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Transition to IFRS: Inception to Implementation in the United States

Lynette Biers
Carroll College, Helena, MT

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Transition to IFRS: Inception to Implementation

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Lynette L. Biers

Carroll College

Author Note

Lynette L. Biers, Helena, Montana.

Correspondence concerning this paper should be addressed to Lynette Biers, E-mail: lbiers@heritagepropane.com
Transition to IFRS: Inception to Implementation

Abstract

In an effort to simplify the ability of United States based businesses to operate in the international world of business by providing comparable, transparent financial statements for both foreign and domestic investors alike, the Securities and Exchange Commission (SEC) is moving towards adoption of International Financial Reporting Standards (IFRS) or the convergence of IFRS with U.S. Generally Accepted Accounting Principles (GAAP). While this potential change could increase the accessibility to foreign capital markets, the transition would also pose many serious and complicated challenges to the companies currently complying with U.S. GAAP. This paper will look generally at the history of how U.S. GAAP and IFRS arrived at this crossroads, how it will affect the U.S. business community at large, and then more specifically at a few of the challenges facing a publicly traded energy company during this transition. It will focus on key areas most greatly affected by these new standards and present an in-depth look at how this possible change in accounting rules could affect their treatment of fixed assets, intangible assets, income taxes, deferred taxes, and the consolidation of partially-owned entities. The resulting consequences to the company’s financial position on paper will also be considered. Comparing and contrasting these two different reporting methods may reveal the subsequent impact this proposed change could have for this U.S. based energy company.
Every business, regardless of size or ownership structure, is faced with the challenge of preparing accurate and informative financial statements that fairly present their true economic position to investors, creditors, and other stakeholders. The rules that govern and regulate the preparation of financial information and reporting standards that businesses are required to follow vary by country and also depend on whether the company is publicly or privately owned. There are currently two predominant sets of standards being utilized globally. In the United States, companies that want to actively trade on the U.S. Stock Exchange are required to comply with U.S. Generally Accepted Accounting Principles (GAAP), while many other countries require their publicly traded companies to adhere to International Financial Reporting Standards (IFRS). Unfortunately, in some areas significant differences exist between these two sets of standards and the result is a lack of comparability and uniformity between financial statements prepared in compliance with each respective set of standards. The confusion over how to understand a company’s financial presentation and to interpret financial statements prepared using U.S. GAAP versus IFRS is a growing concern to both foreign and domestic investors and businesses alike. The question is - what is the best way to bridge the gap that exists between businesses preparing their financials according to U.S GAAP and those using IFRS? Several options are available to the Securities and Exchange Commission (SEC) and the global financial community. The SEC could choose to allow publicly held companies to adopt IFRS as a replacement for U.S. GAAP; or the
two systems, in a joint, cooperative effort, may converge to develop one single set of high-quality, international accounting standards that would be used in at least all major capital markets globally.

History

To better understand the cross roads the global financial community now faces, it is necessary to look at the evolution of both U.S GAAP and IFRS.

Development of U.S. GAAP. The Securities Act of 1933 and Securities Exchange Act of 1934 established the U.S. Securities and Exchange Commission (SEC), which was authorized to prescribe standards for the preparation of financial reports. In 1939 the SEC voted to allow the private sector to regulate accounting practices, and at their request the American Institute of Accountants (AIA) appointed the Committee on Accounting Procedure (CAP) to begin setting standards that would regulate financial reporting. This took place shortly after the stock market crash and there was an obvious need for companies to issue uniform financial statements that could be used by potential investors, creditors, and other users in making rational investment, credit, and other financial decisions. CAP issued 51 Accounting Research Bulletins to guide businesses in preparing their financial statements. Then in 1957 the AIA was renamed as the American Institute of Certified Public Accountants (AICPA). Several years later the AICPA formed the Accounting Principles Board (APB) to replace the CAP and in the following 16 years they issued an additional 31 opinions to supplement the bulletins already in practice. Unfortunately, this board was surrounded by
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increasing controversy, and many professionals felt it became ineffective due to lack of independence, too slow and reactive rather than proactive in a more and more complex business world. Finally a special committee of the AICPA suggested an autonomous board be responsible for setting U.S. accounting standards. Thus the Financial Accounting Standards Board (FASB) was created in 1973 and replaced the Accounting Principles Board. To date, the FASB has issued 168 Statements of Financial Accounting Standards (SFAS) that comprise most of the accounting principles that are now formally known as U.S. GAAP. Some CAP and APB guidelines are still in force while many have been superseded or modified by SFASs. FASB opinions and standards tend to represent conservative accounting principles that lean towards presenting revenues and assets at lower values, and costs and liabilities at higher amounts. They emphasize full and accurate disclosure in the financial statements; and, due to their conservative stance, a business may be required to overstate their weaknesses and understate their strengths in a variety of circumstances which could negatively influence current and potential investors.

