by Ellen M. Heffes

IFRS in Three Years Possible ... But Only with a Stable Platform

This month — April 20 to be exact — marks the comment period deadline for the U.S. Securities and Exchange Commission's *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers*.

The timing of this roadmap will have a profound impact on the finance profession. And, professionals are closely watching to see how the economic crisis as well as the new SEC leadership and presidential administration will affect its ultimate timeline.

Mandatory adoption dates proposed by the SEC range from 2014 to 2016, depending on a firm's accelerated or nonaccelerated filing status. But, even if those dates are extended, many believe it's still a matter of *when*, and not *if*.

With this in mind, Cheryl Graziano, vice president-Operations, Financial Executives Research Foundation and Ellen Heffes, editor-in-chief, *Financial Executive*, spoke with two practitioners from European-based companies that have already implemented IFRS to share insights for U.S. peers.

Martin Wheatcroft is U.S. controller of National Grid, an international energy-delivery company and the largest distributor of natural gas in the northeastern U.S. as well as one of the largest investor-owned energy companies (revenues in excess of $20 billion). In his previous role, as chief accountant in the firm's London headquarters, Wheatcroft oversaw the company's IFRS adoption in 2005.

German-based Deutsche Telekom, a global telecommunications company with revenues of 61.7 billion euros (equivalent to approximately USD 78 billion), went through a similar transition in 2005.

According to Michael Bruecks, vice president Principles, Policies and Research, Group Accounting and Controlling, Deutsche Telekom's board of management commissioned group accounting and reporting in October 2002 to conduct a pre-project on the conversion to IFRS, together with the divisions.

This pre-project was successfully completed in March 2003 and the main project began in April 2003.

Since Deutsche Telekom was obliged to report under IFRS from Jan. 1, 2005, the company chose to present its IFRS opening balance sheet as of Jan. 1, 2003. Additionally, to be able to use several standards parallel for a number of years, IFRS was introduced at the accounting voucher level.

Both National Grid's and Deutsche Telekom's projects were led by the Finance function. Wheatcroft led IFRS conversion efforts on a day-to-day basis, reporting to the group financial director and group financial controller, who were both also involved throughout the process. In turn, business-wide lead accountants in specific areas (e.g. energy, derivatives) were actively involved and reported progress to him.

The team, he explains, had two major parts — a core team led by financial reporting to lead process issues and another group focused on what process issues would impact how the company was managed. Groups such as investor relations, human resources and in-house legal counsel were also involved, and the company's external auditor was a "critical part of the process."

Similarly, at the beginning of 2004, Bruecks says that Deutsche Telekom's organization of the IFRS project was brought more closely into line with the requirements for the live transition the following year. "The main feature of this new organization was the even stronger integration of the project activities into the organization of group accounting and reporting," he says.

Martin Wheatcroft
U.S. controller, National Grid

The project's steering committee comprised the chief financial officer, the heads of group accounting and reporting, group controlling, corporate control, taxes, treasury, investor relations, division CFOs and project management.

The committee set the framework for the project activities, took strategic decisions and monitored compliance with the project milestones. Project management managed all processes and ensured that there was continuous progress.

The project managements of the divisions were responsible for managing the project process for the divisions, and for ensuring communication and coordination with the central project. The divisions reported to the central project management and provided status updates.

A project office was established to support the central working bodies to administer and to develop the formal project standards, and was available as a contact for the IFRS project.

Impact on U.S.-Based Subsidiaries

With the 2005 conversion, IFRS became the leading GAAP for Deutsche Telekom Group. This meant that the company's

U.S.-based subsidiaries also moved to IFRS. To ensure an adequate and common understanding of IFRS, Bruecks recalls Deutsche Telekom dedicated considerable resources toward internal training, the preparation of an IFRS group accounting manual and interaction with peers regarding their interpretation of IFRS to ensure consistent application within the industry.

"This interaction with our peers still continues and the telecommunications operators try to contribute as much as possible to the due process of the International Accounting Standards Board," Bruecks says.

Wheatcroft notes that since National Grid is a public utility, the company needs to monitor what other U.S. regulators will do with IFRS, in addition to monitoring SEC actions. In the interim, given the company's industry (about 95 percent of revenues are regulated), National Grid's U.S. subsidiaries still have to maintain books and report locally under U.S. generally accepted accounting principles even though the company has already converted to IFRS.

