 Borrowing Costs, and would typically not include the equity component of AFUDC, which may be significant for companies with extensive capital programs.

At its November 2008 meeting, the IFRIC considered a request to consider whether regulated entities should recognize an asset or liability under IFRS as a result of price regulation by regulatory bodies or governments. At that meeting IFRIC, voted to reject the item as an IFRIC agenda item and made no recommendation as to whether the IASB should add this topic to their agenda. IFRIC believes there is not a divergence in current practice under IFRS; however, they acknowledged that there could be potential divergence with the adoption of IFRS by those currently applying SFAS 71.

### **Asset impairments**

Two major differences exist between U.S. GAAP and IFRS on impairment:

- When assessing for impairment under U.S. GAAP, a "two-step approach" is applied. First, the carrying value of the asset is compared with the undiscounted value of the expected future cash flows to be generated from the asset. Second, where the carrying value is higher, the asset is written down to fair value. Under IFRS, the carrying value is compared with the asset's "recoverable amount" (defined as the higher of the asset's value in use, which is based on discounted future cash flows or fair value less cost to sell), and if the carrying value is higher, the asset is written down to the recoverable amount. The ultimate effect is that impairment may be recorded earlier under IFRS.
- Under U.S. GAAP, reversals of previous impairments are generally not permitted, although one exception is for utility companies with previously disallowed costs that are subsequently allowed by a regulator. Under IFRS, where the indicator that led to the impairment loss no longer exists or has decreased, the previously-recognized impairment charge is reversed up to the new recoverable amount. (Goodwill impairment is an exception. Even under IFRS, goodwill impairment may not be reversed.) Under IFRS, companies will have to track asset impairments even after the initial writedown in order to determine whether the impairment should be reversed. If a change has occurred, the asset impairment may be reversed; however, the asset should not be revalued to an amount greater than the carrying amount would have been if no impairment loss had been recognized (i.e., the otherwise net carrying amount after regular depreciation expense is deducted). This will require tracking the unimpaired cost of the asset to determine the cap on the amount of any future restoration.

Differences may also arise in areas such as determination of the appropriate level of impairment analysis (e.g., at the plant level or a system level) and the determination of fair value.

## Income taxes

There will be two major effects of a conversion to IFRS on income taxes. The differences between IAS 12, Income Taxes, and SFAS 109, Accounting for Income Taxes, will affect how companies account for income taxes on their income statements and balance sheets. In addition, the many other differences between U.S. GAAP and IFRS standards will likely result in additional book-tax differences that will need to be considered for estimated tax payments, tax return preparation and calculation of deferred tax provisions and assets/liabilities.

Differences in accounting for income tax include:

- Recognition, measurement and disclosure of liabilities associated with uncertain tax positions
- The availability of the SFAS 71 exceptions to SFAS 109 for companies that use or have used the flow-through method of accounting for certain book-tax differences and the deferred recognition of the effect of changes in tax rate on deferred tax assets/liabilities
- The classification of deferred tax assets/liabilities (all are non-current under IFRS)

The pre-tax differences between IFRS and U.S. GAAP need to be assessed to determine whether the new methods of accounting are permissible for tax purposes. If the IFRS methods are permissible and desirable for tax purposes, companies need to assess whether it is necessary to obtain advance consent from the National Office of the Internal Revenue Service for the change in tax method of accounting and determine how the cumulative effect of the change is taken into account for tax purposes. The new IFRS methods of accounting may result in a mandatory change in tax method of accounting (e.g., resulting from the LIFO conformity requirement) or may affect the timing of the recognition of an item for tax purposes (e.g., certain revenue recognition methods). Methods of accounting for which the tax method of accounting has historically followed the book method, but for which a book-tax difference will exist due to conversion to IFRS will result in incremental recordkeeping requirements and a decision as to whether the tax function or another part of the company should maintain the historical calculations needed for tax reporting purposes.

## Derivative instruments

Although IFRS and U.S. GAAP guidance on accounting for financial instruments are conceptually similar, differences do arise as a result of the principles-based approach from IFRS versus the rules-based approach from U.S. GAAP.