Development of IFRS. In contrast to U.S GAAP, the formation of IFRS was a less complicated process. In the late 1950s and early 1960s a need was recognized for international standards due to post World War II economic integration and the related increase in cross-border capital flows. In 1962 the 8th International Congress of Accountants, with membership representing most of the global accounting community, was held and the discussion focused on the world economy in relation to accounting. Many participants urged that “steps be
undertaken to foster development of auditing, accounting, and reporting standards on an international basis” (FASB, 2010, “International Convergence of Accounting Standards,” para. 7). However, it wasn’t until 1973 that the International Accounting Standards Committee (IASC) was established by the AICPA and its counterparts in eight other countries. “Its mission was to formulate and publish, in the public interest, basic standards to be observed in the presentation of audited accounts and financial statements and to promote their worldwide acceptance” (FASB, 2010, “International Convergence of Accounting Standards,” para. 12). By 1987 the IASC had issued 25 standards dealing with various accounting issues. In response to the need for improvements in the governance, funding and independence of the IASC, it was reformed into the International Accounting Standards Board (IASB) in 2001. The IASB was established as an independent standard-setting board and is currently responsible for setting international financial reporting standards. In 2002 the European Union adopted legislation requiring all listed companies to prepare their consolidated financial statements using IFRS starting in 2005; it thereby became the first major capital market to require the use of IFRS. IFRS is designed to reflect the economic substance of a transaction as opposed to the more rule-based U.S. GAAP. These international standards contain less application guidance to follow; this provides for allowable alternative treatments for the same transactions and therefore giving added flexibility for the company to accurately reflect the true economic results of business activities as they interpret it in their financial statements.
As of 2009, in addition to the European Union, over 120 other countries either require or permit the use of IFRS or a local variant of them. With this overwhelming multinational acceptance of International Financial Reporting Standards, the United States faces the need to either change U.S. GAAP to more closely resemble international standards or allow the adoption of IFRS by its publicly held companies in order for them to remain competitive in foreign capital markets. “The U.S. Securities and Exchange Commission has for many years been a strong leader in international efforts to develop a core set of accounting standards that could serve as a framework for financial reporting in cross-border offerings. It has repeatedly made the case that issuers wishing to raise capital in more than one country are faced with the increased compliance costs and inefficiencies of preparing multiple sets of financial statements to comply with different jurisdictional accounting requirements” (AICPA, IFRS.com, “International Financial Reporting Standards (IFRS),” p. 3).

**Development of a convergence plan.** The concept of international convergence of accounting standards is not a new one; discussions and research have been taking place since the 1960s. However, real progress towards this end did not begin until the late 1980s when the FASB became a member of the International Accounting Standards Committee (IASC) consultative group. This meant the FASB was permitted to attend and participate in IASC meetings and have input in the development of new standards. During the 1990s, the FASB developed its first strategic plan for international activities. The plan outlined specific efforts toward achieving that goal. Those included (a) actively
considering the existing requirements of international standards in the Board’s projects, (b) taking on joint projects with other standard setters, (c) actively participating in the IASC’s processes, (d) strengthening international relationships, and (e) expanding international communications.

The next major step towards convergence took place in October, 1996, when the U.S. Congress passed the National Securities Markets Improvement Act of 1996. Section 509, which dealt with promoting the global preeminence of American Securities Markets, stated that the “establishment of a high-quality comprehensive set of generally accepted international accounting standards in cross-border securities offerings would greatly facilitate international financing activities and, most significantly, would enhance the ability of foreign corporations to access and list in United States markets.” In 2002, the FASB and IASB embarked on a partnership, known as “The Norwalk Agreement,” to improve and converge U.S. GAAP and international standards. This agreement “set out the shared goal of developing compatible, high-quality accounting standards that could be used for both domestic and cross-border financial reporting. It also established broad tactics to achieve their goal: develop standards jointly, eliminate narrow differences whenever possible, and, once converged, stay converged (Norwalk Agreement)” (FASB, 2010, “International Convergence of Accounting Standards,” para. 35).

February 2006 brought another milestone when the FASB and IASB issued a Memorandum of Understanding (MoU). The MoU elaborated on the Norwalk Agreement and added the additional directive that instead of trying to
eliminate differences between standards that are in need of significant improvement, the Boards should develop a new common standard that improves the quality of financial information. The MoU believe that servicing the needs of investors means that the Boards should seek to converge by replacing weaker standards with stronger standards. Then in December 2007, after taking public comment for the prior 6 months, the SEC issued a final rule eliminating the requirement that foreign registrants that use IFRS reconcile their statements back to U.S. GAAP. Also in 2007 The SEC issued *Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards*. The Concept Release sought public input on whether to give U.S. public companies the option of using IFRS as issued by the IASB in their financial statements filed with the SEC (*Concept Release*). In response to the Concept Release, the Financial Accounting Foundation (FAF) and the FASB argued against permitting the optional use of IFRS in the absence of the planned adoption by all SEC registrants, citing the complexity that would result from such a dual reporting system. In spite of the objections made by those two organizations, in 2008 the SEC issued a proposed roadmap to the possible use of IFRS by U.S. issuers beginning in 2014. The Commission will decide by 2011 if the adoption of IFRS is in the public interest and would benefit investors. The SEC also proposed that U.S. issuers meeting certain criteria be given the option of filing financial statements prepared using IFRS as issued by the IASB as early as years ending after December 15, 2009 (*Proposed Roadmap*). Again, the FAF and FASB responded to the SEC in a letter and “reiterated the FASB’s strong support
for the goal of a single set of high-quality international standards and recommended additional study to better evaluate the strengths, weaknesses, costs and benefits of possible approaches the U.S. could take in moving toward that goal (Comment Letter)” (FASB, 2010, “International Convergence of Accounting Standards,” para. 45).

In February 2010, the SEC issued their Work Plan for the Consideration of Incorporating International Financial Reporting Standards into the Financial Reporting System for U.S. Issuers (IFRS Work Plan), which was basically an additional statement that made clear that the SEC continues to believe that a single set of high-quality, globally accepted accounting standards would benefit U.S. investors. According to the SEC, “high-quality standards include a comprehensive set of neutral principles that require consistent, comparable, relevant and reliable information that is useful for investors, lenders and creditors and others who make capital allocation decisions.” The Work Plan mapped out a course for the SEC to gather information to decide whether to incorporate IFRS into the U.S. financial reporting system. The Work Plan lists the six key areas that the SEC feels need to be investigated before they can make a final ruling about the incorporation of IFRS. These six areas are:

- The sufficient development and application of IFRS for the U.S. domestic reporting system. This will include looking at the future role of the FASB going forward and exactly what the best method of incorporating IFRS would be.
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- Independent standard setting for the benefit of investors. This mainly focuses on how the IFRS Foundation is funded to evaluate whether the current structure maintains the independence of the standard setting process.

