UNION OF THE ELECTRICITY INDUSTRY
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Sir David TWEEDIE
Chairman of IASB
30 Cannon Street
UK - EC4M 6XH LONDON

19 September 2002
HR/as 02-053

Dear Sir Tweedie,

In response to the invitation to comment publicly made by IASB, please find enclosed the remarks to the IASB Exposure Draft of Proposed Improvements to International Accounting Standards that the Eurelectric Task Force on International Accounting Standards has regarded as appropriate.

We have only included references to the standards that we have considered as deserving comments.

Some of the issues mentioned here below are of particular relevance for the electricity industry, as well as for other industries:

– Dismantling costs.
– Capitalisation of borrowing costs.
– Capitalisation of exchange differences.
– Accounting treatment of compensation for impaired assets associated to competition transition processes.
– Depreciation method applicable to low voltage network assets.

We would like to take this opportunity to state that we are very conscious of the great importance of first-time application process of IAS in Europe and that we remain at your service to co-operate if you consider it as convenient.

Yours sincerely

pp Howard Ramsden
Juan Antonio Hernández-Rubio
Chairman of the Task Force on International Accounting Standards

Gerardo Hermo
Co-ordinator of the Finance and Economics Network

cc. Prof. Geoffrey Whittington

PROPOSED IMPROVEMENTS TO IAS 1
Presentation of Financial Statements

Q1. *Do you agree with the proposed approach regarding departure from a requirement of an International Financial Reporting Standard or an Interpretation of an International Financial Reporting Standard to achieve a fair presentation?*

No. EURELECTRIC does not see the reasons why "the relevant regulatory framework" to decide if the entity is allowed to make a departure from IAS in order to achieve a true and fair view should be the national accounting regulations

EURELECTRIC has the opinion that abiding by this proposed approach in accordance with which the regulatory framework of the country where the statements are issued determines if departure from IAS is possible, contradicts the objectives set by the European Regulation on the Application of Accounting Standards.

It seems unreasonable that two IAS compliant financial statements have to be different because the regulatory requirements concerning the use of the true and fair view override, vary from country to country. In our view the national regulatory framework should not come into consideration when preparing financial statements under International Accounting Standards.

Consequently, we are in favour of deleting the words "if the relevant regulatory framework requires or otherwise does not prohibit such a departure" at the end of the new paragraph 13 and the full paragraph 15.

Q2. *Do you agree with prohibiting the presentation of items of income and expense as "extraordinary items" in the income statement and the notes?*

No. EURELECTRIC believes that a clear distinction between recurring and nonrecurring items is essential in order to evaluate more accurately the results obtained by an entity. Instead of prohibiting the presentation of "extraordinary items" a clearer guidance to differentiate ordinary from non-ordinary items might be welcome.

Also to avoid diminishing the predictive capacity of financial statements, we regard as premature to delete the line "operating profit" from the minimum requirements of income statement formats.

Q3. *Do you agree that a long-term financial liability due to be settled within 12 months of the balance sheet date should be classified as a current liability even if an agreement to refinance or to reschedule payments is completed after the balance sheet date and before the financial statements are authorised for issue (paragraph 60).*

EURELECTRIC agrees with the above principle.

Q4(a) *Do you agree that a long-term financial liability that is payable on demand because the entity breached a condition of its loan agreement should be classified as current at the balance sheet date, even if the lender has agreed after the balance sheet date and before the financial statements are authorised for issue, not to demand payment as a consequence of the breach (paragraph 62)?*

EURELECTRIC agrees with the above principle.

Q4(b)(i) *Do you agree that if an entity is in breach of a loan agreement but is given a grace period and rectifies the breach within the grace period the liability should continue to be classified as non-current.*

EURELECTRIC agrees with the above principle.

Q4(b)(ii) *Do you agree to the same classification if the grace period is given before balance sheet date, the breach has not yet been rectified but has not expired by the date of issue of the financial statements.*

EURELECTRIC agrees with the above principle.

