WHITE PAPER

SEA CHANGE: TRANSITIONING TO IFRS

How Oil and Gas E&P Companies Can Manage Upheaval in Global Financial Reporting Standards

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EXECUTIVE SUMMARY

As the world transitions to a single, unified global accounting standard with the implementation of international financial reporting standards (IFRS), oil and natural gas exploration and production (E&P) companies in particular face daunting challenges with the transition.

Even in countries that have already adopted or set out a path for adoption of the new standard, many questions still linger about how to interpret what amounts to largely broad statements of accounting principles under IFRS.

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And in those countries where IFRS implementation has yet to occur, the questions loom even larger. Of particular concern is reconciling with and switching over from US generally accepted accounting principles (GAAP), the standards that have underpinned the vast majority of upstream oil and gas financial reports worldwide for more than a generation.

Oil and gas E&P companies thus must avail themselves of the most robust yet flexible financial management software solutions to successfully manage and thrive in this new world order for financial reporting.

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INTRODUCTION

The global upstream oil and natural gas industry is hardly a stranger to upheaval. In fact, it's safe to say that upheaval has been the norm throughout the history of the oil and gas exploration and production business. Whether it entails commodity price swings, geopolitical crises, disasters natural and man-made, or environmental and social issues, dramatic change has always punctuated the history of this most vital of industries.

This pattern of frequent upheaval has been accentuated in just the past three years by a wild rollercoaster of developments:

- The spike, then collapse, of oil and natural gas prices—followed by another spike in oil prices while gas prices remain depressed
- The game-changing energy supply impact of commercializing development of gas and oil shales in North America—a trend starting to migrate to the rest of the world
- The disastrous Gulf of Mexico oil spill—and how it's affecting the promise of deep-water oil and gas
- The rancorous debates over balancing energy, environmental, and economic needs—encompassing issues as thorny as peak oil supply and climate change amid a distressed global economy
- The unprecedented political upheaval sweeping the Middle East and North Africa—and with it alarming questions over current and future energy supplies

Certainly the question of a transition to new accounting standards for financial reporting may seem mundane in comparison with these headline-grabbing topics. However, the prospect of a new global financial reporting standard presents the upstream oil and gas industry with comparably daunting challenges and far-reaching change.

Of special concern are the small and medium-sized companies; experience to date suggests that these firms have tended to lag expectations in making timely progress in the transition to IFRS.

Senior executives at E&P firms worldwide will need the most flexible and yet comprehensive financial management software tools to be able to manage this "sea change."

BACKGROUND

The quest for a universally accepted set of accounting and financial reporting standards has been pursued for decades.

Reconciliation of differing standards among various countries has long been a costly, complicated, and cumbersome process. Most noteworthy has been the challenge of reconciling other countries' standards to US GAAP standards. While US GAAP standards for decades had been the most widely recognized and accounting standards in many countries, each country developed its own variation of GAAP. This was especially true for oil and gas upstream operations.

No industry has faced a greater burden in this regard than the oil and gas E&P industry, among the most international of industries. Many oil and gas companies—and not just the majors—have operations in a number of countries, and reconciling a number of financial reports under differing methodologies can be a herculean task. Even among exclusively domestic E&P companies in many countries, there is a predilection for establishing multiple subsidiary and joint venture entities.

Accordingly, adopting a truly global, single set of accounting principles would benefit investors and other users of financial statements by cutting the costs of comparing alternative investments and improving the quality of information. This, in turn, will expedite analysis by investors and other capital providers, thus enhancing their willingness to provide financing.

Progress toward that end has been marked since the 1970s, but a truly concerted international effort with a broad-based transition to IFRS started during 2005–2008. Currently, more than 113 countries permit or require IFRS reporting, including those of the European Union. The table on the following page lists the IFRS adoption of many key nations. Note the number of these nations that are major oil and gas producers.

Most of these countries started their transition in 2005. In 2006, the International Accounting Standards Board and the US-based Financial Accounting Standards Board signed a memorandum of understanding to improve both GAAP and IFRS and to facilitate their convergence.

In the years to come, as the world transitions to IFRS, oil and gas E&P companies will face many complex judgments and difficult choices in how best to proceed as they adopt the new financial reporting standards. Even in those countries with several years of experience under their belts, companies still have many concerns as a consequence of limited IFRS guidance that specifically addresses key aspects of the upstream oil and gas business:

- Crucial uncertainties regarding the exploration phase
- Substantial lag time between first outlays and production start-up
- Lack of a clearly drawn connection between exploration and development capital expenditures (capex) and resource value
- Environmental challenges and how to account for them
- Complex risk sharing with government entities
- The panoply of resource rent approaches among various countries

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There is already ample evidence of the challenges in the road to convergence and adoption, and it's critical that E&P companies be prepared to take key steps now, armed with the best financial management tools available.

