



Power & Utilities IFRS Webcast Series presents:

International Accounting Standards (IAS) 32 and 39 and Energy Transacting

Presenters: Brian Murrell and Andy Hickey

Moderator: Jan Umbaugh

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Audit • Tax • Consulting • Financial Advisory •

About your presenters



Brian Murrell, Deloitte & Touche LLP

Brian is a partner in Deloitte's Regulatory & Capital Markets Consulting (R&CM) group. He serves as the U.S. Energy & Resources IFRS lead for R&CM. Brian has significant experience with complex technical accounting guidance impacting energy companies under IFRS and U.S. GAAP.

Brian spent four years in Europe focused on assisting European energy companies convert to IFRS. He served as an IFRS thought leader for Deloitte's UK Firm and throughout Deloitte's European energy operations. Brian also was Deloitte's liaison to the International Energy Accounting Forum, an industry group focused on developing consensus around IFRS technical accounting conversion issues.



Andy Hickey, Deloitte & Touche LLP

Andy leads the Energy & Resources Complex Accounting & Valuation group in Deloitte's R&CM practice. He has over 15 years of experience serving large public companies in both assurance and consultative roles.

Andy has worked on derivative accounting implementations and actively participates in various advisory roles for Deloitte's energy transacting clients. He has in-depth knowledge on the emerging IAS 39 and FAS 133 issues and related implementations, and brings the experience from recent projects of a similar scope with Deloitte energy clients. He has assisted various energy companies with their IFRS implementation, and is an IFRS Steering Committee Advisor for the R&CM practice.

Agenda

Introduction

Derivative accounting overview

Energy transacting considerations

How to ensure a smooth transition

Final thoughts

International Financial Reporting Standards

- IFRS are global standards issued by London-based International Accounting Standards Board (IASB)
- Principles-based approach:
 - Requires understanding of transaction substance and economics
 - Increased reliance on professional judgment in arriving at accounting conclusions, rather than following prescriptive rules
 - Thinking about the answer instead of finding it!
- Retrospective application upon first-time adoption (with some exceptions under IFRS 1)
- Likely to be significant differences from U.S. GAAP

Derivative accounting overview

IAS 32: PRESENTATION

- Presentation of financial instruments
- Other classification considerations (e.g., liability versus equity)

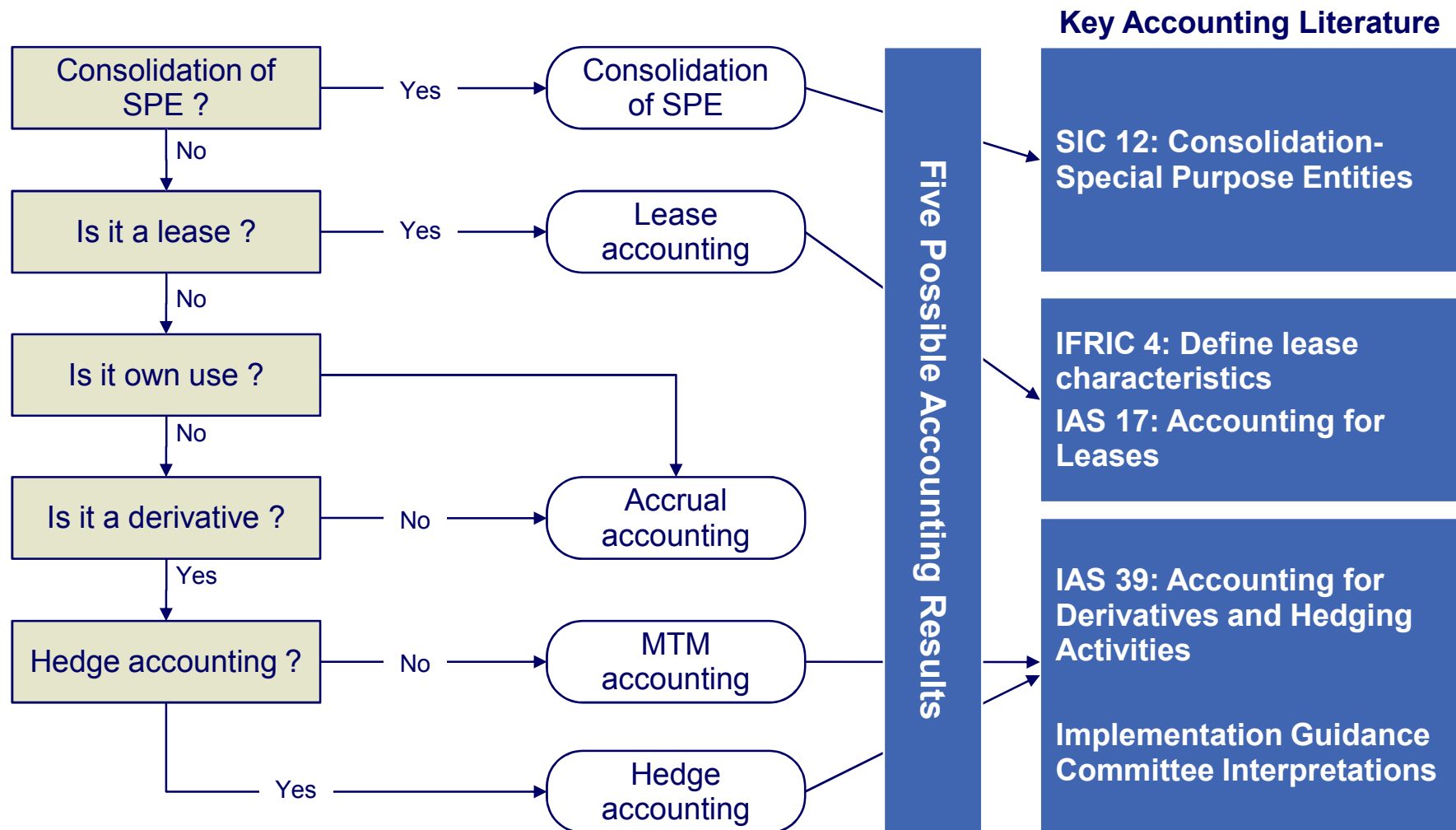
IAS 39: RECOGNITION & MEASUREMENT

- Scoping considerations, including “own use” exemption
- Definition of derivative
- Hedge accounting guidance