Broadly speaking, IFRS and U.S. GAAP approach financial instruments in a similar manner, although there are differences between the standards in terms of their detailed application. For instance, even the definition of a derivative differs under the two accounting frameworks, meaning that the contracts within the scope of derivative accounting will differ. U.S. GAAP additionally has a significant number of interpretive issues specific to energy transacting which are not specifically addressed under IFRS. Consequently, different interpretations are also likely.

Finally, U.S. GAAP has certain exemptions for legacy contracts which were executed before a particular date. Since IFRS adoption is on a fully retrospective basis, P&U companies may have long-term arrangements that have to be reconsidered for possible embedded derivative terms.

## Asset retirement obligations

Both IFRS and U.S. GAAP provide for the recognition of costs of dismantling an asset and restoring its site as a liability (e.g., a “provision” under IFRS), with an offsetting amount included in the capitalized cost of the asset. While both accounting frameworks provide for a present value approach in measuring the liability obligation, the mechanics of each approach differs. For example, IFRS allows a company to incorporate provision estimates based on internally generated costs, whereas U.S. GAAP requires third-party external costs to be used in the provision estimate.

Further, under U.S. GAAP, the company’s credit-adjusted risk-free rate of interest is used to discount the liability, whereas IFRS requires a rate reflecting current market conditions and risks specific to the liability. The selection of the appropriate rate to use in each case for IFRS purposes requires careful consideration. Under both IFRS and U.S. GAAP, subsequent to the initial recognition of the asset retirement obligation, the provision is reviewed at each balance sheet date and adjusted to reflect the current best estimate, which may include adjustments to the discount rate used to measure the provision. However, under IFRS the entire obligation is remeasured using the current discount rate while under U.S. GAAP only the incremental increase in the obligation is remeasured using the current discount rate and the previous portion of the obligation remains measured using the discount rate in use at the time that portion was recorded.

## Leases

There are several key differences between IFRS and U.S. GAAP in the area of lease accounting, including:

- IFRS lease accounting standards cover a wider range of transactions than under U.S. GAAP. While only property, plant, and equipment (land and/or depreciable assets) can be subject to a lease under U.S. GAAP, IFRS covers lease arrangements for all assets, with the exception of certain intangibles.
- Although many of the lease classification criteria are similar under IFRS and U.S. GAAP, IFRS does not have the bright lines and specific criteria as found in U.S. GAAP lease standards. Rather, IFRS focuses on the transfer of risks and rewards of the arrangement for lease classification, with only limited indicators and examples provided. Additionally, the nomenclature of leases under IFRS and U.S. GAAP differs: IFRS has only operating and finance leases, whereas U.S. GAAP has operating, capital, sales-type, direct financing, and leveraged leases.
- In leases which include both land and a building, IFRS requires that the land and building elements of a lease be considered separately for purposes of lease classification, unless the land element is immaterial. However, in addition to the significance of the land element, U.S. GAAP considers the land and building elements a single unit unless certain specific criteria are met. During the European conversion, this proved to be a particularly time-consuming process; many companies sought advice from valuation specialists to assist with the allocation.



## Inventory

The cost of inventory under both U.S. GAAP and IFRS generally includes direct expenditures of getting inventories ready for sale, including overhead and other costs attributable to the purchase or production of inventory. IAS 2, Inventories, requires use of either the FIFO method or the weighted-average cost method. Further, IFRS requires that the same costing formula be used for all inventories with a similar nature and use to the entity. Most regulated gas distribution utilities have PGA or similar clauses to recover gas costs and several of these gas distribution utilities have for years used the LIFO method of accounting for gas inventories. During periods of rising prices, the LIFO costing method leads to higher recognized costs of sales and, with PGA clauses, more-timely rate recovery. However, LIFO is not a permitted method of inventory accounting under IFRS.