IFRS ADOPTION STATUS WORLDWIDE

COUNTRY	STATUS FOR LISTED COMPANIES AS OF APRIL 2010 STATEMENT	OIL PRODUCTION, 1,000 BARRELS PER DAY (2009)	NATURAL GAS PRODUCTION, BILLION CU. M. PER YR. (2009)
Argentina	Required for fiscal years beginning on or after January 1, 2011	598.5	41.4
Australia	Required for all private sector reporting entities and as the basis for public sector reporting since 2005	463.8	42.3
Brazil	Required for consolidated financial statements of banks and listed companies from December 31, 2010, and for individual company accounts progressively since January 2008	1,950	11.9
Canada	Required from January 1, 2011, for all listed entities and permitted for private sector entities, including not-for-profit organizations	2,590	161.4
China	Substantially converged national standards	3,797.7	85.2
European Union	All member states of the EU are required to use IFRS as adopted by the EU for listed companies since 2005	NA	NA
France	Required via EU adoption and implementation process since 2005	18.1	0.95
Germany	Required via EU adoption and implementation process since 2005	56.0	12.2
India	Converging with IFRS at a date to be confirmed.	664.6	39.3
Indonesia	Convergence process ongoing; a decision about a target date for full compliance with IFRS is expected to be made in 2012	857.5	71.9
Italy	Required via EU adoption and implementation process since 2005	82.9	7.4
Japan	Permitted from 2010 for a number of international companies; decision about mandatory adoption by 2016 expected around 2012	133	4.6
Mexico	Required from 2012	2,601.7	58.2
South Korea	Required from 2011	0	0.46
Russia	Required for banking institutions and some other securities issuers; permitted for other companies	1,348.1	59.6
Saudi Arabia	Not permitted for listed companies	7,920	77.5
South Africa	Required for listed entities since 2005	14	5.9
Turkey	Required for listed entities since 2008	45.6	0.64
United Kingdom	Required via EU adoption and implementation process since 2005	1,348.1	59.6
United States	Allowed for foreign issuers in the US since 2007; target date for substantial convergence with IFRS is 2011, and decision about possible adoption for US companies is expected in 2011.	5,360.0	593.4

Sources: IFRS Foundation (International Accounting Standards Board), Oil & Gas Journal, International Energy Agency

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THE EUROPEAN EXPERIENCE

In July 2002, the European Parliament passed legislation requiring listed companies to convert to IFRS by 2005. Deloitte & Touche LLP noted that the short time frame and extensive reach of the directive had many companies scrambling to comply, placing significant resource pressure—human and financial—on those companies.

"A more tangible measurement of the effort can be found by comparing the length of European companies' 2004 (local GAAP) and 2005 (IFRS) financial statements," Deloitte & Touche noted. "The latter averaged more than 50% longer than the former; in some instances, reports doubled in length. Much of the increase [could] be attributed to an increased level of disclosure in the financial statements in areas such as judgments made and assumptions used. "[1]

Especially problematic during the transition were accounting issues such as asset impairments, financial instruments, lease accounting, and emission rights.

Among the lessons learned from the European experience, Deloitte & Touche cited the following[2]:

- "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 a 'business as usual' state for IFRS reporting. The highest quality financial data are obtained when companies fully integrate IFRS into their systems and processes. The compressed time frames 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 EU 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."

[1] Deloitte & Touche, "IFRS for SMEs in your pocket–UK edition," brochure, March 2010

[2] ibid

UK CONCERNS

A further wrinkle in the transition to IFRS occurred in the UK. The UK Accounting Standards Board issued a consultation document in late 2009 regarding the introduction of a new accounting framework, International Financial Reporting Standard for Small and Medium-Sized Entities (SMEs).

The new framework will affect tens of thousands of companies in the UK, according to Deloitte & Touche:

"Despite the title, the standard is not restricted to SMEs. While listed and 'publicly accountable' companies will be required to report under full IFRS, all other companies except those small enough to report under Financial Reporting for Smaller Entities will be affected. This will include subsidiaries in listed groups which have not adopted IFRS throughout the group.[3]"

CANADIAN EXPERIENCE

In Canada, the Accounting Standards Board proposed that all publicly accountable enterprises migrate from Canadian GAAP to IFRS during a five-year transition period ending in January 2011.