IFRS 7: DISCLOSURES

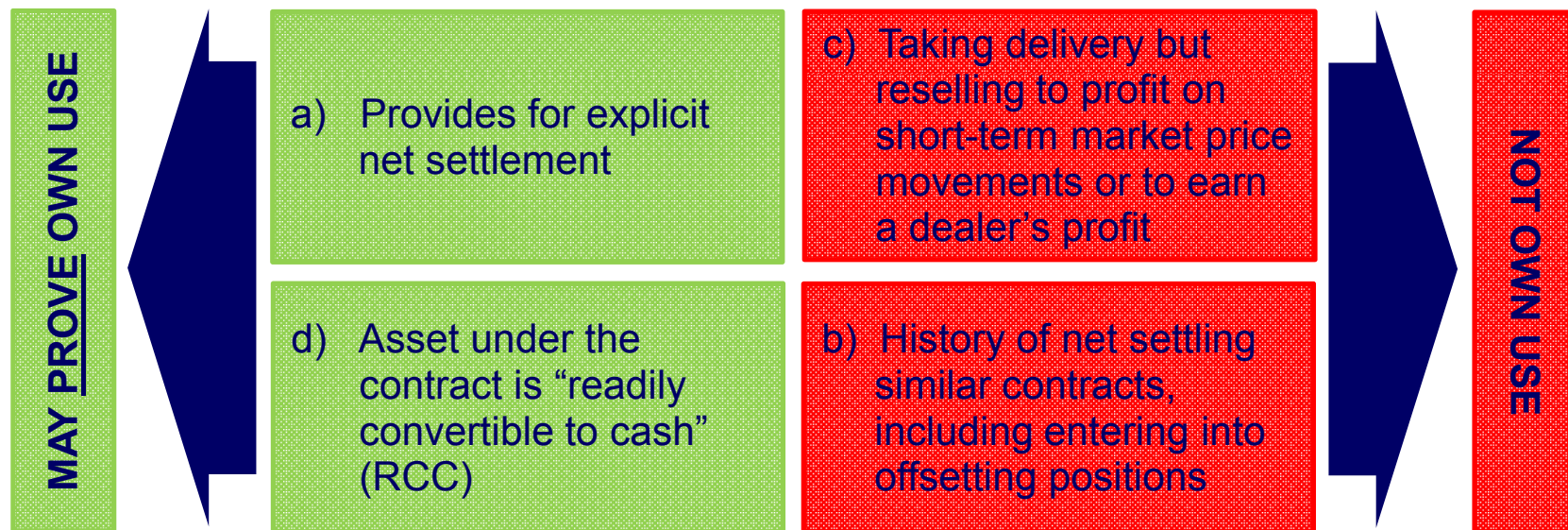
- Prescribes disclosure requirements for financial instruments

The accounting framework



Own use scope exemption

- Contracts for non-financial items which physically deliver may be scoped out as contracts for “own use” (IAS 39.5)
- IAS 39.6 describes four means of “net settlement”:



Own use scope exemption

- IAS 39.7 precludes own use if a contract is a “written option” to deliver a “readily convertible to cash” asset
- Many commodities transactions allow counterparties to vary the volumes delivered, and thus may not be own use
- Analyze “requirements” contracts to determine whether they constitute written options
- Can this “optionality” be economically exercised?

U.S. GAAP comparison:

- Own use is not elective and may be harder to achieve than NPNS
- Narrower “net settlement” definition under U.S. GAAP
- Few energy-specific Derivatives Implementation Group (DIG)-equivalents under IFRS (for example, RCC not defined)

Derivative definition

- IAS 39.9 defines a derivative as a contract:
 - Whose value changes in response to an underlying
 - Requires little/no initial net investment
 - Settles at a future date
- Derivatives recorded at fair value on balance sheet
- Value changes recognized in earnings (except in certain hedging situations)

U.S. GAAP comparison:

- Broader IFRS derivative definition, so more derivatives likely
- Greater emphasis on operational use of in the business under IFRS
- IFRS does not require a notional
- Fewer prescriptive energy-specific interpretations under IFRS