In addition, a LIFO conformity requirement exists for U.S. tax purposes: a taxpayer may not use LIFO for tax purposes unless LIFO is also used for financial reporting purposes. Unless the tax law is changed, LIFO taxpayers will need to revert to a non-LIFO tax method of accounting for tax purposes upon adoption of IFRS for financial reporting purposes. The financial reporting effects of adopting IFRS are charged or credited to retained earnings, but the cumulative effect of changing tax methods of accounting is recognized as taxable income over four years (in the case of changes that increase taxable income). LIFO P&U sector companies will need to discuss with their regulatory commissions whether a change from LIFO will also occur for purposes of setting PGA rates and, if so, whether there will be a transition period. If LIFO is also discontinued for purposes of setting PGA rates, the price charged for gas will be reduced for a period of time to reflect the low cost older LIFO layers, but rate base will be increased to reflect the more current costs of gas inventory. In industries without PGA clauses, a change from the LIFO method accelerates the payment of taxes because lower cost of goods sold is recognized for book and tax purposes while sales prices remain constant. With a PGA clause and a change from LIFO for PGA rate-setting purposes also, there is an adverse dollar-for-dollar impact on cash flow because revenues will be lower to reflect the liquidation of LIFO layers, but there will be no impact on current or deferred tax liability.

## Initial adoption

IFRS requires one year of comparative financial information to be reported under IFRS based upon the rules in effect at the reporting date. For example, a company with a December 31, 2008 reporting date would be required under IFRS to also provide comparative financial statements in compliance with IFRS for 2007 using those standards effective as of December 31, 2008. This requirement differs from the U.S. Securities and Exchange Commission (SEC) announced proposed rule changes for the early adoption of IFRS that would require presentation of two comparative years (in addition to the year of change) of statements of income, cash flows, and equity. However, it is worth noting that in 2005, when foreign private issuers from the European Union initially adopted IFRS, the SEC provided an accommodation on the first year that allowed companies to include only one year of comparative information. Thus, the SEC may consider a similar accommodation for domestic registrants upon mandating IFRS for all U.S. issuers.

Generally, companies must apply initial adoption rules retrospectively—with some limited exceptions. Any differences resulting from the change in accounting policies from U.S. GAAP to IFRS upon the initial adoption date of IFRS are recorded directly through retained earnings. Key adoption differences or optional exemptions specific to P&U companies include:

- Fair value and other estimates at initial adoption date need to be consistent with estimates made at the same date under U.S. GAAP (after adjustment to reflect any difference in accounting policies), unless there is objective evidence that those estimates were in error.
- PP&E that previously did not require impairment losses if the undiscounted cash flows exceeded carrying value may require writedown at adoption date if recoverable value is less than carrying value.
- At initial adoption, a company may elect to measure PP&E at the date of transition to IFRS at its fair value and use that fair value as its deemed cost at that date.
- Acquisitions and business combinations prior to the date of initial adoption do not require retrospective application of IFRS related to the assets acquired and liabilities assumed.

In September 2008, the IASB issued an exposure draft requesting public comment on additional exemptions for first-time adopters of IFRS. Included in the exposure draft are the following exemptions:

- To exempt companies from retrospective application of IFRS for operations subject to rate regulation.
- To permit companies subject to rate regulation to elect to use the carrying amount of items of PP&E held, or previously held, for use in such operations as their deemed cost at the date of transition to IFRS if both retrospective restatement and using fair value as deemed cost are impracticable.
- To exempt companies with existing leasing contracts accounted for in accordance with IFRIC 4, Determining Whether an Arrangement Contains a Lease, from reassessing the classification of those contracts according to IFRS when the same classification has previously been made in accordance with national GAAP.

If adopted as proposed, and P&U companies subject to rate regulation elect to use their previously-held carrying value of PP&E as their deemed cost at the date of transition, companies will continue to be required to identify components of its deemed cost as of the transition date for prospective application of IFRS, which may require significant effort.

Public comments are due by January 23, 2009. A copy of the exposure draft can be found on the IASB website – [www.iasb.org](http://www.iasb.org).