Q5. *Do you agree that an entity should disclose the judgement made by management in applying the accounting policies that have the most significant effect on the amounts of items recognised in the financial statements paragraph 108 and 109).*

No. EURELECTRIC believes that meaningful disclosures could easily reach the commercially confidential domain and harmless disclosures from the commercial point of view could easily be useless and irrelevant.

PROPOSED IMPROVEMENTS TO IAS 2
Inventories

Q1. *Do you agree with eliminating the allowed alternative of using the last-in, first-out (LIFO) method for determining the cost of inventories under paragraphs 23 and 24 of IAS 2?*

EURELECTRIC agrees with the above principle.

Q2. *IAS 2 requires reversal of write-downs of inventories when the circumstances that previously caused inventories to be written down below cost no longer exists (paragraph 30). IAS 2 also requires the amount of any reversal of any write-down of inventories to be recognised in profit or loss (paragraph 31). Do you agree with retaining those requirements?*

EURELECTRIC agrees with the above principle.

Other comments

1. The singularities associated with the acquisition and disposal process of some energy materials may well require a new class of asset that has some characteristics of a fixed asset and some characteristics of inventories. In particular it should follow the capitalisation and disposal rules of fixed assets and the expensing rule of inventories (i.e. taken to the profit and loss statement on a usage basis). Nuclear fuel would be a good example of this kind of asset.

PROPOSED IMPROVEMENTS TO IAS 16
Property, Plant and Equipment

Q1. *Do you agree that all exchanges of items of property, plant and equipment should be measured at fair value, except when* the *fair value of neither of the assets exchanged can be determined reliably? (see paragraphs 21 and 21A)?*

No. EURELECTRIC views are contrary to the proposed change.

Although it is sometimes difficult to make a distinction between exchanges which are in effect sales of dissimilar items and swaps of similar assets that have a similar use in the same line of business, the earnings process is incomplete in the latter case and, consequently, no gain or loss should be recognised.

This issue is not particularly relevant for the electricity industry.

Q2. *Do you agree that all exchanges of intangible assets should be measured at fair value, except when the fair value of neither of the assets exchanged can be determined reliably (Note* that *the Board intends to retain the policy in IAS 18, Revenue, prohibiting the recognition of revenue from exchanges or swaps of goods or services of a similar nature and value.)?*

EURELECTRIC supports the proposed change. There should be no reason to treat intangible assets differently.

Q3. *Do you agree that depreciation of an item of property, plant and equipment should not cease when it becomes* temporarily *idle or is retired from active use and held for disposal (see paragraph 59)?*

EURELECTRIC agrees with the above principle.

Other comments

1. We agree with the comments made by EFRAG regarding the sometimes difficult distinction between incidental income as mentioned in paragraph 17B and the proceeds from selling any items produced when bringing the asset to the necessary location and condition as mentioned in paragraph 15 (b).

   However, it is necessary to mention that this issue is not of great relevance for the electricity industry.

2. The question of the costs to dismantle and remove an asset and restore its site (paragraphs 20A and 20B) is of particular relevance for the electricity industry, particularly for electricity generation companies. We believe that the proposed accounting treatment is adequate and coherent with the Commission Recommendation on the recognition, measurement and disclosure of environmental issues in the annual accounts and annual reports of companies. It is also coherent with the contents of the FASB Statement nº 143, *Accounting for Asset Retirement Obligations*.

   Nevertheless, despite the agreement with the amended standard, there are certain issues of particular relevance for the electricity industry that must be noted. In the first place, additional guidance might be helpful with regard to liability measurement changes in periods subsequent to initial measurement. Paragraph 60 of IAS nº 37 makes clear the accounting procedure to be followed for incorporating measurement changes due to the passage of time, but no guidance is provided for incorporating changes resulting from revisions of either the timing or the amount of the estimated cash flows. To deal with this issue, the FASB Statement nº 143 establishes that:

> *"When asset retirement costs change as a result of a revision to estimated cash flows, an entity shall adjust the amount of asset retirement cost allocated to expense in the period of change if the change affects that period only or in the period of change and future periods if the change affects more than one period"*

Given the critical importance of these dismantling costs for some industries, it should be clearly stated that a dismantling cost adjustment should only be realised under well-founded technological reasons in order to avoid an unnecessary volatility in the entities' annual income.