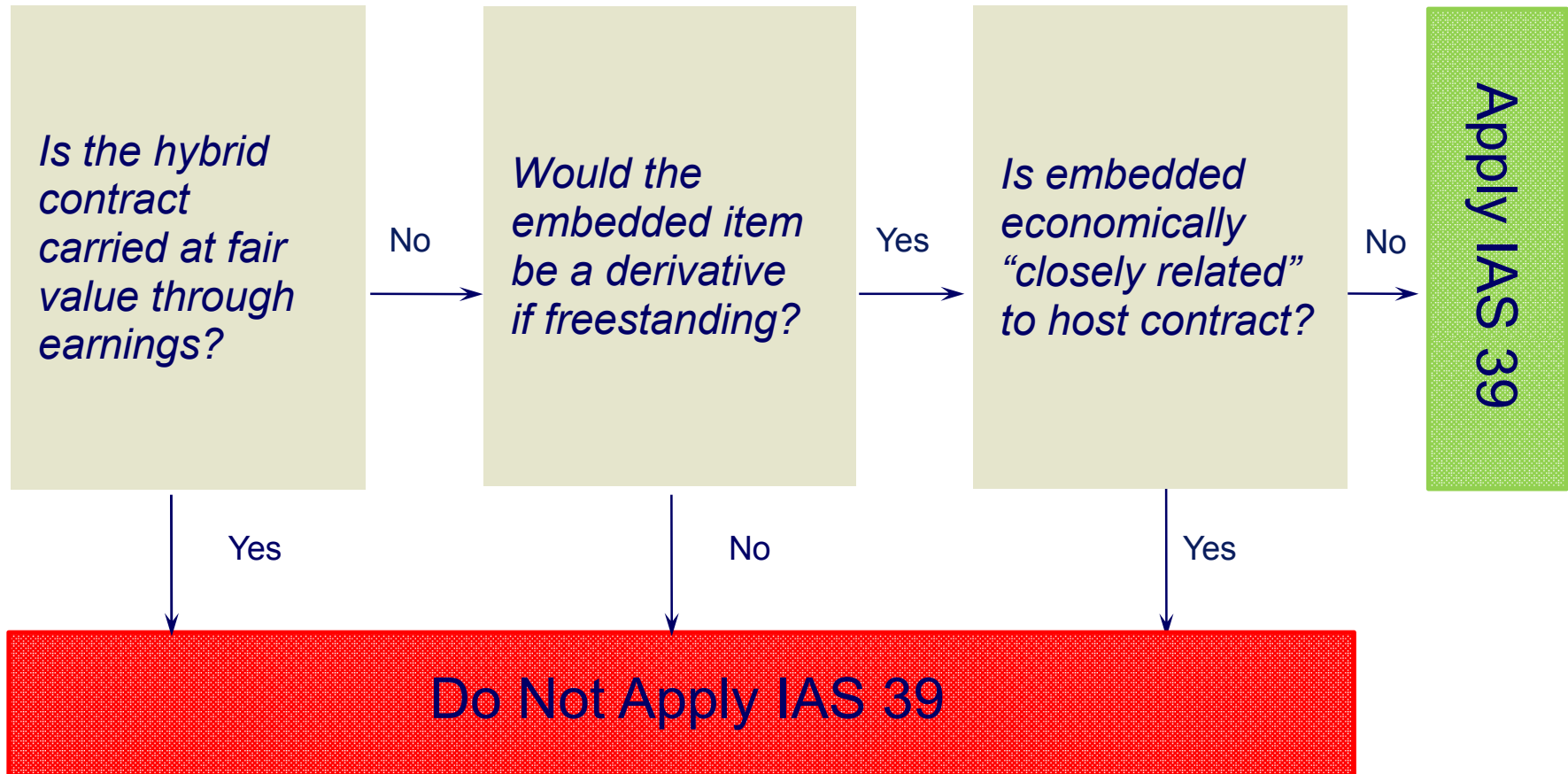
Embedded derivatives

- IAS 39.10 defines terms which cause:
 - “some or all of the cash flows that otherwise would be required by the contract to be modified according to a ... variable,” in a manner similar to a derivative instrument
- If not “closely related” to host, embedded derivative must be separately recorded at fair value
- Embedded derivatives may include:
 - Pricing terms linked to similar commodities or commodities used in the production process (e.g., power linked to natural gas)
 - Indexation to broad-market indices (e.g., PPI)

U.S. GAAP comparison:

- Differing implications for embedded derivative pricing terms
- No grandfathering exemptions under IFRS