The biggest concern, as it is now in the US, was the switch from full cost to successful efforts accounting. While some Canadian oil and gas companies that were also registered in the US had the option of using US GAAP for reporting purposes, they ran the risk that the Canadian SEC would eventually disallow the use of US GAAP, or even the future use of full cost accounting over the long term.

A survey taken in March-April 2010 by the Canadian Financial Executives Research Foundation indicated that while a majority of large Canadian companies were on track to meet the January 2011 deadline, only a minority of small and medium-sized companies were even at the 60% completion stage. The lag was attributed to resource issues and inadequate staff to focus on the transition[4].

US ROADMAP

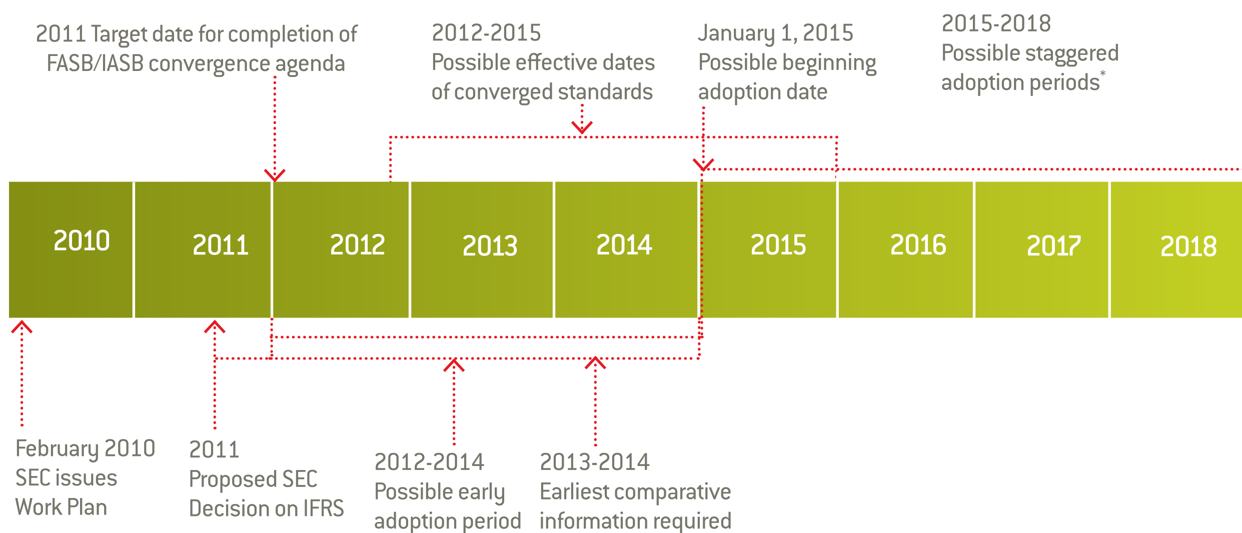
In 2008, the SEC issued a proposed roadmap setting out a route to adoption of IFRS in the US. In 2010, the commission signaled its support for a single set of global accounting standards and acknowledged that IFRS is the best approach to achieve that goal. In 2011, the SEC is expected to decide whether or not to further incorporate IFRS into US public markets, although the commission would not commit to a specific timeframe within the year.

In its 2010 statement, the SEC outlined a work plan governing two main aspects of IFRS adoption: 1) Analyzing IFRS characteristics and any benefits of further incorporating the global standards in the US, and 2) Assessing how and when IFRS should be effectively incorporated in US financial reporting[5].

Given that the SEC has suggested that any transition to IFRS would entail at least four years, PricewaterhouseCoopers has outlined a proposed timeline with key dates (see chart).

[3] Deloitte & Touche, "IFRS for SMEs in your pocket—UK edition," brochure, March 2010.
[4] Canadian Financial Executives Research Foundation, IFRS Readiness in Canada, 2010; August 2010.
[5] Securities & Exchange Commission, press release, Feb. 24, 2010.