"We have to provide dual reporting," he adds, "The conversion process actually happens at the U.S. subsidiary level because of the significant differences in the utility world," says Wheatcroft, noting, "There are some pervasive differences between U.S. GAAP and IFRS."

He cites pensions as an example. Since pensions are a component of employee costs, it hits every business unit. In such a significant area, he says, the numbers are substantial at the consolidated financial statement level. "Thus," he notes, "We need to push IFRS to a much lower level and foster better understanding of implications in a language that everyone can understand."

Realistic Timetable, Stable Platform

Both Wheatcroft and Bruecks emphasize the importance of a stable platform of accounting standards before embarking on an IFRS conversion. Though the European Union decided in 2002 to require listed companies to adopt IFRS, the "stable platform" of IFRS to be applied in the 2005 consolidated financial statements, was not available until March 2004.

This gave European companies only one year to prepare their first IFRS consolidated financial statements.

Before that, Bruecks says, "all conversion efforts were based on assumptions, [i.e.] Exposure Drafts, of how the stable platform would look."

Once a stable platform occurs, a move to IFRS in the U.S. is possible. So, should the time suggested by the SEC in the proposed roadmap be enough for U.S. firms?

Wheatcroft says: "Yes, with one caveat: it depends on the timing of new standards that are currently in train [process]." U.S. companies, he says, "are at a major advantage because there are less shifting sands." He comments he would have liked to have three years. "We really had only one year, because IFRS was not fully written until 2004."

He indicates a few open projects, and says he "would endorse a moratorium on standards after those are completed."

Resources and Costs

To deal with changes, Bruecks says distributing know-how within the Finance group is a key success factor. For Deutsche Telekom, this required educated internal staff. Using consultants definitely helps but internal resources need to be made available. During a conversion phase, finding these new resources is difficult and often costly.

Information technology is also a considerable area of cost. With the conversion to IFRS, many companies of the Deutsche Telekom Group have to prepare yet another set of financial statements, since IFRS financial statements typically do not fulfill the requirements for individual accounts of the company's legal entities.

Consolidated financial statements, individual accounts and tax accounts typically have to be prepared on different bases that ultimately increase the complexity of IT systems.

Wheatcroft provides a different perspective, noting that this type of project involves people and processes more than systems. "Any company with a good ERP system has the right technology. An IFRS project is similar to the adoption of a new accounting standard in a specific area; what is different is the scale of the project."

That said, he is quick to point out that National Grid did encounter complexity in the adoption of International Accounting Standard 39, *Financial Instruments: Recognition and Measurement*, given its extensive energy and debt portfolios. Wheatcroft notes, however, that U.S. companies may have existing systems to apply Financial Accounting Standard 133, *Accounting for Derivative Instruments and Hedging Activities*.

So IAS 39 adoption might need just a system upgrade rather than an entirely new one.

Accounting Differences and Practical Realities

Another area to consider for those adopting IFRS is what do when an IFRS standard is absent in a particular area for which an accounting policy is needed. Bruecks sheds some light on this as a U.S. foreign private registrant.

"We always looked and keep on looking to U.S. GAAP literature to find solutions for issues not addressed in IFRS. Interacting with peers on accounting matters and adequate interpretations of IFRS also helps to ensure consistent application of IFRS — which is, in effect, the focus of all enforcement bodies worldwide."

However, he emphasizes that any accounting solutions have to be based on IFRS first and not on management of reconciling items between IFRS and other GAAPs. "This requires an in-depth knowledge of IFRS and the framework they are based on. A "national solution"

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— Michael Bruecks, vice president Deutsche Telekom

to interpret IFRS might help in the short-run, but those solutions bear the risk of being challenged later on."

Any IFRS adopters are also faced with the prospect of elimination of what is referred to in a FERF study (*International Financial Reporting Standards: A Project Plan for U.S. Companies)* as the different versions or "flavors" of IFRS. For a large company like National Grid, Wheatcroft notes it was hard to eliminate all the differences and advises a lot of dialogue with internal and external auditors to get agreement.

Bruecks agrees: different people think differently about IFRS. To find an appropriate solution for all, issues need to be communicated early in order to involve different levels of management and auditors.