- Investor understanding and education regarding IFRS. This will consider how familiar with IFRS investors are currently and how they stay abreast of changes in accounting standards. The benefits of adopting a single global standard will be fully realized only if investors understand and have confidence in the financial reporting system.

- The regulatory environment. They will evaluate how incorporating IFRS will impact other parties, such as industry regulators and private companies.

- The impact on issuers. The change to IFRS would impact more than just the information in the financial statements of issuers. The extent of these changes will include its effect on accounting systems, controls and procedures, contractual arrangements, corporate governance, accounting for litigation contingencies, and the difference for smaller issuers versus larger issuers.

- Human capital readiness. A number of parties such as preparers, investors, auditors and educators will need to become familiar with IFRS. This Work Plan will analyze those considerations (Grant Thornton, 2011, “On the Horizon for IFRS,” pp.3-10).
In June of 2010 the FASB and IASB agreed to prioritize the major projects for which the need for improvement is most urgent in order to expedite the convergence project. And in October 2010 the SEC issued their first progress report on their work to improve and achieve convergence of U.S. GAAP and IFRS. Indicating they believe that one single set of standards is the optimal option and is consistent with their mission of protecting investors and maintaining fair, orderly and efficient markets and facilitating capital formation. But the SEC has not yet made their final ruling and is still doing intense analysis on several of the key areas listed above. The major areas still under debate are the method of incorporation of IFRS and the anticipated implementation period. In anticipation of the SEC’s ruling, which may be released as early as the latter part of 2011, the financial community continues to assess what the adoption or incorporation of IFRS into the U.S. financial reporting system will mean to them.

**Adoption Benefits and Challenges**

While the SEC continues their study and the FASB and IASB continue their convergence work, the business and financial communities are beginning to explore what the potential benefits and certain challenges of adoption of IFRS might be if the SEC allows the pursuit of this option instead of waiting for the convergence work to be completed.

**Benefits of IFRS adoption.** The potential benefits of being on the leading edge of conversion may be numerous and increase the desirability of early adoption. One of the foremost reasons is the ability to provide transparent
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financial statements to foreign and domestic lenders and investors alike that would be understandable to both the international and local financial communities. The ability of foreign investors to better comprehend the stated financial position of a U.S. based company could grant easier access to foreign capital markets and investment opportunities. This increased comparability with international competitors would also facilitate cross-border acquisitions, ventures, and spin-offs by eliminating the fears that a foreign company would have about misinterpreting financial statements prepared using U.S. GAAP rules that they are unfamiliar with. Overall, having every company’s financial statements prepared under one set of uniform standards would be overwhelmingly beneficial to all participants in the financial and accounting communities.

An additional advantage this change would bring is the ability to streamline financial reporting operations for U.S. companies with global operations and both foreign and domestic reporting requirements. Having only one set of accounting standards to comply with will provide these businesses the capability to develop common reporting systems for all their operations and employ regional financial centers. It would also reduce over-head costs and create flexibility for moving financial resources. This cohesion will also provide the opportunity for corporations to centralize training and development, which would also help achieve consistency and accuracy in statutory reporting.

Challenges of IFRS adoption. Along with a variety of benefits come a multitude of challenges as well. The transition to new accounting standards is more than just an accounting exercise and will require a magnitude of
concentrated effort on the part of all the various levels of management within a company. First and foremost will be the need to address human capital readiness and the deficiency of IFRS reporting knowledge for all staff whose areas of responsibility are affected by the change in rules. Acquiring the skills and knowledge necessary to move towards these new policies will be a key step in the process for any company choosing to adopt IFRS. Classes, seminars, and other training venues will be important to educate the employees and management since IFRS is different from U.S. GAAP in many areas. IFRS is designed to reflect the economic substance of a transaction and contains less application guidance as opposed to the more rule based GAAP. Judgment by management in the application of these standards will be needed in some areas of the business where this was not previously required. Also, current Sarbanes Oxley controls and business policies may need to be re-evaluated and replaced. These key controls and policies are crucial to properly validate supporting documentation for any new judgments used in applying IFRS to the various business transactions and to how these transactions are reflected in the financial statements.

This new education process presents not only a challenge for the business community but for the collegiate system and CPA firms as well. Colleges and universities will be required to adjust curriculum to provide instruction of IFRS along with professors appropriately prepared to teach them. Certified Public Accounting (CPA) firms will also be faced with changes due to firms either choosing or being required to adopt IFRS. If they haven’t already done so, CPA firms will need to staff experts in the application and interpretation of IFRS so
they can both advise the client-companies who follow IFRS and properly audit their financial statements. Whether one is a member of the business, accounting, or education community, the adoption of International Financial Reporting Standards will bring expenses and challenges associated with the education of all groups affected by this change.

For the companies that choose early adoption, there will be expensive one-time costs in conjunction with such an extensive enterprise-wide implementation of new accounting policies and procedures. Including associated audit fees and other external advisor expenses related to the first-time adoption efforts. There may also be a need to upgrade and adapt various computer software programs or systems, such as accounting programs, across the entire business enterprise in order to facilitate the adoption of IFRS and comply with its reporting requirements. Managing and budgeting for these costs will be a crucial part of the early adoption process.