Accounting for embedded derivatives

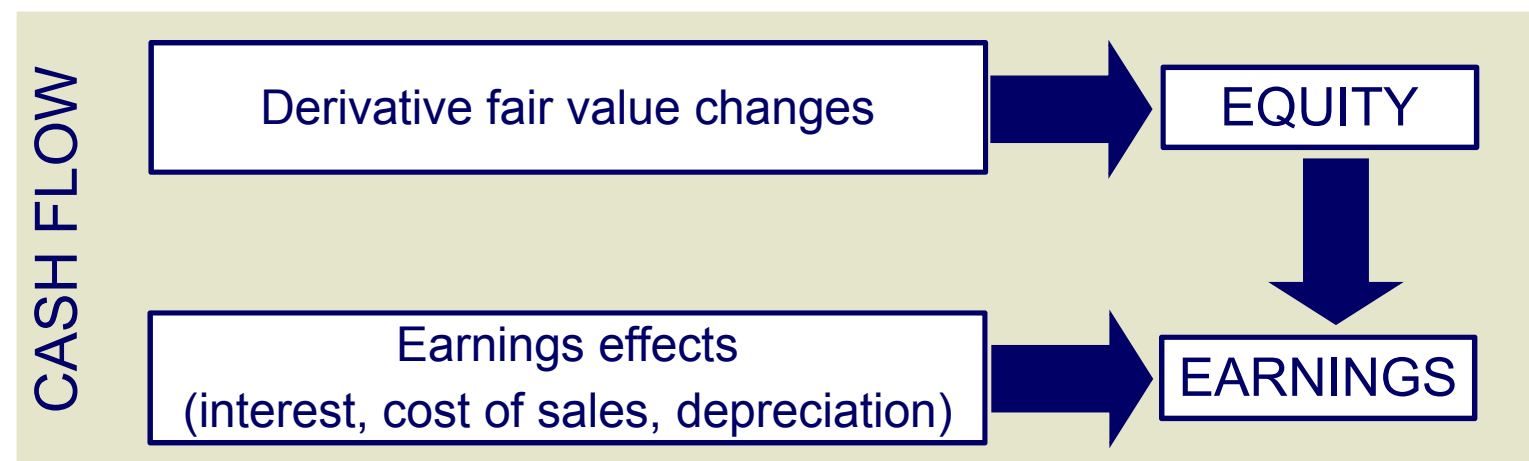
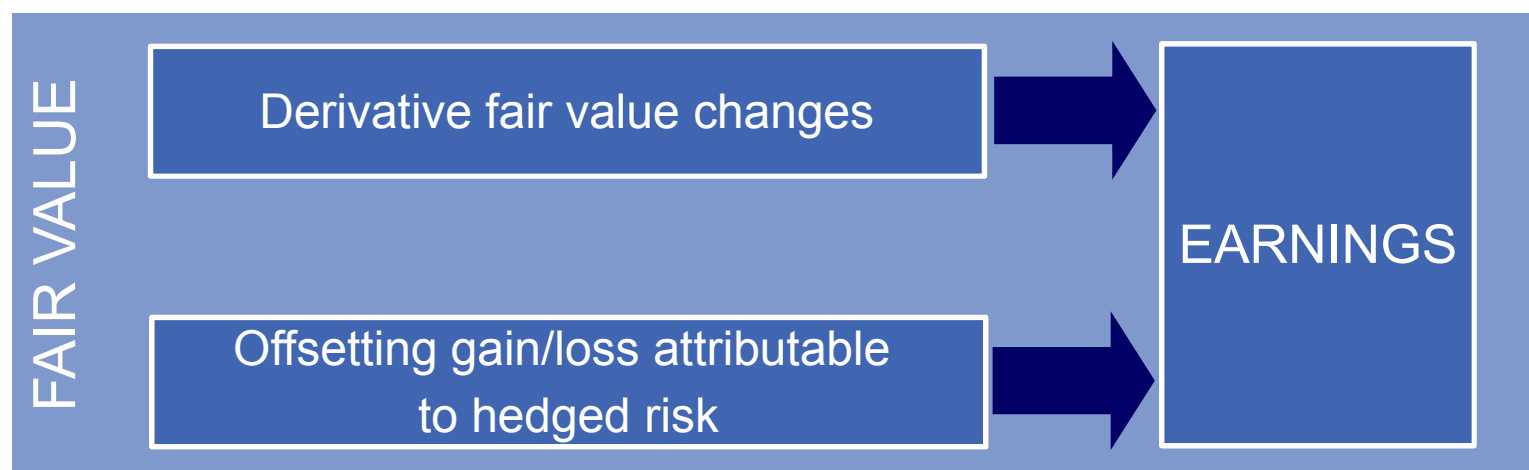


Embedded derivatives in energy contracts

- Some relevant industry examples:
 - Complex pricing formulas in long-term fuel supply contracts
 - Power priced off of fuel source(s)
 - Price indexation based on inflationary factors
 - LNG pricing based on either U.S. Henry Hub natural gas prices or dated Brent crude oil
 - Distillate products (propane, butane) priced off of crude oil, LSFO
 - Purchases/sales in other currencies

- An illustration: A long-term natural gas price formula:
$$P=1.1735*P_o(1+D)*(0.06+0.74*PPI/PPI_o+0.1*GO/GO_o+0.1*HFO/HFO_o)$$

Hedge classification



Hedge effectiveness

- Hedge classification and effectiveness of the relationship impact accounting result
- “Effectiveness” refers to derivative’s ability to generate offsetting changes in fair value/cash flows of hedged item
 - Assessment – establishes whether hedge accounting can be applied. Effectiveness must be assessed as between 80% – 125% (prospectively and retrospectively).
 - Measurement – records amount of ineffectiveness to be reported based on a comparison of actual changes in fair value or estimated cash flows in the hedged item and hedging derivative.

U.S. GAAP comparison:

- No “matched terms” or “short-cut method” under IFRS
- No DIG G20 equivalent allowing deferral of option time value

Hedging requirements

- Requires specific written documentation of:
 - Overall risk management policy
 - Nature of risk being hedged
 - Hedging instrument
 - Results of hedge assessment at inception
 - How effectiveness will be measured at inception and how and when it will be tested periodically
 - Accounting policy (including specifically how the instrument will be accounted for)

- No documentation = no hedge

Disclosures

- IFRS 7 requires disclosures about:
 - Significance of an entity's financial instruments
 - Qualitative and quantitative information about exposures to risk (including credit, market, and liquidity risk)
 - Significant accounting policies
 - Fair value methods/techniques employed
 - Hedge accounting (as applicable)

U.S. GAAP comparison:

- IFRS disclosures are more extensive
- Certain U.S. GAAP MD&A disclosures will now be a part of audited financial statements