Secondly, the singularities associated with some industries, in particular regulated entities, should also be declared with respect to the accounting treatment of these dismantling costs. Regulated entities must take into account certain specific criteria to recognise a regulatory asset and a regulatory liability. These criteria usually coincide with those established by the FASB Statement nº 71, *Accounting for the Effects of Certain Types of Regulation*, in paragraphs 9 and 11. The question of differences in the timing of recognition of period dismantling costs for financial reporting and tariff-making purposes (leading to the corresponding regulatory assets) might also become important in some cases

3. The issue of the component approach to be applied to depreciation (par. 12) is also worth to be remarked. We believe that this component depreciation approach cannot be applied to a distribution network, such as electricity, water, gas and telecoms.

   In our view, for heavily interconnected installations, it is not possible to track components with different useful lives or providing benefits to the entity in a different pattern from a financial point of view. A distribution network is not an asset with a limited and definite useful life, comprising different components with different costs but **an asset of an ongoing nature**. Hence, the most logical basis of valuation should be the current value of the network, i.e. what a potential competitor would find it worth paying for it or the cost of a technically up to date new asset with the required service capability.

   In an ongoing asset with an indefinite life, calculating annual depreciation on a useful life basis does not make great sense. It would be more accurate to regard the estimation of the annual network renewal as the relevant issue. This annual charge would have a mixed composition, including the consumption of future economic benefits embodied in the asset, the operation and maintenance expenditure to keep original service standards plus an estimate of expenditure required to raise standards to the current quality service levels.

   To sum up, an appropriate accounting treatment for a distribution system, such as an electricity low voltage network, should be addressed in a standard to be applied to properties and equipment of a similar nature.

4. New paragraphs 53A and 53B specify that compensation from third parties for items that were impaired shall, in the period in which it is received, be included in profit or loss for that period and disclosed separately.

We agree in principle with these two paragraphs but we regard that particular attention should be addressed to a singular issue in the regulated industries when there is a process of changing the regulation, which is the issue of stranded costs. For instance, in the electricity industry, the impairment of assets has been recently linked to the transition from a regulated regime to an open market regime. Regulatory authorities may grant the electricity entities the right to be compensated for the costs to be incurred as a result of the regulatory change. This right may lead to the recognition of an asset, as long as the conditions usually taking into account are met.

5. According to paragraph 46 of the improved standard, an annual reassessment of residual values of all assets (where residual values are not insignificant) must be carried out. EURELECTRIC believes that this change imposes an unreasonable burden particularly since residual values are likely to fluctuate according to current economic conditions.

   EURELECTRIC believes the text should be amended to remove the requirement for annual reassessment of residual value where there are no indications of impairment.

PROPOSED IMPROVEMENTS TO IAS 17
Leases

Q1. *Do you agree* that when classifying a lease of land and buildings, the lease should be split into two elements –a lease of land and a lease of buildings? The land element is generally classified as an operating lease under paragraph 11 of IAS 17, Leases, and the buildings element is classified as an operating or finance lease by applying the conditions in paragraphs 3-10 of IAS 17.

Yes. This revised draft makes important changes in presentation of leases which are considered appropriate in accordance with the economic substance of lease. But paragraphs 11B and 11C are not very clear:

– The allocation between land and building is made in proportion to their relative fair values at the inception of the lease. If the lease qualifies for finance lease, it must be recorded within tangible assets and it is not clear whether at fair value or at original cost. If fair value is applied, all tangible assets in this category must be stated in fair value, which might increase costs for the companies if they do not use "fair value" criteria for fixed asset valuation.

– "Immaterial value of land: Guidance on what "immaterial" exactly means is missing, hence subject to manipulation.

Q2. *Do you agree* that when a lessor incurs initial direct costs in negotiating a lease, those costs should be capitalised and allocated over the lease term? Do you agree that only incremental costs that are directly attributable to the lease transaction should be capitalised in this way and that they should include those internal costs that are incremental and directly attributable?

EURELECTRIC agrees with the above principle.