Contract accounting under IFRS and U.S. GAAP is significantly different; therefore one additional area to be addressed by each company as part of their implementation plan is the potential need to renegotiate business contracts as they expire, giving consideration to their treatment by the new standards so that the new contracts correctly reflect the desired economic benefit. The types of contracts most likely to be affected would be leases and debt agreements. Depending on the nature of the business and the number of leases entered into during the normal course of that business, negotiating new leases could be very time intensive and also another source of added expense to the company.
A company’s debt agreements and their reporting and measuring covenants could also be significantly different under IFRS than were previously required under U.S. GAAP. And there is the chance that some U.S. lenders will not be willing to accept the new presentation and will still require statements that conform to U.S. GAAP to prove adherence to the debt covenants. Therefore, a company facing that situation will need to prepare two separate sets of financial statements. This dual reporting requirement would create an ongoing concern and an additional expense for the business, making this an important facet to be considered by management before choosing to proceed with early adoption of IFRS.

The need to manage stakeholder expectations, including the budget and planning aspects of the project along with investor relations, will be of vital importance. Ultimately, creating and implementing a plan up front and facilitating organizational buy in will be crucial to overcoming these many challenges and promoting a successful transition to IFRS.

**Impact of Implementation**

An assessment of the impact of adopting IFRS is not complete without an understanding of IFRS 1: First-time Adoption of International Financial Reporting Standards, which was developed by the IASB to provide transition guidance to enterprises preparing their first set of financial statements in full compliance with IFRS.
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There are several key elements of IFRS 1. The first requirement is that the company must identify the date of the first IFRS financial statements. It is required that the company be compliant with IFRS standards effective at this chosen date. Then, subject to certain exemptions, apply IFRS retrospectively for comparative statements presented.

There are fifteen optional exemptions to ease the burden of retrospective application and there are also four mandatory exceptions where retrospective application is not permitted. The exemptions provide limited relief for first-time adopters, mainly in areas where the information needed to apply IFRS retrospectively may be most challenging to obtain. There are, however, no exemptions from the disclosure requirements of IFRS, and companies may experience challenges in collecting new information and data for retrospective footnote disclosures.

(PriceWaterhouseCoopers, 2009, p. 17)

Next, an opening balance sheet must be prepared at the transition date, which is the beginning of the earliest financial year presented. Assuming a company adopts IFRS by fiscal 2011 and the SEC rule of presenting 2 years of financial statements is permitted in its 10-K publication, the transition date for the purpose of IFRS 1 would be January 1, 2010 (first day, fiscal 2010). The effect of retrospectively applying IFRS to transactions before the transition date is recognized as an adjustment to equity in the opening balance sheet. All
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comparative financial statements and disclosures must be in full compliance with IFRS guidance for recognition, measurement, presentation and disclosures starting with the transition statements. Extensive disclosure is required in the first set of IFRS financial statements to explain the effect of transition. As per IFRS 1, an additional footnote is required to include the following:

- A reconciliation between previous U.S. GAAP, and IFRS for: a) equity at the transition date; and at the most recent reporting date under the previous U.S. GAAP and b) profit and loss for the most recent reporting period under the previous U.S. GAAP;
- An explanation of material adjustments to the cash flow statement for the most recent reporting period under the previous GAAP.

The adoption of IFRS and does not come without the possibility of a significant impact on the financial statements. A study of 130 reconciliations of foreign filers using IFRS compared to their statements following U.S. GAAP shows the differences between the two accounting systems can be quite large (Ciesielski, 2007, “It’s Not a Small World, After All,”). Approximately two-thirds of the companies studied showed higher earnings under IFRS than U.S. GAAP. The median difference was 12.9%, however in some cases income was more than double under IFRS. The other one-third showed lower earnings with a median difference of 9.1% and in some cases income was less than one-third of
the amount that would have been shown using U.S. GAAP. Only two companies showed the same earnings under both IFRS and U.S. GAAP.

There was also a material difference in equity when applying the two systems. Slightly more than half of the companies studied showed greater equity under IFRS than U.S GAAP with a median difference of 6.6% (Ciesielski, 2007, “It’s Not a Small World, After All,”). The remainder showed lower equity under IFRS with a median difference of 12.7% while only one company had the same calculated equity under both systems. The main areas that contributed most significantly to the previously stated difference were in the accounting for property, plant and equipment, pensions, minority interests, capitalization of interest, purchase price accounting, and asset impairment.

**Impact of IFRS on ETP.** The task of trying to gain a complete understanding of what this major transition entails to the majority of U.S. business is more overwhelming than can be adequately dealt with in this study. Therefore, the remainder of this paper will focus on one specific company and its financial statements: Energy Transfer Partners, L.P. (ETP). As a current employee of ETP, the implementation of IFRS will directly impact my duties and job-related responsibilities. Energy Transfer Partners, L.P. ([NYSE:ETP](https://www.nyse.com)) is a publicly traded partnership owning and operating a diversified portfolio of energy assets. ETP has pipeline operations in Arizona, Colorado, Louisiana, New Mexico, and Utah, and owns the largest intrastate pipeline system in Texas. ETP currently has natural gas operations that include more than 17,500 miles of gathering and transportation pipelines, treating and processing assets, and three storage facilities
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located in Texas. ETP also is one of the three largest retail marketers of propane in the United States, serving more than one million customers across the country.

This study will focus on the key areas of fixed assets, intangible assets, income taxes, deferred taxes, and the consolidation of partially-owned entities and the resulting consequences adoption of IFRS as applied to the above listed areas would have on the company’s reported financial position. Footnote disclosure requirement differences will also be considered. By comparing and contrasting the two different reporting methods at a broad level, I intend to give an educated glimpse into the subsequent impact this proposed change may have for the financial statements of Energy Transfer Partners.