Illustrative IFRS-U.S. GAAP differences

	Potential Differences	Potential Implications	
		Financial Statement	Process/Systems
Derivative definition	<ul style="list-style-type: none"> ▪ Different derivative definitions ▪ Greater emphasis on operational use in the business ▪ IFRS does not require a notional ▪ Fewer prescriptive energy-specific interpretations 	<ul style="list-style-type: none"> ▪ Differing balance sheet amounts ▪ Different income statement impacts 	<ul style="list-style-type: none"> ▪ May require reassessment of prior conclusions ▪ Changes to deal capture, including different list of in-scope instruments
Own use/NPNS exception	<ul style="list-style-type: none"> ▪ Own use is not elective ▪ Own use potentially harder to achieve than NPNS 	<ul style="list-style-type: none"> ▪ Some NPNS deals may be fair valued under IFRS ▪ Some U.S. GAAP derivatives will require own use under IFRS 	<ul style="list-style-type: none"> ▪ Updated policies and changes in supporting documentation ▪ Systems challenges to address differing accounting answers
Embedded derivatives	<ul style="list-style-type: none"> ▪ Differing implications for embedded derivative pricing terms ▪ No grandfathering exemptions under IFRS 	<ul style="list-style-type: none"> ▪ Different valuation outcomes, if only embedded portion valued ▪ Potentially recognize more embeds 	<ul style="list-style-type: none"> ▪ Changes to contract assessment process ▪ Modification to valuation models ▪ Systems data capture changes

Illustrative IFRS-U.S. GAAP differences

	Potential Differences	Potential Implications	
		Financial Statement	Process/Systems
Valuation	<ul style="list-style-type: none"> No IFRS equivalent of FAS 157, so differing methodologies Different day 1 gain recognition guidance 	<ul style="list-style-type: none"> Recorded balance sheet values may differ Some inception gains may be deferred 	<ul style="list-style-type: none"> Update valuation methodologies to reflect different approach Track deferred amounts for potential subsequent recognition
No industry-specific guidance	<ul style="list-style-type: none"> US GAAP has a number of “DIG” issues relevant for energy-specific situations Other U.S. GAAP guidance around gross versus net reporting and around revenue recognition 	<ul style="list-style-type: none"> Different scoping outcomes will impact financial statement amounts Potentially different income statement netting, etc. 	<ul style="list-style-type: none"> Update accounting policy determinations and assessment process Update systems to automate tracking of new data requirements
Lack of regulatory accounting rules	<ul style="list-style-type: none"> No ability under IFRS to offset derivative gains/losses in regulatory assets/liabilities 	<ul style="list-style-type: none"> Potentially greater earnings volatility if value changes taken directly to earnings 	<ul style="list-style-type: none"> Reconsider amounts in U.S. GAAP regulatory balances Apply hedge accounting? Different transacting strategies?

Energy transacting considerations

- Notional considerations
- Own use not elective, but potentially more restrictive than “normal purchase/sale”
- Different embedded derivative outcomes
- Lack of industry-specific guidance
- No regulatory assets/liabilities rules under IFRS

Application to common energy transactions

Load-following contracts

- Notional determination
- Valuation considerations

Unit-contingent contracts

- Similar lease analysis
- Notional determination

Storage and transportation

- Scoping considerations
- Potential net settlement

Fuel procurement contracts

- Potential embedded derivative differences
- Own use considerations

Impacts beyond financial statements

Core impact areas:

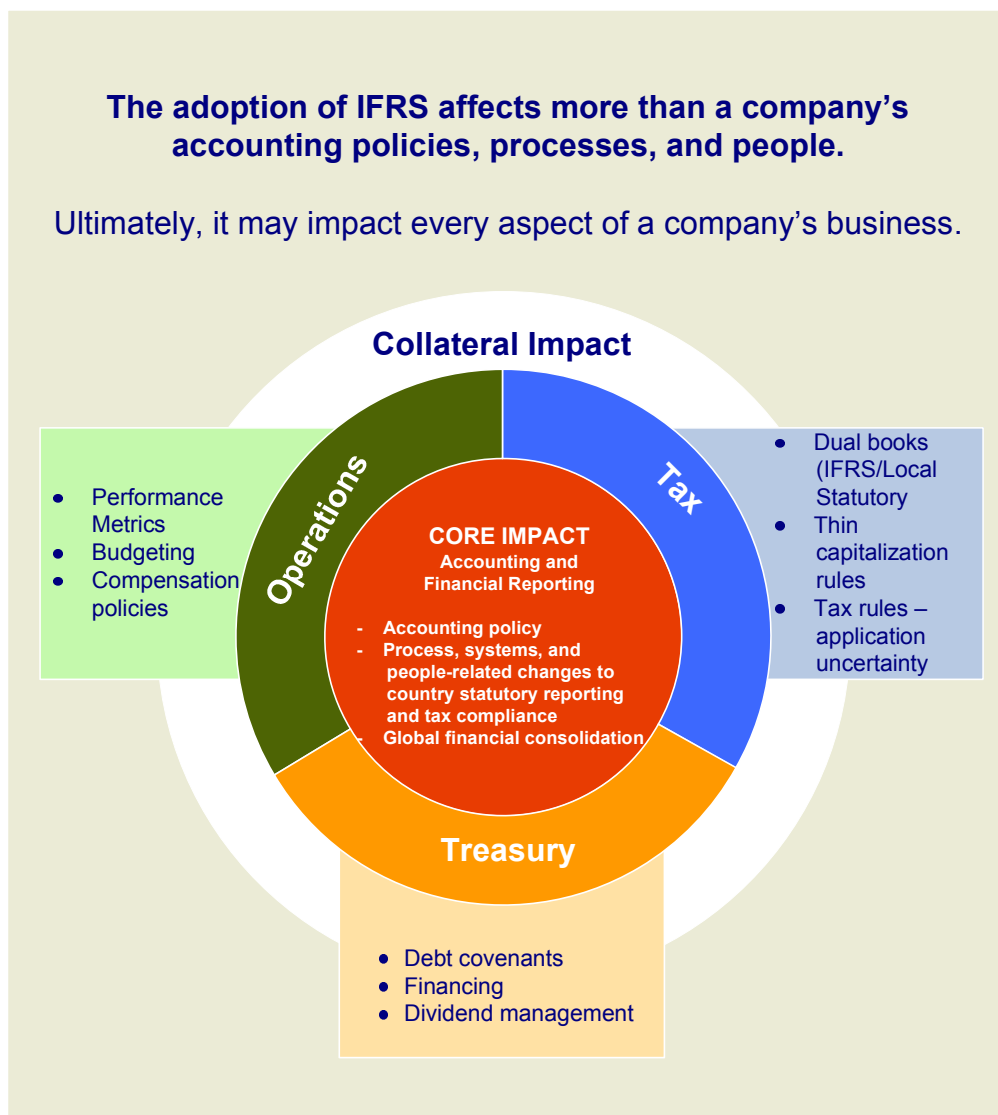
- Technical accounting
- Processes and systems
- Risk monitoring and controls
- Human resource matters

