Application of IFRS 1 *First-Time Adoption of International Financial Reporting Standards*

Property, Plant and Equipment for Rate-Regulated Entities

Background

1. In February 2008, the Canadian Accounting Standards Board ("AcSB") confirmed that Canadian publicly accountable enterprises will be required to adopt International Financial Reporting Standards ("IFRS") beginning January 1, 2011, with consistent comparative information required for the year 2010. In preparation, the Canadian Electricity Association ("CEA"), the Canadian Gas Association ("CGA"), and the Canadian Energy Pipeline Association ("CEPA") have been working collectively to develop resolutions to each of the common issues faced by these rate-regulated industries in the conversion and implementation of IFRS.

2. The rates charged to our customers for regulated electricity and natural gas utilities and oil and natural gas pipelines are governed and set by our regulators. Regulators are authoritative bodies, with powers similar to courts of law. As rate-regulated entities are often "natural" monopolies, the regulation of revenues or rates for these particular entities is regarded as a substitute to a competitive market and exists to protect the interests of the utility's customers and other stakeholders.

3. Traditional regulation generally will permit rates to be set at levels intended to recover the estimated costs of providing the regulated services or products, including the cost of capital. The cost of capital consists of both debt (interest) and an "allowance" for earnings on shareholders' investments. This type of regulation is referred to as "cost of service." Cost of service regulation is common in Canada, the United States and other countries who will need to adopt IFRS.

Recommendation

4. This paper recommends that, as at the date of transition to IFRS, an enterprise subject to rate regulation is not required to retrospectively restate the net book value of those items of property, plant and equipment (PPE) which include amounts currently capitalized under the entity's national generally accepted accounting principles (GAAP), but not permitted to be capitalized under IFRS. Where it is impracticable for the enterprise to comply with IFRS, the enterprise may elect the historical carrying cost for PPE to be the deemed cost as at the date of transition to IFRS, subject to any impairment.

The Key Transition Issue

5. Rate-regulated entities are capital intensive, and in many cases, construct their own assets. The cost of a self-constructed item of PPE will comprise the cost elements specified in International Accounting Standard 16, *Property, Plant and Equipment*.

6. In addition, under their national GAAP, entities that operate in a rate-regulated environment can capitalize as part of their PPE, amounts that would not qualify as an element of cost under IAS 16, or IAS 23, *Borrowing Costs*. The rate-setting treatment for a transaction or event can differ from its treatment for general financial reporting purposes. In order to reflect the economic impacts of rate-regulation, some national GAAPs (in particular in Canada and the United States) allow for rate-regulated entities to account for a transaction or event differently than an entity that would not be subject to rate regulation. These national GAAP treatments present a challenge with respect to the application of IFRS 1 and, specifically, the retrospective accounting required for fixed asset accounts.

Fixed Asset Accounts at the IFRS Transition Date

7. The cost of self-constructed PPE for rate-regulated entities will comprise the cost elements specified in IAS 16. Further, for a rate-regulated entity, elements of cost for PPE can also reflect amounts which would not be permitted to be capitalized under IFRS. The following are two examples:

    i. An "allowance for funds used during construction (AFUDC). The AFUDC is the imputed return to equity and actual cost of debt incurred during the period over which the property is being constructed. The imputed equity return is included in income and then capitalized on the basis of the property being constructed; thus the entity earns a regulated return on capital used to finance construction. This AFUDC is recognized as a result of specific rulings and guidance provided by the regulator, and is expected to be recovered through future economic inflows. The AFUDC is allocated to each asset class and, as part of the total cost of the assets, is depreciated over the useful life of the related PPE once it is placed in service.

       To the extent that AFUDC is greater than amounts that would be permitted to be capitalized in accordance with IAS 23, the excess would not be an amount permitted to be capitalized under IAS 16.

    ii. Non-directly attributable items, including, but not limited to, indirect overheads, cost of employee benefits related to pensioners, cost of moving assets, gains/losses, etc. These indirect costs are also capitalized as part of the total cost of self-constructed assets as a result of specific rulings and guidance provided by the regulator, and are expected to be recovered through future economic inflows. Similar to AFUDC, non-directly attributable items are allocated to each asset class and depreciated accordingly.

       Amounts capitalized in respect of non-directly attributable items are not permitted to be capitalized under IAS 16.

8. Once these amounts are added to the cost of PPE, they are not identified as individual assets, given there is no income tax or other statutory requirement to track these amounts separately. Thereafter, as noted, all amounts capitalized as part of the cost of

PPE are subject to depreciation. Where applicable, they are also subject to impairment testing.

9. In accordance with IFRS 1, rate-regulated entities can either restate the historical cost of their PPE (when necessary to adjust for the previous inclusion of the imputed cost of equity component of AFUDC, as well as non-directly attributable items) or elect to use the exemption, provided in paragraph 13 of the standard, in respect of fair value as deemed cost. The following analyzes each of these alternatives as applied to the transitional issue at hand.