PROPOSED TIMELINE FOR US ADOPTION OF IFRS



** Staggered adoption possible based on earliest adoption in 2015 or 2016.*

Source: PricewaterhouseCoopers LLP

The timeline represents a relatively short fuse for IFRS convergence and/or adoption, given the scope of change. As PricewaterhouseCoopers puts it, "The complexity and significance of these sweeping changes greatly exceed that of traditional revisions to US GAAP.[6]"

And the impacts are likely to be greatest on the upstream oil and gas business, according to PricewaterhouseCoopers: "The impact of IFRS is felt all along the oil and gas value chain, but many of the key dilemmas and judgments are greatest at the exploration and production stage.[7]"

GLOBAL OIL AND GAS IMPACTS

Some oil and gas companies face a more immediate challenge than other businesses in the transition to IFRS, given the importance of their international operations and the likelihood that many global competitors are already reporting under IFRS.

Experience to date with global companies that already have adopted IFRS suggests that, for some companies, full conversion and adoption typically takes from two to five years. That experience also points to the greatest transitional challenge residing in the upstream oil and gas industry, according to PricewaterhouseCoopers:

[6] PricewaterhouseCoopers LLP, "IFRS in the US: Current situation and next steps," white paper, December 2010.

[7] ibid

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Our experience shows that certain industries, such as the full cost oil and gas industry, typically have the longest and most complex conversion process because significant accounting policy changes are required. It is often extremely difficult to extract the historical information necessary to make these changes, and the accounting processes and systems have to be modified on a go-forward basis. ”

PRICEWATERHOUSECOOPERS

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Whatever the timeframe, the changeover to IFRS offers an opportunity for E&P companies to reassess how they are viewed and evaluated by investors and other interested parties.

More important are the potential benefits flowing from a transition to a single, global set of accounting standards. Drafting and then reconciling foreign subsidiaries' accounting and reporting standards imposes expensive and redundant work on the part of E&P companies. Adoption of a single global standard allows them to realize significant cost savings by centralizing these functions. It would also create a more uniform way for companies to benchmark their performance against all competitors, not just the domestic ones.

ACCOUNTING METHODOLOGY

Perhaps the most significant change for upstream oil and gas companies in the transition to IFRS involves the full cost accounting method vs. successful efforts. Under US GAAP, the full cost method mandates that all costs incurred in exploration and development—including seismic data acquisition and mineral rights acquisition—be capitalized in cost centers. Under IFRS, however, full cost accounting is allowed only during the exploration and evaluation phases. Even in that context, assets in these phases must be assessed as to tangibility and impairment.

According to Ernst & Young, it won't be possible to apply the full cost method “without making very significant modifications to the application of the method.[9]” That in itself raises questions as to whether it could still be termed full cost.

With the successful efforts method under IFRS, costs other than leasehold costs incurred prior to exploration and evaluation would be expensed as incurred. With IFRS, only minor changes to the successful efforts method are mandated, and it maintains the core of that method by capitalizing costs pending evaluation

[8] PricewaterhouseCoopers, “Financial reporting in the oil and gas industry: International Financial Reporting Standards,” white paper, April 2008.

[9] Ernst & Young, US GAAP v. IFRS: The Basics for Oil & Gas Companies.

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BUSINESS TRANSACTIONS

Certain business transactions common in the oil and gas E&P business can present new challenges under IFRS.

For example, what's deemed a joint venture in common practice among E&P companies may not fit the definition of a joint venture under IFRS standards. In particular, the establishment of true joint control—entailing actual unanimity in decision making among the companies involved—is required to qualify as a joint venture under IFRS (see accompanying sidebar).

Without it, that investment would be accounted for as an associate or as a financial asset, according to Ernst & Young[10] .

JOINT VENTURE ACCOUNTING NEEDS GROW AS JV DEALS PROLIFERATE

Joint ventures (JVs) have long been a staple of doing business in the upstream oil and gas industry. Whether a JV is mandated because of the often massive capital requirements of oil and gas projects or because of local-source requirements in many countries, its use has only grown in recent years. The proliferation of mega-projects (especially in the light of expanding deep-water exploration and development) and the acceleration of resource nationalism trends have put JV transactions atop many exploration and production companies' priority lists.

The upstream oil and natural gas industry is in fact seeing a new uptick in JVs to accommodate the meteoric growth of activity in North America's unconventional gas and oil shale plays: Major international oil companies are increasingly entering into JVs with independent producers in US and Canadian shale plays not only to participate in prolific, long-lived resource plays as stand-alone investments, but also to glean know-how and technology applicable to shale deposits in their own countries. And independents benefit from the infusion of capital to carry out ambitious oil and gas shale development plans.

The complexity and sensitive nature of JV transactions demand an optimized financial management solution tailored to oil and gas upstream operations.