Many other business areas affected:

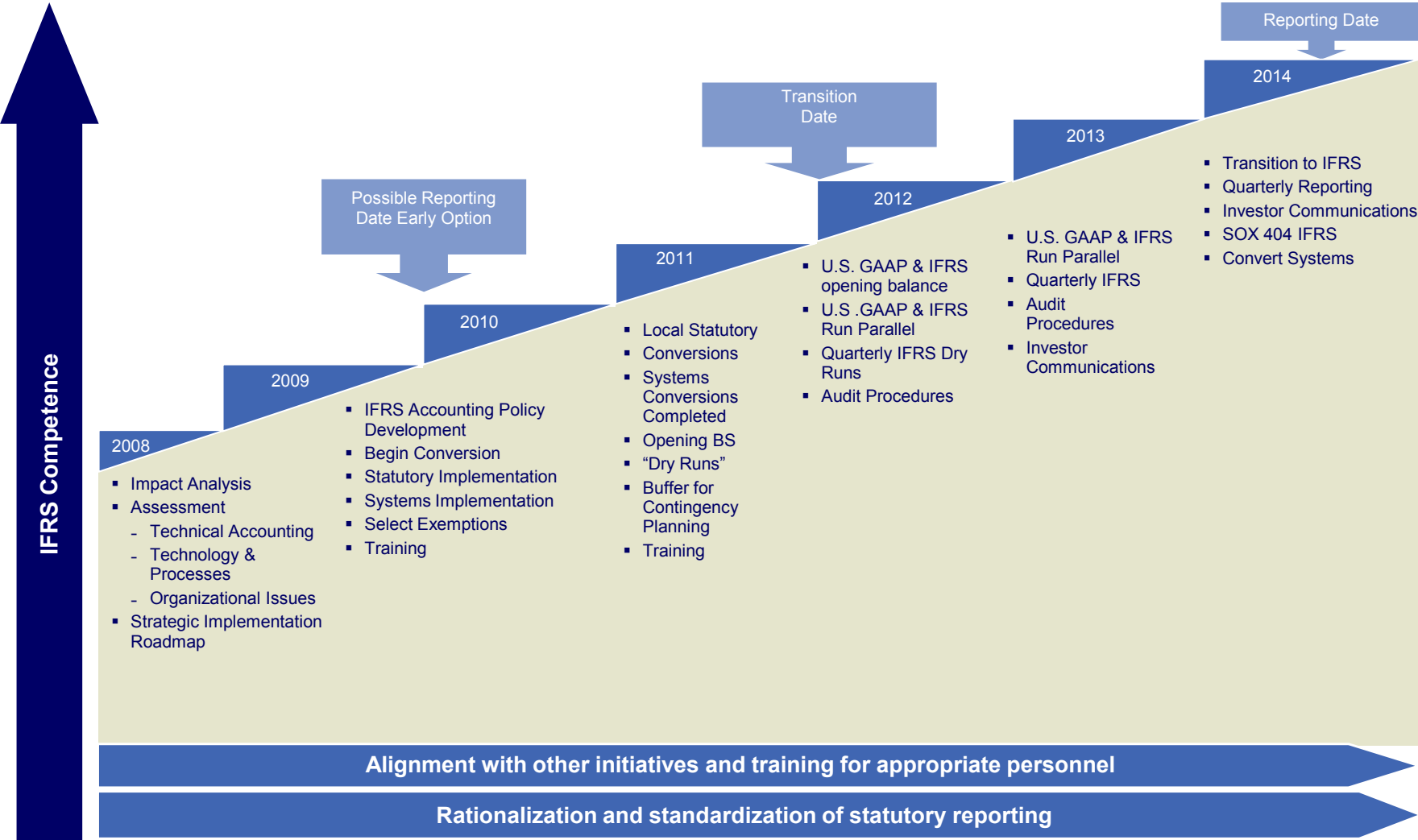
- Operations and Technology
- Tax
- Treasury

Impacts multiple transacting areas:

- Debt covenants
- Compensation plans
- Revenue contracts
- Tax returns
- Joint ventures and alliances
- Investor communication



Illustrative IFRS conversion strategy



Key impacts of IFRS implementation

Technical Accounting

- Overall approach to IFRS implementation
- First time adoption policy considerations, including reporting dates and use of exemptions
- Ongoing policy considerations, including alternatives and approach to “principles”

Process and Statutory Reporting

- Internal controls and processes including documentation and testing
- Management and internal reporting packages
- Global reporting packages
- Statutory reporting, including “opportunities” around IFRS adoption