Restating Historical Cost under IFRS 1

10. Restating the historic cost balances of PPE involves recreating the fixed asset records back to the commencement of operations, as if all current IASs and IFRSs had been in place since then. To restate historical cost under IFRS 1, a rate-regulated entity would:

    - Incur substantial costs in order to separate out from the historical records amounts currently capitalized, which could not be recognized as part of PPE under IFRS, and re-create the accounts going back years and in some cases several decades. The information required to do this may no longer be available;
    - Re-compute carrying values as most regulated entities construct many of their own assets. This would be necessary since capitalization of interest and overhead costs would need to be re-computed on a revised carrying amount;
    - Reconsider impairment under IAS 36, *Impairment of Assets*;
    - Re-compute gains or losses on dispositions, if any;
    - Re-compute amounts upon retirements of assets, which may or may not have been fully depreciated; and
    - Re-compute and re-record depreciation expense.

    Completing all of the above activities to recreate an opening IFRS compliant set of records would be imprecise, complex and time-consuming, and we question the benefit of undergoing such an exercise given what will likely be significant costs.

11. The reality facing rate-regulated entities is that significant costs and time would be incurred, and further, certain records may not be available. As such, management may only be able to develop an estimate of the historical amount of PPE and accumulated depreciation that would have been recorded in accordance with IFRSs, and this estimate would be based on incomplete data.

12. We are aware that the European experience was different in respect of the retrospective restatement of PPE, specifically as AFUDC and indirect items were not an issue. For example, in the electricity industry, many of the utilities were already IFRS compliant and were able to “roll” their PPE for IFRS purposes. On the other hand, the water industry was not IFRS compliant in respect of PPE, but there, the issue was that the industry had not followed componentization accounting.

Fair Value as Deemed Cost

13. In accordance with IFRS 1, an entity may elect to measure an item of PPE at the date of transition to IFRS at its fair value, and use that fair value as its deemed cost at that date.

14. A PPE asset in a rate-regulated environment will generate cash flows in relation to what the entity can recover through rates. The cash flows attributable would be a function of the recovery of the carrying amount through the inclusion in rates of depreciation charges, as well as a return on the PPE as granted by the regulator. Unless the amounts incurred to construct the PPE were imprudent (in which case impairment would result), a rate-regulated entity is likely to recover the total PPE cost through customer rates. However, rate-regulated entities would still need to consider continuing changes in the form of regulation, regulatory actions, competition where applicable and customer impacts when assessing recoverability through rates.

15. Implementing the fair value option for PPE, including assets in-service, standby equipment, operating reserves, facilities, construction-in-progress and a variety of other assets, would require a revaluation of all assets in each class in order to prevent selective revaluation of individual PPE. As capital-intensive industries, rate-regulated enterprises have substantial amounts of PPE, and, considering that many assets are self-constructed, establishing fair value at a point in time would be extremely difficult. A lack of qualified independent valuators would lead to a significant number of the required valuations being performed by management. This, in turn, would lead to attestation issues.

Basis for Recommendation

16. This paper proposes that the IASB amend IFRS 1 to permit rate-regulated entities an exemption in respect of retrospective measurement of PPE and accumulated depreciation based on the following rationale:

    i. Completing all the activities necessary to recreate the opening IFRS compliant statement of financial position would be complex, time-consuming and costly for rate-regulated entities. The required historical information would rarely be available in sufficient detail to compile this information. As such, the costs of retrospective treatment would outweigh any related benefits in financial reporting.
    ii. The effect of allowing amounts currently capitalized, which could not be recognized as part of PPE under IFRS, is temporary as the PPE would be depreciated over time.
    iii. Amounts currently capitalized, which would not be permitted under IFRS as part of PPE, have generally already been exposed to the purview of the regulator. Given the regulator's approval over the recovery of these amounts (as evidenced through rates sufficient to recover depreciation charges), we believe that the carrying value of the PPE at the date of transition would be broadly comparable to the result using fair value as the deemed cost.

iv. The fair value option upon transition may not be practicable for all rate-regulated entities, for the reasons stated in the previous section. Consistent with IFRS requirements, all PPE would still be subject to impairment testing upon transition.

17. The relief being requested is in respect of amounts currently capitalized within PPE which would not be permitted to be capitalized once IFRS is adopted. In order to avoid selective valuation, the relief would also apply to amounts capitalized within construction-in-progress PPE. Transactions, business events and decisions of the regulator after transition would be accounted for in accordance with IFRS.

18. Based on the above discussion, the following exemption under IFRS 1 is proposed:

> *As at the date of transition to IFRS, an enterprise subject to rate regulation is not required to retrospectively restate the net book value of property, plant and equipment for items previously capitalized under a national GAAP, but that would not otherwise be permitted to be capitalized in accordance with IFRS. Where it is impracticable for the enterprise to comply with IFRS, the enterprise may elect the historical carrying cost for PPE to be the deemed cost as at the date of transition to IFRS, subject to any impairment.*

Conclusion

19. In conclusion, this proposed exemption will allow rate-regulated entities in Canada, and in other parts of the world, to avoid incurring costs that would likely exceed the benefits to users of retroactively restating the amounts of PPE.