The following paragraphs will be referring to the specific U.S. GAAP, Statement of Financial Accounting Standards (SFAS), Accounting Research Bulletins (ARB), FASB Interpretation Numbers (FIN), and Emerging Issues Task Force (EITF) issue numbers that relate to the specific standards being discussed. Corresponding IFRS International Accounting Standards (IAS), Standing Interpretations Committee (SIC) pronouncements, and International Financial Reporting Interpretations Committee (IFRIC) clarifications will also be specifically named. This information is given in the event the reader desires to locate the exact standard in question since for the intent of this paper quoting the entire original standard would only prove as laborious reading to the general audience.
Changes to plant, property, and equipment accounting. The first area to compare is that of plant, property and equipment (PP&E). The carrying value and depreciation of PP&E are the two main areas where U.S. GAAP differs from IFRS. Under SFAS 34, PP&E is carried at historical cost and the standard also prohibits revaluations. Depreciation is typically on an entire asset approach, and there is no PP&E roll-forward disclosure required. There are significant differences in the treatment of PP&E under IFRS. While historical cost is the primary basis of accounting, IAS 16, permits the revaluation to fair value, if fair value can be measured reliably and the revaluation occurs consistently for the same asset class, less accumulated depreciation and impairment. If the current fair value is lower than the historical value, this will result in a loss reflected in net income, lower net asset value and equity on the balance sheet. The change in fair value will show as an addition back to net cash earned from operating activities on the cash flow since this would be a non-cash transaction. If the current fair value resulted in a higher than historical value, the opposite would be true, with an increase to net income, higher net asset value and equity and a subtraction to the net cash earned from operations on the cash flow statement.

IAS 16 requires a component approach for depreciation, where assets are required to be split into various components and depreciated over their respective useful lives. ETP operates in a capital intensive industry and has significant PP&E assets that will comprise a significant number of components, many of which will have differing useful lives. A separate component may be a physical component such as a major spare part, or a non-physical component such as a
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major inspection or overhaul. ETP may need to further segment their PP&E under the requirements of IAS 16. This change in approach to depreciation may directly impact ETP’s net income. Breaking out the many components would more than likely result in shorter useful lives for calculated depreciation, therefore increasing depreciation expense and lowering net income. The effect on the balance sheet due to the increased depreciation would be reflected in a lower net asset value of PP&E and also lower equity. This impact on the cash flow would be shown as an addition back to net cash earned from operations as a non-cash expense item.

Under IAS 16, ETP would be required to disclose a roll-forward of PP&E, showing additions, deletions, revaluation, depreciation and impairment losses. There is also an additional requirement of the annual assessment of useful lives, depreciation methods and residual values.

Changes to goodwill and intangible accounting. Goodwill and other intangible assets is another group of assets that will require different accounting treatment for ETP upon the adoption of IFRS. When comparing the differences between IFRS and U.S. GAAP the main area that affects goodwill is that of impairment. SFAS 142 requires an annual impairment test and also a test when events or changes in circumstances indicate that the fair value of a reporting unit with goodwill has been reduced below carrying value. This is a two step process. First, the fair value of the reporting unit is compared to its carrying value. If there is a deficiency, a goodwill impairment loss is the difference between the carrying value and the implied fair value of goodwill. The implied value is derived by
assessing the fair value of the reporting unit and subtracting out the fair value of all non-goodwill assets. The remainder is the implied fair value of goodwill. A reporting unit is defined as an operating segment or one level below an operating segment.

Under IAS 36, goodwill is tested for impairment at the cash-generating unit (CGU) level. A CGU is the lowest level or group of assets that generates cash in-flows from continuing use that are largely independent of cash flow from other assets or groups. This may be different from a defined reporting unit under U.S. GAAP and may lead to a calculated impairment under IFRS when none would exist under U.S. GAAP. The impairment loss is also calculated differently under IAS 36. The loss under IFRS is the difference between the carrying value of the CGU and the asset’s fair value less costs to sell, or the asset’s value in use.

The need to recognize goodwill impairment more readily under IFRS will lead to lower net income due to the recorded loss on the asset. Impairment will also result in lower value of assets and equity on the balance sheet and be shown as an addition back to net cash earned from operations on the cash flow statement.

The differences in the treatment of all other types of intangible assets are not as significant between the two sets of standards. Basically, under SFAS 142, these assets cannot be revalued and there is no specific requirement to review the residual value except as events change or circumstances indicate the current estimate is no longer appropriate. Under IAS 38, intangible assets may be revalued to fair value if there is an active market upon which to base the new
value and the residual value is reviewed at least at each annual reporting date. While an entry is made to record the gain or loss when an asset is revalued, a change in the asset’s residual value is accounted for prospectively as a change in accounting estimate and the respective amortization schedules are adjusted to reflect the write off of the new residual value. If a gain is recorded, net income will increase, on the balance sheet assets and equity will increase and an adjustment will be made on the cash flow to reduce the net cash received from operating activities. The inverse would be true for ETP if a loss were recorded and also if the amortization expense increased due to an adjusted residual value.

**Changes to inventory accounting.** Inventory is another area where ETP could experience greater earnings volatility under the standards of IFRS in comparison to U.S. GAAP. Following SFAS 151, ARB 43, and EITF 04-13 policy inventories are carried at the lower of cost or market value and if the value of inventory is written down, no reversal of that estimated loss is permitted. However, the opposite is true of IFRS: IAS 2. Reversals of write-downs are required for subsequent recoveries, but are limited to the amount of the original write-down. This resulting cycle of recorded loss, then recovery of values, will be reflected in unstable earnings statements with each adjustment that is made. Assets and Equity will rise and lower with the value of the assets and cash flows will constantly need to be adjusted to reflect true net cash generated from operating activities.