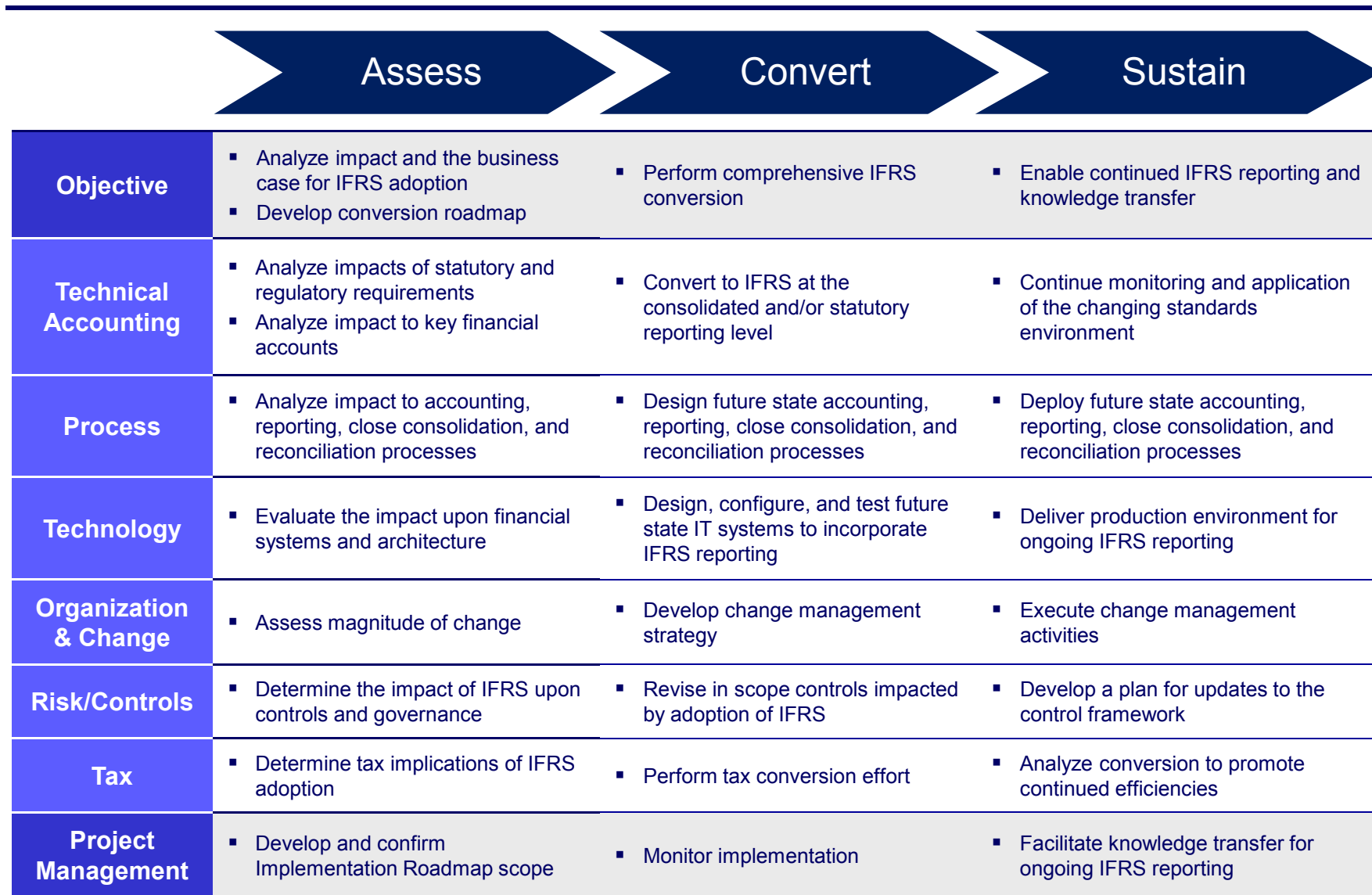
Technology Infrastructure

- General ledger and chart of account structure, including performance metrics
- Global consolidation
- Sub-system issues related to configuration and data capture
- Capabilities to manage multiple GAAP accounting during transition

Organizational Issues

- Tax structures
- Treasury and cash management
- Legal and debt covenants
- People issues including education and training, compensation structures
- Internal communications
- External and shareholder communications