He is also quick to state that although many companies prepare their consolidated financial statements under IFRS, consistency in their application has clearly not yet been reached. He references a related Ernst & Young survey of 2005 financial statements.

The study notes that though the 2005 implementation of IFRS has been a resounding success overall, IFRS financial statements: are more complex than financial statements based on national accounting standards; retain a strong national identity; and require extensive judgment to be applied in the selection of IFRS accounting treatments (including the application of IFRS 1, *First-time Adoption of IFRS*) that restricts consistency and comparability.

In the wake of that reality, first-time adopters can consider several one-time elections. Both Wheatcroft and Bruecks provide some tips. "The purpose of the exemptions in IFRS 1 are designed to and do make the IFRS conversion process easier," Bruecks says.

"In making the choice, the focus should be on the availability of the information required if the company does not want to use the exemption. On the other hand, the impact of the exemptions on the presentation of the company's performance have to be analyzed carefully and at the earliest stage possible.

"Having a look at the first IFRS consolidated financial statements presented by European companies in 2005, it becomes clear that companies used the exemptions differently depending on how they assessed the implications of their application on the presentation of the performance of the company."

Expressed differently, Wheatcroft says the exceptions are to deal with impracticalities. "In reality it's not a difficult decision. If it's relevant to your company you will apply it. If it's not, you won't."

He also reiterates the importance of information availability using the FAS 133 example. "FAS 133 means U.S. companies may have the documentation that would allow them not to need the IAS 39 exceptions, whereas European companies on the whole weren't in that position. I think it will all come down to [each company's] circumstances."

User Reaction

But what about street reaction? The E&Y study notes that European companies did not seem confident that IFRS financial information was sufficient, or in some cases entirely appropriate, for the purpose of communicating their performance to the markets.

However, when asked about analyst and investors reaction to the IFRS move, Wheatcroft says of his firm: "Actually we were very pleased when there was no reaction whatsoever."

He adds: "An accounting change is not the same as changing cash flows and share prices should be based on cash flows." The bigger perspective, he says, is that "it was a learning experience for analysts as much as it had been for us." In that regard, he comments, "the change has been generally helpful because analyst understanding has improved."

This understanding has come from open, thorough and early communication. Deutsche Telekom, for example, communicated its first IFRS figures in April 2005 roadshows, before its first quarterly consolidated financial statements under IFRS were presented.

In these presentations, all major reconciling items from German GAAP to IFRS were explained. "The purpose of this early communication," Bruecks explains, "was to manage expectations of the financial community and to avoid surprises."

National Grid also used presentations as well as charts, detailed reconciliations and analyses explaining accounting differences. "We were pioneers in explaining IFRS to analysts, so that was part of our story," says Wheatcroft.

"We spent a reasonable amount of time to explain and it worked pretty well. The analyst community has changed because of IFRS. Now they can look across Europe rather than being stuck in a particular country. Though IFRS hasn't increased the coverage for National Grid because we were already one of the top 30 companies in the United Kingdom, it has improved the quality of dialogue with our analysts," he says.

Mindset Change

A take-away is that the key success factor in any IFRS conversion project is communication, communication, communication. Bruecks says this starts with knowledge being made available early on. "If knowledge about IFRS is not distributed early, accounting will not be based on IFRS but will be a process of managing reconciling items between IFRS and other GAAPs."

The timeline, he says, is always critical. "It is essential to plan early, to make policy decisions early and to fully consider the industry and reporting implications when doing so; to understand well in advance the system changes and issues that changing GAAPs might create."

Consequences, evaluation and resolution should be a part of the project, Wheatcroft adds. "Communication must be outside of Finance. Nonfinance management teams don't need to understand the complexities of pension accounting, but do need to know how numbers will change."

In the U.S., he says, there is often fairly clear guidance as to how to account for something. "IFRS guidance is broader and provides a fundamentally different way of looking at things."

For example, he wrote an IFRS-related memo that had one reference to an accounting standard. "In comparison, I looked at a similar U.S. GAAP-related memo that had about 30–40 references to U.S. standards."

Finally, don't underestimate the mindset shift that IFRS brings. Wheatcroft says, "It brings about a different way of thinking. In reading the words on the page, we need to understand that IFRS is coming from a different direction."