**Changes to consolidation accounting.** Consolidation, joint ventures, and partially owned entities is an additional area that ETP’s accounting policies will
change under IFRS. With SFAS 141, FIN 35, FIN 46(R), and ARB 51, investments in entities over which ETP has significant influence, but not control, are accounted for using the equity method of accounting and are carried at ETP’s share of net assets plus loans and advances. Investments in unincorporated joint ventures and undivided interest in certain operating assets are consolidated on a pro rata basis. In applying the equity method, the investor uses only its investment in common shares and in-substance common stock of the investee and there is no requirement for uniform accounting policies within the group of consolidated joint ventures. IFRS applying IFRS 3, IAS 27, IAS 28, IAS 31, and SIC-12 treatment of each of these situations is slightly different. Adhering to IFRS, jointly controlled entities may be accounted for using either the equity method or proportionate consolidation. An investor in jointly controlled assets and jointly controlled operations accounts only for the items that it controls or incurs. Although similar to U.S. GAAP, this issue of control will need to be thoroughly analyzed and documented by ETP for its investments in privately held companies. For example, IFRS explicitly links the ability to control with obtaining ownership benefits from the entity’s activities. Also, control is determined by the impact of potential voting rights held by both ETP and by other parties if those rights are exercisable. These include options, warrants, convertible shares or contracts to acquire shares. U.S. GAAP does not contemplate potential voting rights for non-variable interest entities. In some cases the economic interests of the investor will not equal the voting interests. In
these cases, the investor applies the equity method using its total economic interests.

According to Steven Stellato, controller of Energy Transfer Company, the natural gas entity of Energy Transfer Partners, the new treatment of joint ventures under IFRS will be highly advantageous for ETP. In reference to ETP’s most recently completed joint venture with Fayetteville Express Pipeline, LLC. (FEP), Mr. Stellato (personal communication, 2010) says:

Under IFRS, we could elect to account for the investment using proportionate consolidation. Considering the low debt balance and the significance of the asset base (of FEP), this would be favorable to our balance sheet presentation. Also, the impairment rules are different for joint ventures. Under IFRS, the investment is written down if its carrying amount is impaired. Under U.S. GAAP, you only impair your investment if the controlled entity incurs an impairment.

And the final and probably most significant difference is that uniform accounting policies are required to be used throughout a consolidated group, by an equity method investee, or a jointly controlled entity. Answering the question of control will be the determining factor in what amounts are recorded into the financial statements of ETP with regards to partially owned entities. Because of this uniform accounting policy requirement, key areas of the business being
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acquired or consolidated will need to be addressed to ensure like accounting policies are in place. These areas include: contingent assets and liabilities, onerous leases, deferred income taxes, employee benefits, share based payments, acquisition-related costs, and contingent consideration.

Changes to lease and contract accounting. Lease accounting is probably one of the most significant areas that will change with the convergence of U.S. GAAP and IFRS. ETP currently leases a variety of different types of assets including land, buildings, propane tanks, vehicles, office machines, and miscellaneous others; therefore, any changes in lease accounting will have a large impact on their accounting procedures. Operating lease accounting will be eliminated and most leases will be treated as a purchase, similar to how capital leases are currently treated. Eliminating the ability to utilize operating leases ensures that companies will be forced to fully disclose lease liabilities to investors and creditors. All leases will create a lease obligation liability and corresponding right-of-use asset on the balance sheet.

U.S. GAAP provides explicit quantitative thresholds under SFAS 13 and ARB 43 that are used to classify lease agreements. Unlike IFRS, there are additional criteria applied only to the lessor under U.S. GAAP. In GAAP, there are four criteria which are requirements for classifying lease agreements. Under IFRS there are no specific criteria, only general indicators that are open to interpretation. The IAS 17 and IAS 37 guidance for leases focuses on the overall substance of the transaction. A finance lease is a lease that transfers substantially the risks and rewards incidental to the ownership of the leased asset from the
lessor to the lessee: title to the asset may or may not transfer. “While the lease classification criteria identified in SFAS 13 are considered in classification of a lease under IFRS, there are no quantitative breakpoints or bright lines to apply,” (PricewaterhouseCoopers, 2009, p. 74), and there are several additional indicators that a contract may be a finance lease under IFRS. These include: if the lessee can cancel the lease and the lessor’s losses associated with the cancellation are borne by the lessee; gains or losses from the fluctuations in the fair value of the residual are borne by the lessee; if the asset was designed specifically for the lessee; or the lessee can extend the lease at a rent that is substantially lower than the market rent. With an operating lease, the payments are expensed as they are made, affecting net income and operating cash flows but not reflecting a future liability on the balance sheet. Accounting for finance leases is considerably different and has a more significant impact on the balance sheet. This impact on the balance sheet and income statement may require additional oversight from senior management and reconsideration of the internal controls over the leasing process and related financial reporting. Successful evaluation of leases under IFRS may require a very different set of skills than those necessary for evaluation leases under the present standard. The process will require more business knowledge and professional judgment. There will be a need to distinguish payments for rent from payments for services. The lease term will also play a significant part in the accounting for this new classification of leases. It will be necessary to reassess future lease terms, including options and bargain renewals, based on what leases will most likely occur. This assessment will need to be
made each reporting period and any resulting adjustment made to the financial statements. If there are contingent rents, the business will be required to estimate and capitalize the future payments each reporting period and adjust through income.