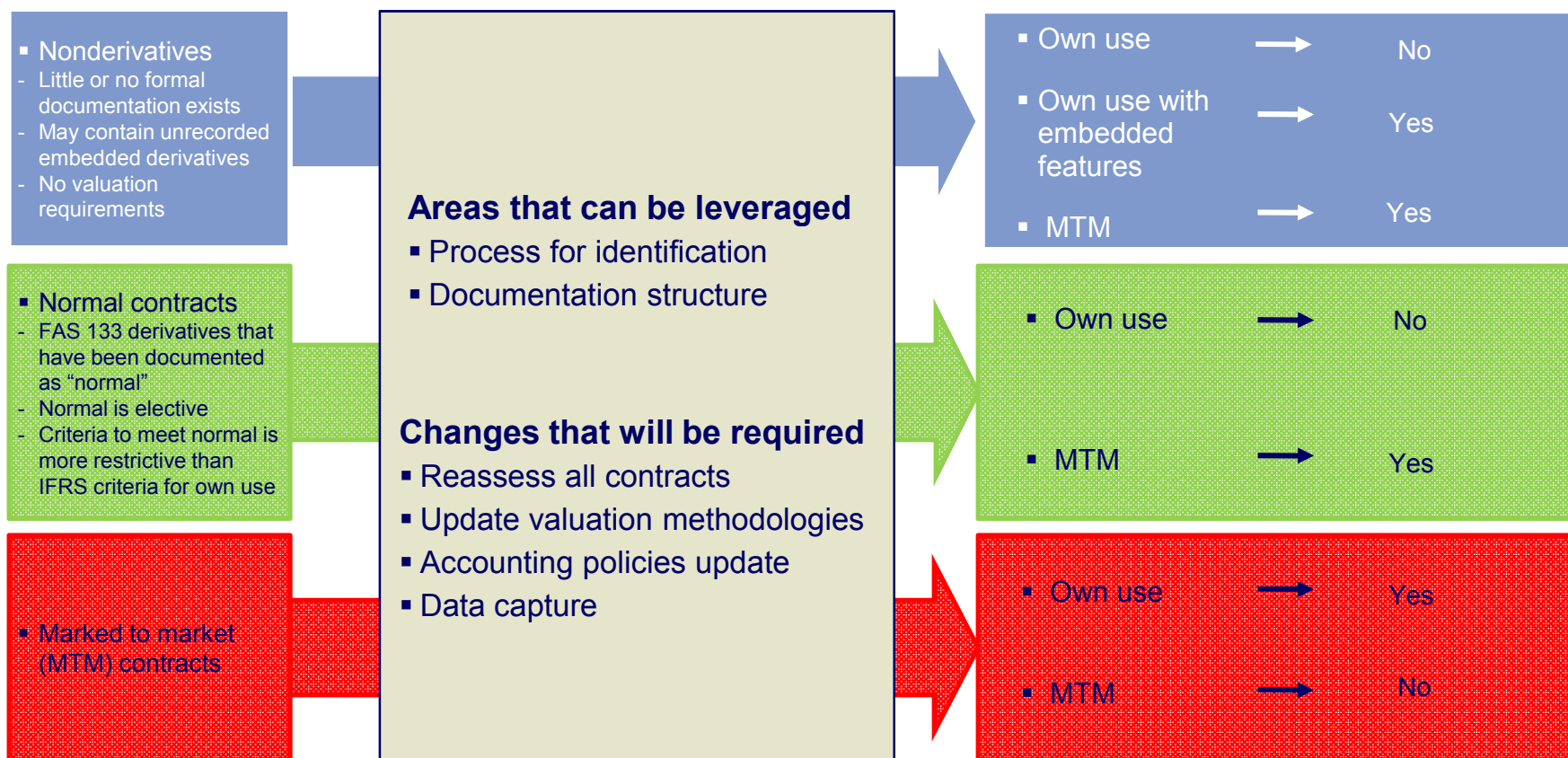
A phased implementation approach



Illustrative commodity contract assessment



This analysis shows how current US GAAP contract classifications may differ under IFRS and the processes required to manage this change. Although some US GAAP efforts may be leveraged, fundamental differences in the derivative definition and scope exceptions may mean that significant effort is required to understand the specific IFRS impacts on its commodity contracts.



Lessons learned

Conversion is complicated and takes time

- Establish workstreams and set milestone goals with project management supervision
- Consider needed change in thinking to move to a principles based methodology
- “Pay now, or pay later” – near-term shortcuts generally postpone (not avoid) costs
- Identify resource constraints early on and manage around ongoing responsibilities

Efforts best served by focusing on topical areas

- Many areas can be focused on in parallel, but only if designed as discrete workstreams with dedicated resources to ensure that continued progress is made
- Effort on converting financial instrument reporting alone under IAS 32/39/IFRS 7 is as big of a task as converting the remaining accounting requirements

Coordination is key

- Coordinate efforts and get buy-in across business units, geographies
- Develop controls in parallel with operational changes across the organization
- Think through implications on “non-accounting” areas, such as systems, tax

Don't underestimate training needs

- Training is key at all levels of the organization to ensure a smooth transition to IFRS
- Include everyone so the whole organization speaks the same “language”
- Tailor training programs by level and role (i.e., accounting personnel require different level of education from front office/deal originators, legal, etc.)

Final thoughts

- IFRS is now the global accounting standard and will impact U.S.-based companies
- Derivative accounting will be a significant conversion area
- Start with GAAP, but also consider other impacts beyond just technical accounting
- Plan ahead, and don't underestimate implementation lead times
- Take the time to assess potential IFRS impacts and map out your implementation approach

Deloitte resources

- www.iasplus.com
 - A news page (updated almost daily)
 - Detailed summaries of all standards and interpretations
 - E-learning modules for each IAS and IFRS
 - Model IFRS financial statements and disclosure and compliance checklists
 - Downloadable Deloitte publications relating to IFRS (over 100 publications available)
 - Background on all IASB and IFRIC agenda projects, plus decision summaries of all IASB and IFRIC meetings
 - Comparisons of IFRS and various local GAAP

Deloitte resources (continued)

- www.deloitte.com/us/ifrs
 - Recent publications on IFRS issues
 - IFRS trainings
 - Resource library
 - Podcasts and Dbriefs
 - IFRS and U.S. GAAP pocket comparison
- DART (subscription only)
 - Q&A on key differences between U.S. GAAP and IFRS on accounting for:
 - Derivatives
 - Embedded derivatives
 - Hedge accounting

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Questions & Answers

Power & Utilities IFRS Webcast Series

November 21, 2008

IAS 12 – Income Taxes

December 12, 2008

IAS 16 – Property, Plant and Equipment

December 19, 2008

Regulatory Assets/Liabilities

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