PROPOSED IMPROVEMENTS TO IAS 21
The Effects of Changes in Foreign Exchange Rates

Q1. *Do you agree* with *the proposed definition of functional currency as "the currency of the primary economic environment in which the entity operates" and the guidance proposed in paragraphs 7-12 on how to determine what is an entity's functional currency?*

Yes. EURELECTRIC agrees with the proposed improvements.

Q2. *Do you agree* that *a reporting entity (whether a group or a stand-alone entity) should be permitted to present its financial statements in any currency (or currencies) that it chooses?*

Yes. EURELECTRIC believes that the option to present financial statements in any currency (or currencies) is a clear improvement. In principle, we would not be against adding a disclosure requirement under which the reasons for the selection of the reporting currency would be summarised if that currency were not be that of the country of registration of the parent. However, this disclosure should not be interpreted as a restriction: whatever the reasons, any currency could be used as presentation currency.

Q3. Do you agree that all entities should translate their financial statements into the presentation currency (or currencies) using the same method as is required for translating a foreign operation for inclusion in the reporting entity's financial statements (see paragraphs 37 and 40)?

EURELECTRIC agrees with the above principle.

Q4. *Do you agree that the* allowed *alternative to capitalise certain exchange differences in paragraph 21 of IAS 21 should be removed?*

No. Many companies, including electricity companies, often have to develop large size overseas projects that have to be financed in currencies against which there is no practical means of hedging. Therefore, the omission of former paragraph 21 may be very relevant for many industries.

If a severe devaluation of any of those currencies took place, the additional costs incurred should be regarded as a part of the acquisition costs associated to that project, provided that the adjusted carrying amount does not exceed the lower of the replacement cost and the amount recoverable from the sale or use of the asset. It should be taken into account that the exchange differences associated to the devaluation would not have been incurred if the investment on the asset had not taken place.

To sum up, we are in favour of not removing the alternative treatment contained in former paragraph 21.

Q5. *Do you agree that:*

(a) goodwill and
(b) fair value adjustments to assets and liabilities

that arise on the acquisition of a foreign operation should be treated as assets and liabilities of the foreign operation and translated at the closing rate (see paragraph 45)?

EURELECTRIC agrees with the above principle. We agree that goodwill and fair value adjustments are generated as a result of the acquisition of an entity and therefore relate to the acquired entity and should therefore be translated at the closing rate.

PROPOSED IMPROVEMENTS TO IAS 23
Borrowing Costs

Comments

1. This Standard nº 23 is included in the Improvement Project. However, no specific amendments are proposed, since the Board has decided to address the issues in connection to this standard in the context of a wider project on how to measure an asset on initial recognition.

   In spite of not proposing any definite modification, we are concerned that the IASB may well consider the elimination of the current option to capitalise borrowing costs, forcing the cost to be treated as an immediate expense.

   In capital intensive industries, with long lasting assets, we believe it would be worth maintaining the capitalisation treatment. This capitalisation of borrowing costs should be understood in the most comprehensive sense. Any financing costs directly attributable to the construction or acquisition of the asset that could have been avoided if the investment had not taken place, including exchange differences, should be capitalised

   By applying this treatment, the acquisition cost of any item would be the same, whatever the acquisition process chosen by the entity, either an own constructed project or a project developed and built by a third party. Any vendor would include the financing costs of a project in their sales price.

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EURELECTRIC Position Paper On Accounting Harmonisation with regard to the Regulation on the Application of Accounting Standards

September 2002

EURELECTRIC Position Paper On Accounting Harmonisation with regard to the Regulation on the Application of Accounting Standards

This Position Paper has been drafted bythe EURELECTRIC Task Forces on International Accounting Standards and approved by the Network of Experts for Finance & Economics and the EURELECTRIC Management Committee.

EURELECTRIC Task Forces on International Accounting Standards:
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The **Union of the Electricity Industry - EURELECTRIC**, formed as a result of a merger in December 1999 of the twin Electricity Industry Associations, UNIPEDE and EURELECTRIC, is the sector association representing the common interests of the European Electricity Industry and its worldwide affiliates and associates. Its mission is to contribute to the development and competitiveness of the Electricity Industry and to promote the role of electricity in the advancement of society.