Under IFRS an asset is recorded in PP&E and a liability for the future lease payments are recorded at the time of the transaction. Depreciation expense is accumulated on the asset and interest is expensed at the time of each payment. Net income and equity lower as the payments are made. Cash flows from investing decreases when the lease is incurred and an asset is recorded and cash flows from financing activities lower as the principle payment on the financing lease is paid and cash flows from operations reflect the change in accounts payable for the liability and lower as the interest portion is recorded as part of the cash payment. Because of increased depreciation and interest expense, EBITDA (income before interest, taxes, depreciation and amortization) will increase as well. EBITDA is an income statement line item that investors watch to gauge the health of a business because it is an approximate measure of a company’s cash flow.

ETP would also be required to reassess its liabilities and existing purchase commitments under IFRS criteria for onerous contracts or a contract where the costs involved with fulfilling the terms and conditions of the contract are higher than the amount of economic benefit that will be received. Under U.S. GAAP, there is no general requirement to recognize a loss for onerous contracts. In assessing whether a contract is onerous, ETP would consider the unavoidable
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costs of meeting the contractual obligations and the economic benefits expected to be received and the present value of the obligation under an onerous contract is recognized as a provision. The amount of this provision is then recorded as an expense in the income statement and a liability on the balance sheet. Equity is also negatively impacted by the recognition of this provision. The cash flow will need to be adjusted for this non-cash transaction to reflect the true earnings from operations.

**Changes to income tax and deferred tax accounting.** The line items of income tax expense and deferred taxes will present minimal differences for ETP. The main difference between the two sets of standards is determining exactly when an asset is recorded. For presentation purposes, under SFAS 209 and FIN 48 all deferred tax assets are recognized and a valuation allowance is recognized to the extent it is more likely than not that the deferred tax assets will be realized. Conversely, with IAS 12, SIC-21, and SIC-25 deferred taxes are recognized if it is probably that they will be realized. According to U.S. GAAP uncertain tax provisions are recognized if the tax position is more likely than not of being sustained based on its technical merits. The amount recognized is the greatest amount that is more likely than not of being sustained. IFRS has no specific guidance for income tax uncertainties. Under both sets of standards deferred tax is measured based on rates and tax laws that are enacted at the reporting date. With U.S. GAAP deferred taxes are classified as current or non-current while under IFRS all are classified as non-current. ETP is a master limited partnership and subject to very limited taxation, therefore the changes in income tax expense
and deferred tax accounting will not be material to the consolidated financial statements of Energy Transfer Partners.

**Changes to derivatives and financial instrument accounting.** The final area that will have a significant impact on the statements of ETP is that of derivatives and financial instruments. An interesting finding from historical 20-F filings (which is the documentation that foreign companies are required to file with the SEC if they want to be traded on the U.S. Stock Exchange) is that many foreign filing companies chose not to apply hedge accounting under U.S. GAAP due to perceived onerous documentation and assessment requirements, whereas these same companies continued to designate the derivatives as hedges under IFRS. SFAS 115, 133, 138, 149, 150, and SFAS 155 state that when hedge accounting is discontinued, cumulative gains and losses previously recognized in equity in respect of a cash flow hedge must remain in equity unless it is probable that a forecast transaction will not occur by the end of the originally specified time period or within a two-month period thereafter. However, under IAS 32, 39, IFRS 7, and IFRIC 2 when hedge accounting is discontinued and the hedged transaction is no longer expected to occur, then the amount previously recognized in equity is transferred to profit or loss immediately. Both sets of standards require separate presentation on the face of the balance sheet for certain classes of financial assets and liabilities. They also converge on the standard that requires a financial asset and a financial liability be offset only when there is a legally enforceable right to offset and an intention to settle net or to settle both amounts simultaneously. There are additional requirements for master netting.
arrangements related to derivatives. Due mainly to the rules surrounding discontinued hedge accounting stating that an immediate profit or loss has to be recognized, there is a larger impact to the income statement and equity under IFRS then U.S. GAAP. The cash flow from operations is only directly affected when the transaction is physically settled for a cash value.

Changes in reporting requirements. Not only are there major changes facing ETP in their presentation of their financial statements, there are also differences in the reporting requirements between IFRS and U.S. GAAP. In respect to financial instruments, the disclosure requirements are similar between the two systems; however, IFRS 7 and IAS 32 do have several additional disclosures that would be necessary for ETP to prepare. Qualitative and quantitative disclosures are required by both sets of standards in respect to risks arising from financial instruments and management’s approach to managing these risks. The fair value of each class of financial asset and liability is disclosed as well as information about the methods and significant assumptions used in determining fair value. This is true for IFRS as well as U.S. GAAP. However, the Securities and Exchange Commission (SEC), and therefore SFAS 133 and SFAS 161, limits the disclosures to those relating to market risk unlike IFRS, which also requires disclosure of credit and liquidity risks arising from financial instruments. According to IFRS, the level of disclosure varies depending on the nature of the financial instruments. Qualitative disclosures are required in respect of each of the following for each type of risk: exposure to risk, how the risk arises, the entity’s objectives, and the policies and processes for managing risk.
For credit risk, an entity must disclose summarized quantitative data, including information about: amounts best representing exposure to credit risk, concentrations of credit risk, financial assets that are past due or impaired, and collateral held and other credit enhancements. Basically, these disclosure requirements under IFRS are much more detailed than under U.S. GAAP.

IFRS 8, Operating Segments, is effective as of 2009 and would substantially harmonize required segment disclosures, since it is based on “management reporting” standards of U.S. GAAP. However, additional disclosures of liabilities by segment would be required under IFRS. Generally, IFRS has more extensive disclosures for segments and therefore requires disclosures for both business segments and geographical segments, with one considered primary and the other secondary.