[10] Securities & Exchange Commission, press release, Feb. 24, 2010.

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IDEAL SOFTWARE SOLUTION

The ideal software solution for upstream oil and gas JV accounting offers easy, quick implementation, flexibility in ascertaining procurement processes, and powerful cost allocation capability.

This dynamic, multi-dimensional software readily integrates general ledger, accounts payable, fixed assets, and other financial processes with a JV partner's operational systems.

Robust inventory analysis and costing features precisely track all expenses related to a JV exploration and development project. Ideally, the software manages all financial processes for a company's disparate business units, no matter how varied the function or geography. Easy configurability is another advantage, as it helps users accommodate different types of businesses in JV accounting.

The ideal software solution also provides:

- A unified ledger for easy extraction of data to manipulate in third-party transactions
- Flexible scalability as JV E&P projects move forward and change
- Global essentials, which include different books for different local reporting standards and the ability to readily enter adjustments for GAAP
- Real-time reporting on elements such as JV cost statements, JV billing and cash call statements, and dual-currency profit and loss (P&L) and balance sheet reports
- Multidimensional visual analytics and purchasing, inventory, and budgeting support for JVs

REPORTING RESERVES

While reserves reporting is arguably the most important information that E&P companies report to their stakeholders, IFRS nonetheless does not specifically require that companies disclose their reserves and related information.

However, such information typically is mandated by regulators and country standards, and IFRS requires companies to provide any additional disclosures needed to fully assess their financial standing and performance.

Critical differences among reporting methodologies arise in the areas of reserves reporting regarding what's proved and what's probable, commodity price assumptions, the inclusion of royalties in reserve evaluations, the status of minority interests, the inclusion of associates in consolidated reserves reports, and the parameters of estimating reserves.

COPING WITH TRANSITION: THE RIGHT TOOLS

Weathering the transition to a new global accounting standards regime, especially with staff-challenged small and medium-sized oil and gas companies, calls for the best financial management software tools available.

Accommodating IFRS changes that range from subtle to sweeping demands a software solution that is robust yet flexible, multi-dimensional yet focused, and comprehensive yet tailored to the specific needs of upstream oil and gas companies.

Especially critical is the capability to manage a vast number of local variations in language, currency, and business standards, facilitating the integration of international offices with minimal customization and maintenance.

Ease and speed of implementation are vital elements to consider, given the short fuse for transitioning to IFRS. Minimizing IT involvement is a major plus when a software solution is designed to be administered and maintained by finance executives.

It's also essential to ensure consistency while tracking purchases through, for example, the complexities of a joint venture exploration project.

To optimize the transition to IFRS, oil and gas E&P companies need a financial management software solution with the following features:

- A unified ledger that lets users combine multiple-ledger functions into one user-definable chart of accounts, including cash, payables, project tracking, and varied organizational accounting structures

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- Ability to apply multiple charts of accounts to the same set of accounts, providing different accounting perspectives on the same transactions
- Support for multiple parallel accounting books for each entity, accommodating transactional differences under different accounting treatments
- Easy integration with other systems, allowing an enterprise-wide view of the business at the financial and operational level
- Ability to store multiple currencies while facilitating easy adjustments to a single accounting standard
- Multidimensional analytical tools to map key performance indicators such as per-barrel lifting costs, working interest breakdowns, and profit per barrel
- Ability to capture and store non-financial statistical data
- Real-time financial reporting across a wide range of categories
- A slate of robust, interactive business performance tools for budgeting, forecasting, financial consolidation, strategic planning, and extended reporting and analysis
- Support for budgeting and purchasing/inventory transactions
- An easily configurable interface to readily accommodate global strategic business units

SUMMARY AND CONCLUSIONS

As the global upstream oil and gas industry adjusts to the wrenching change being introduced via the transition to IFRS, new accounting challenges continue to arise. Even with several years of experience in a number of countries, it's clear that many questions remain to be answered with the transition to a new, unified global accounting standard. Accordingly, it is more important than ever to have powerful and flexible tools to manage that change.

The ideal tool for managing this transition is financial management software that provides real-time insight into critical financial and operational information, allowing users to respond quickly to business change. It also simplifies other reporting complexities associated with business change.

In fact, such a tool should be thought of not only as a financial management system, but also as a change management solution. That would make it an invaluable tool for an oil and gas upstream industry enduring the most dynamic change in accounting standards in a generation.

ABOUT INFOR.

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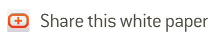

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