EURELECTRIC supports the adoption of the EU Regulation on the Application of the International Accounting Standards.

According to this regulation, a single set of international accounting standards (IAS) will be applied to the consolidated accounts of publicly traded companies from 1 January 2005. The regulation also provides an option for Member States in respect of annual accounts and of non publicly traded companies to permit or require the application of the standards issued by the International Accounting Standards Board (IASB).

In this regard, EURELECTRIC strongly believes that any sort of prohibition on applying IAS on annual accounts would go against the stated objectives of the Regulation, that is to say a higher degree of transparency and comparability of financial statements and hence greater efficiency in capital markets. National governments should permit and moreover encourage the use of IAS by all companies, though this application must be done in a tax-neutral way.

A prohibition on applying IAS to the annual accounts of companies belonging to listed groups would lead to **some** contradictions in the financial information presented by different subsidiaries, depending on their listed or non-listed **status**.

The Regulation and the efficiency of capital and energy markets

The regulation **prescribes** the use of IAS "with a view to harmonising the financial information presented" by publicly traded companies "in order to ensure a high degree of transparency and comparability of financial statements and hence an efficient functioning of the Community capital market and of the Internal Market".

The Regulation on the Application of Accounting Standards is particularly crucial for the energy and electricity industry, which is currently undergoing a general re-shaping of the markets in which the energy agents are playing.

The energy industry is opening up to competition and a new package of EU legislation is about to be implemented on a European Union basis. The new package requires a non-discriminatory access to the gas and electricity transmission networks, a free choice of supplier for the majority of consumers and an electricity generation business working under free competition rules.

As mentioned above, in this new competitive environment, the application of a unified set of accounting rules becomes particularly crucial. The existence of different accounting rules for determining the value of strategic assets undermines the competitiveness of the companies, the ability to evaluate the market value of such assets and their appeal to potential acquirers.

The same can be said for the companies as a whole. The integration of the energy and financial markets is impaired by the existence of different accounting rules. Buying, selling, merging and spinning-off are severely distorted by the application of different accounting rules, which prevents the companies from competing on an equal footing for available financial resources.

The need for companies to access financial resources is not confined to listed companies. Non-listed companies may also take advantage of an accounting level playing field to obtain loans, to issue commercial paper or to deal in leasing contracts.

Professional issues regarding the Regulation on the Application of IAS

Accounting processes need to be faster and safer for the sake of the companies and cheaper for the benefit of customers. It is apparent that the co-existence of two sets of accounting standards is extremely inefficient.

On the one hand, a simultaneous application of two sets of standards more than doubles the work burden associated with accounting processes. By way of illustration, it is only necessary to think about the complexity of the consolidation process when several subsidiaries applying several different national accounting standards must be integrated.

On the other hand, a higher complexity leads to a higher probability of inaccuracies, as extremely complex accounting processes are more liable to error.

Finally, there is an inherent lack of transparency and comparability linked to the application of two sets of standards. A high level of transparency and comparability of financial reporting has been **identified by the Commission** as “a necessary condition for building an integrated capital market which operates effectively, smoothly and efficiently”.

Tax issues regarding the Regulation on the Application of IAS

A serious disadvantage of the first-time application of IAS is the uncertainty regarding the tax impact for both the inland revenue and the companies.

The neutrality of the migration process from the application of one set of standards to the other must be preserved, making the necessary legal adjustments to ensure that all necessary adjustments can be dealt with through the application of IAS 12.

Conclusion

In conclusion, we believe that the Regulation on the Application of Accounting Standards represents an important step towards a higher degree of transparency and comparability of financial statements and hence greater efficiency of capital markets.

In our view, the option for Member States in respect of annual accounts and of non publicly traded companies to permit or require the application of the standards issued by the IASB is also a positive step. A close relationship between individual and consolidated accounts would help financial reporting users to interpret and understand more easily the financial situation and evolution of the enterprises, given that both sets of accounts would be drawn up following the same valuation and presentation criteria. Therefore, we are concerned about the intention of some national standard setters to forbid the application of IAS to individual accounts. This prohibition would go against the objectives of the reform and also against the interests of both financial reporting users and preparers.