# More Than Accounting and Financial Reporting

Without question, IFRS will impact the general ledger and financial statements. But in a relative sense, the accounting and financial reporting may be the easy part. How you handle the nonfinancial aspects of the transition to IFRS may be a far more accurate indicator of your success. Among the areas warranting your attention are tax, human resources, contract management, and technology.

**Tax issues:** As P&U companies address the tax consequences of a conversion from U.S. GAAP to IFRS, companies should identify any specific areas in which an eventual conversion to a principles-based financial reporting approach while remaining on a rules-based system prescribed by Congress, U.S. Treasury and the Internal Revenue Service (IRS) can eliminate book-tax differences or result in conformity between IFRS and tax methods of accounting for at least a portion of a calculation. The Treasury and IRS re-proposed regulations regarding capitalization of costs related to tangible assets in March 2008. The regulations cover numerous topics, including the proper unit of account to determine whether a “repair” cost is currently deductible or a capitalizable addition for tax purposes. The regulations are expected to be finalized in 2009 and it is expected that the new rules will apply prospectively (i.e., without a cumulative catch-up adjustment). The calculations pertaining to certain issues covered by the new regulations may be facilitated by a conversion to asset componentization for financial reporting purposes. To the extent there is flexibility available in applying asset componentization principles for IFRS purposes, it would be convenient if the IFRS approach would be such that information needed for the tax analysis under the

## Other Considerations Around the Regulatory Asset/Liability Issue

The lack of specific IFRS guidance for assets and liabilities arising from rate-regulated activities will likely present a number of challenges for P&U companies. One challenge may simply be separately identifying the individual items included in current U.S. GAAP regulatory asset or liability balances and determining whether they individually qualify as IFRS assets or liabilities. If items do qualify for IFRS recognition, companies may still need to revisit related process and policy documentation to address those IFRS considerations.

Items which do not qualify for recognition will present other challenges, including potentially making different policy or strategic decisions around the handling of particular transactions. For example, some P&U companies that have derivative instruments presently do not to apply hedge accounting, since gains or losses related to their regulated businesses will be deferred through those regulatory balances. If these amounts cannot be deferred under IFRS, companies may reconsider using hedge accounting as a means to mitigate unwanted earnings volatility.

Other differences may arise in terms of the timing of certain expenditures and their impacts on the income statement. Items which may have been deferred under U.S. GAAP for future recognition in earnings may be viewed differently under IFRS.

Affected companies should think through the possible alternatives and proactively plan for these changes well in advance of the conversion to IFRS to ensure that this issue is appropriately addressed.

final capitalization regulations were already available due to use for financial reporting purposes under IFRS. If regulated P&U utilities transition from using AFUDC to using general interest capitalization rules under IFRS, there may be similar opportunities to incorporate the various sub-methods of tax accounting for interest capitalization into the approach to be used for financial reporting purposes.

A conversion from U.S. GAAP to IFRS will impact a company's effective tax rate. The pre-tax differences between U.S. GAAP and IFRS will affect the denominator of the effective tax rate, but many of the differences will have a corresponding effect on deferred taxes and, thus, not impact the effective tax rate. However, numerous differences between SFAS 109 and IAS 12 will change a company's total tax provision. For example, accounting for flowthrough of deferred taxes and changes in tax rates may change for regulated P&U companies and would effect the timing of the recognition of tax expense. The timing of the recognition of investment tax credit may also change. Other differences between U.S. GAAP and IFRS that could impact effective tax rates involve accounting for uncertain tax positions and share-based compensation and the need to record deferred taxes with respect to undistributed earnings of subsidiaries. Further, differences in the carrying values of property, plant and equipment under IFRS may change state apportionment factors.

For more information, see “IFRS for U.S. Companies: Tax Implications of an Accelerating Global Trend” at [www.deloitte.com/dtt/cda/doc/content/us\\_tax\\_ifrs\\_pov\\_061708.pdf](http://www.deloitte.com/dtt/cda/doc/content/us_tax_ifrs_pov_061708.pdf).