Disclosures for discontinued operations are different as well. SFAS 144 states that a component of an entity can be classified as discontinued operations, while under IFRS 5 divestment must represent a separate, major line of business or geographical area of operations to be classified as discontinued operations. With U.S. GAAP requirements, ETP would need to prepare comparative income statement and cash flow information to be presented for discontinued operations. IFRS does not require the cash flow comparative to be disclosed.

There is one key difference between the two sets of standards when it comes to recording subsequent events. ETP would be required under U.S. GAAP and IFRS to adjust its financial statements to reflect events that occur after the
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reporting date, if events provide evidence of conditions that existed at the reporting date. The difference is in the timing of when the event occurs. For U.S. GAAP, it can occur up to the date that the financial statements are issued, which may be later than when the financial statements are authorized for issue. IFRS limits the adjustment to only events that occur before the statements are authorized for issue.

After studying the comparison of the above areas, it is clear that from the numbers to the disclosures about the facts behind how those numbers were derived, IFRS will have a significant impact on most aspects of the financial statements presented by Energy Transfer Partners, L.P.

Summary

Not since the 1930s has the U.S. business community faced such an uncertain future in regards to what accounting guidelines will apply to the preparation of their financial statements. U.S. GAAP has developed through various stages from barely existent and disjointed to a complete framework of guidelines for financial accounting. It now faces the next step in its evolution - that of being replaced or significantly revised in order to remain viable in international financial circles. On the other hand, while IFRS has only been in existence since the 1970s, it has developed rapidly and become a comprehensive set of standards and regulations widely implemented in many foreign countries and is the only set of standards officially recognized by the European Union. Due to the overwhelming acceptance of IFRS internationally instead of U.S. GAAP,
the United States now finds itself at the crossroads of choosing to adopt IFRS, work with IASB to converge the two sets of standards, or risk losing potential foreign capital and investors by refusing to revise or replace U.S. GAAP. The SEC recognizes that failing to adapt to the current financial environment is not in the best interests of U.S. business. However, the SEC has yet to make a final decision on exactly how to best facilitate the goal of a single set of high-quality international standards that protect investors; maintain fair, orderly and efficient markets, and facilitate capital formation.

For specific companies such as Energy Transfer Partners, L.P., the transition to IFRS will bring changes to their financial statements in addition to the basic challenges of preparing for human capital readiness, added consulting and audit fees, first-time adoption issues, and other miscellaneous associated expenses.

When looking at the comparison between the two sets of standards, it appears that there is much more volatility to net income, equity, and other balance sheet items when applying IFRS instead of U.S. GAAP. Under IFRS treatment of PP&E depreciation expense will rise in the first few years and the ability to revalue the assets to fair value can either raise or lower net income, equity, and the asset value depending on current market conditions for those assets. The changes affecting goodwill result in more frequent impairment loss under IFRS, which will lead to lower net income, equity, and lower value of assets on the balance sheet. Inventory also presents another area of fluctuation for net income. While under both sets of standards inventory is required to be carried at lower of
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historical cost or market value, IFRS requires a reversal of a prior loss write-down for subsequent recoveries. The resulting cycle of recorded loss followed by recovery will produce unstable earnings with each adjustment.

The most advantageous change under IFRS for ETP comes with the new rules of consolidation, joint ventures, and partially owned entities. The ability to elect to account for these types of investments using proportionate consolidation will be favorable to their balance sheet presentation. Overall, the change in standards will make joint ventures a more attractive option not only for Energy Transfer Partners, but also for other U.S. and foreign companies.

Lease and contract accounting will present the greatest challenge to ETP because of the effort and work involved to track and account for leases under IFRS. Due to the accounting changes with IFRS, the revenues and expenses are weighted more heavily in the first few years after the inception of the lease or contract but level out in comparison with U.S. GAAP in the long run. There is also a more significant impact on the balance sheet due to recording liabilities and assets where none would currently be recorded under U.S. GAAP. Derivatives and financial instruments will also have a larger impact on the income statement when applying IFRS. This is due mainly to the rules that an immediate profit or loss has to be recognized when hedge accounting is discontinued.

Only the cash flow statement of ETP will remain fairly unaffected since most of the changes in standards between IFRS and U.S. GAAP only result in non-cash adjustments to the income statement.
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There are several new or different footnote disclosures required when applying IFRS, but the differences in this area will not have as significant of an influence on financial reporting as applying new accounting standards will have to the balance sheet and income statement.

Given the multitude of changes in both accounting policies and disclosure and reporting requirements, the potential task of converting from U.S. GAAP to IFRS appears daunting and overwhelming to Energy Transfer Partners and to other U.S. based businesses as well. The predominant question of the financial world is, if and when the SEC may formally commit to the use of IFRS for U.S. registrants. According to experts on the topic at the international accounting firm of Grant Thornton:

The only thing certain is that a decision to implement IFRS for U.S. issuers will have a monumental impact on issuers, financial statement preparers, auditors, regulators, and many others. There are numerous advantages to a U.S. implementation of IFRS, including increased attractiveness of U.S. companies to foreign investment; perceived lower costs and increased availability of capital; and increased investor protection. (Grant Thornton, 2011, “On the Horizon for IFRS,” pp.11).

While some professionals agree with the opinion stated above, there are those that oppose any departure from U.S. GAAP (Borson, 2009, “Public
Companies Oppose IFRS”). While it currently remains unclear which businesses will benefit and which will not, there are participants in the United States business community who believe the rewards of converging U.S. GAAP with International Financial Reporting Standards or completely transitioning to IFRS will be worth the effort and expense involved to accomplish such an arduous endeavor.
References