**The HR factor:** As noted, IFRS involves much more than reorganizing the chart of accounts. It represents a change that cascades well beyond the finance department.

Consequently, human resources issues may be a major concern. A conversion project will place increased demands on your personnel, which may come at a time when you are least able to handle it. Finance organizations have streamlined in recent years, downsizing accounting functions through reduced hiring, layoffs, and attrition, as well as outsourcing or offshoring key functions. Unfortunately, these personnel reductions may mean that the people who could best help with your IFRS efforts are no longer available.

Recruiting may pose another challenge, particularly in the United States. College accounting programs across the country represent an important pipeline for keeping finance functions staffed and operating. Yet, most U.S. university accounting programs are only now beginning to develop comprehensive instruction on IFRS.

This issue can be addressed through training programs in the U.S. and internationally, to help key personnel become proficient in both IFRS and U.S. GAAP.

**Contract management:** An IFRS conversion will potentially impact your existing contracts. Consider involving your legal team as part of the remedy. Issues may include the following:

Many contracts may need to be reviewed to make sure the proper accounting treatment is followed under IFRS. To improve the efficiency of this process, a contract database could be created (if not already in place) to better monitor the IFRS conversion and tracking of effects.

Many P&U companies participate in joint ventures that they don't directly control. Thus, it can be difficult for the company to obtain all the necessary information to accurately convert to IFRS. For example, trying to identify the components of a plant that was funded — but not built — by your company may prove vexing. In such instances, you may want to reassess (and potentially revise) your requirements for financial and accounting information from the joint venture.

The IFRS conversion may trigger the need to amend contracts with financial institutions and joint venture partners in regards to financial accounting information to be supplied by your company. You may have to reword certain sections to address regulatory or third-party requirements to replace U.S. GAAP information with IFRS information.

**Technology issues:** IFRS is expected to have wide-ranging impacts at different levels of the IT systems architecture. The realignment of the company information systems will pose a real challenge for IT (along with the rest of the organization). Virtually all applications and interfaces in the system architecture can be affected, from the upstream or source of data to the farthest end of the reporting tools. As such, time and resource needs may be significant.

As you plan changes to your IT systems, you will need to take into account external factors such as FERC and state regulatory requirements, financial consolidation of subsidiaries, stock markets, and external auditors. This business transformation should not be considered a one-step project. It may be necessary to implement short-term initiatives strategically designed to institute an effective long-term solution for the organization.

Also note that during transition, you will need to be able to produce both U.S. GAAP and IFRS financial reports. This parallel reporting will likely pose additional technology and process complications.

## The European Experience

In July 2002, the European Parliament passed legislation requiring listed companies to convert to IFRS by 2005. The short timeframe and extensive reach of the directive had many companies scrambling to comply. Anecdotal reports suggest that the conversion placed significant resource pressure – human and financial – on finance teams and their companies at large.

A more tangible measurement of the effort can be found by comparing the length of European companies' 2004 (local country GAAP) and 2005 (IFRS) financial statements. The latter averaged more than 50 percent longer than the former; in some instances, reports doubled in length. Much of the increase can be attributed to an increased level of disclosure in the financial statements in areas such as judgments made and assumptions used.

Certain accounting issues proved especially vexing during the transition, including asset componentization, impairments, financial instruments, and lease accounting considerations.

### Potential Technology Impacts

Upstream Source Systems and Transformation Layer	General Ledger and Financial Applications	Reporting Data Warehouse Planning and Calculation Engines	Downstream Reporting Capabilities
Differences in the accounting treatment between current accounting standards and IFRS will create a need for new input data.	Differences in the accounting treatment between current accounting standards and IFRS will likely drive changes to general ledger design, chart of accounts, as well as sub-ledgers and feeds.	IFRS has much more extensive disclosure requirements, requiring regular reporting and usage of financial data that may not be standardized in current data models.	The differences that arise in the accounting treatment between current accounting standards and IFRS will create a need for changes in reporting.
Data and transactions that are captured, stored and ultimately sent to the financial systems may not have all the needed attributes or qualities.	Multinational companies may ultimately realize a need to re-develop general ledger platforms or additional sets of books to ensure compliance with multiple financial reporting requirements.	Increased need for documented assumptions, sensitivity analyses; potential factors that could affect future development may expand the scope of information managed by financial systems.	Assumption changes from period to period can introduce significant volatility and require detailed support for derivation and rationale for changes, requiring design of additional reports.
Sub-ledgers within the ERP may have additional functionality to support IFRS that is currently not being utilized but could be implemented.	Multi-ledger accounting functionality within newer releases of ERPs may be considered for long-term solutions.	Reporting warehouse feeds to calculation engines may need to be adjusted in a standardized way to support reporting processes.	External reporting templates will likely require revisions to reflect IFRS requirements.
Transformation layer not likely to have been designed with IFRS in mind; data sender/receiver structures may need to be adjusted.	Changes to IFRS will likely necessitate redesigned accounting, reporting, consolidation, and reconciliation processes, which may impact configurations of the financial applications.	Data governance functions and meta data repositories (potentially including data dictionary, ETL and business intelligence tools) may need to be adjusted to reflect revised data models.	Increased disclosures such as sensitivity tests and roll-forwards may require additional ad hoc query capabilities.
Over time, the potential for acquisitions of companies using IFRS will increase; altering source systems and Extract, Transform and Load (ETL) tools to provide all needed data elements will make integrations significantly more efficient.	Differences that arise in accounting treatment between current accounting standards and IFRS may create a need for new expense allocations and other calculations.	Current valuation systems may not have functionality to handle IFRS requirements.	

Among the lessons learned from the European experience were the following:

**The effort was often underestimated.** The original misconception that conversion was solely an accounting issue was replaced with a growing realization that the initiative was larger and more complex.

**Projects often lacked a holistic approach.** Because of the limited view cited above, companies frequently did not take the collateral effects into consideration, such as the impacts on IT, HR, and tax.

**A late start often resulted in escalation of costs.** Those few companies that anticipated conversion and took steps to prepare for it were in much better shape than those that did not. Companies that delayed their response paid a price for it, in terms of higher costs and greater diversion of resources.

**Many companies did not achieve “business as usual” state for IFRS reporting.** The highest quality financial data is obtained when companies fully integrate IFRS into their systems and processes. The compressed timeframes often precluded this possibility; instead, first-year financials were often produced using extraordinary, labor-intensive, and unsustainable measures.

**Several companies are only now starting to explore benefits from IFRS implementation.** Due to multiple constraints, the first-year effort in the E.U. was focused more on “getting it done.” Potential benefits in terms of reducing complexity, increasing efficiency, decreasing costs, and improving transparency had to be deferred.

## Smoothing the Transition

If you decide an accelerated IFRS conversion is desirable, here are a few considerations for smoothing implementation:

**Leverage existing projects:** If you are already going through — or have recently completed — an ERP or finance transformation project, now may be the time to consider IFRS adoption. Recent versions of major ERP systems are designed to accommodate IFRS, which can be mapped in, usually with significant cost savings.

**Conduct a trial run:** Implementation might be easier if you take a bite-sized approach starting with a single country or reporting entity. Use existing reporting requirements and local country IFRS requirements to your advantage. For example, subsidiaries in countries adopting IFRS over the next three years may be good candidates for your trial run. Learn from this initial conversion exercise, and apply the lessons learned to your global rollout down the road.

**Consider shared services centers:** IFRS provides a compelling reason to establish shared services centers, to potentially consolidate local GAAPs or subsidiary reports down to a single reporting standard. Geographically-dispersed finance offices could be drastically reduced or even eliminated in favor of a central finance function, strategically located to take advantage of tax incentives, payroll savings, and facilities cost reductions. In many cases, this concept is already aligned with the strategic direction P&U companies have taken or are currently considering relative to their finance function.

**Strengthen controls:** Depending on your operational structure, you may find that decentralized activities are reducing corporate oversight and impacting internal controls. IFRS offers the opportunity to implement standardized frameworks and processes to enhance the overall control environment.

**Refresh your policies:** Conversion to IFRS drives a need to revisit fixed asset componentization, inventories, derivatives, revenue recognition, and other accounting policies (as discussed on page 4). In other words, IFRS provides a refresh exercise for accounting policy implementation, with the aim of more accurate and timely financial reporting.

**Improve your access to capital:** Capital is migrating away from the U.S. for a number of reasons, including the weakness of the dollar, the credit crisis, and the growth of foreign financial centers in Europe and Asia. Regardless of the cause, when it comes to raising capital, trends are clearly global. IFRS can potentially improve liquidity and access to capital by offering greater transparency, in the form of full and better disclosure, to investors.

Access to capital may also be enhanced by virtue of aligning with a common standard. Markets and investors have been demanding a common standard for years, and IFRS has increasingly served that need. As such, companies reporting under IFRS may have an improved ability to access other capital markets that have adopted the standard.

## Getting It Right

IFRS will present major challenges even before you get to the nuts and bolts of the conversion process. For example, just deciding when to tackle IFRS represents a hurdle in itself. That’s where the development of a comprehensive IFRS implementation roadmap comes into play. There are simply too many variables to allow for a back-of-the-envelope calculation. You need to assemble your best minds in finance, HR, tax, legal, IT, investor relations, and other constituencies. You should call upon your board, audit committee, and other stakeholders. And you will need to assess the business landscape to understand what your peers are doing.

Don’t allow yourself to be distracted by the rising decibel levels around IFRS. The benefits of a reasoned and deliberate conversion defined by a thorough plan may be substantial.





## Resources

Deloitte has extensive IFRS experience in the P&U industry. With thousands of IFRS-experienced professionals in our global network, we provide a comprehensive array of services related to IFRS. As a multidisciplinary organization, we can help companies address a wide range of IFRS issues.

### **Deloitte offers companies assistance with:**

- evaluating the potential impacts of IFRS
- assessing readiness for IFRS conversions
- implementing IFRS conversions, providing support with technical research, project management, and training
- addressing the implications of IFRS in such areas as tax, finance operations, technology, and valuation

### **Deloitte's U.S. Power & Utilities group:**

We proudly serve power and utilities clients in each sector of the industry, helping them address their most critical challenges in order to deliver value for their shareholders and execute initiatives designed to further their strategic objectives

#### Overview of our Power & Utilities group:

- Audits half of the Fortune 1000 utilities and energy companies
- Provides accounting and enterprise risk services to 79% of the Fortune 500 utilities and energy companies
- Provides consulting services to the entire top 10 utilities and energy companies in the Fortune 1000
- Provides financial advisory services to 9 out of 10 utilities and energy companies in the Fortune 1000
- Provides tax services to the entire top 10 utilities and energy companies in the Fortune 1000
- More than 1,500 U.S. practitioners serving the industry, including over 350 Partners, Principals and Directors

Our practitioners understand that leadership demands active participation across the industry's diverse community. We actively participate in the following organizations:

- American Gas Association
- Edison Electric Institute
- Electric Power Supply Association
- United States Energy Association

### **Thought leadership:**

- 2008 Deloitte Electric Consumer Survey
- 2008 Deloitte Utility Commissioners Survey
- 2008 Deloitte Energy Conference Summary Report
- The Risk Intelligent Enterprise: ERM for the Energy Industry

#### Technical Publications:

- Power & Utilities Accounting, Financial Reporting and Tax Update
- Energy Quarterly Brief

### **Deloitte's Online Resources:**

For a wealth of online resources related to IFRS, visit [www.deloitte.com/us/ifrs](http://www.deloitte.com/us/ifrs). Available materials include newsletters, whitepapers, pocket guides, timelines, webcasts, podcasts, and more.

### **International Accounting Resources:**

The International Accounting Standards Board (IASB) develops international financial reporting standards for general purpose financial statements. Visit the IFRS section of [www.iasb.org](http://www.iasb.org) for additional details and copies of the standards.

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