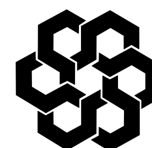

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**International Accounting Standards Board**

*This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.*
*These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.*

# INFORMATION FOR OBSERVERS

**IASB Meeting:** **22 May 2008, London (Agenda Paper 8)**

**Project:** **IFRS 1: First-time Adoption of IFRSs**

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## Introduction

1. In March 2008, staff of the Canadian Accounting Standards Board (AcSB) presented to the IASB several proposed amendments to IFRS 1 to address challenges that jurisdictions and entities are likely to face in adopting IFRSs in the next few years. The IASB agreed to add a project to its agenda to address these matters and tentatively decided to propose amendments to IFRS 1 as follows:[1]

    a. To introduce a principle that an entity need not reassess the accounting for a transaction at the date of transition to IFRSs based on facts and circumstances at that date if previous GAAP had introduced the same accounting as IFRSs based on an assessment of facts and circumstances at an earlier date. For example, suppose that an entity's previous GAAP had, from periods beginning 1 January 2007, incorporated the same requirements as IFRIC 4 *Determining Whether an Arrangement Contains a Lease*, with a transitional requirement to assess contracts existing at that date. If the

[1] As reported in March 2008 issue of *IASB Update*.

entity's date of transition to IFRSs is 1 January 2010, the entity would not need to reassess at 1 January 2010 those leases that it had already assessed under its previous GAAP.

b. To introduce a principle prohibiting retrospective estimates that could be affected significantly by hindsight.

c. To permit an entity using full cost accounting for oil and gas to measure exploration, evaluation, development and production assets on transition to IFRSs based on an allocation of the amount recognised under the entity's previous GAAP. The Board agreed with the AcSB staff's conclusion that either retrospective restatement of oil and gas assets or their measurement at fair value at the date of transition to IFRSs, as currently permitted by IFRS 1, would involve a high level of cost and effort without providing significant benefits to users.

2. In addition, the Board asked the staff to consider whether it would be impossible to apply the derecognition requirements of IAS 39 retrospectively in cases other than those set out in paragraph 1b above. However, no first time adopter would be required to apply those derecognition requirements to transactions that occurred before January 2004, the date currently specified in IFRS 1.

3. This paper:

a. Provides follow-up analysis of the issues discussed in March 2008 (see paragraphs 5-22). These comprise the following:

i. Proposal to introduce an exemption from reassessment of prior accounting when that prior accounting required assessments in the same manner as IFRSs, but at a different date (see paragraphs 5-10);

ii. Proposal to introduce a principle prohibiting retrospective fair value measurement (see paragraphs 11-14);

iii. Proposed disclosures to accompany oil and gas industry exemption (see paragraphs 15-19); and

iv. Follow-up regarding derecognition of financial assets and financial liabilities (see paragraphs 20-22).

b. Brings forward an additional proposed amendment to IFRS 1 dealing with non-IFRS-compliant amounts in property, plant and equipment, based on a submission from Canadian rate-regulated entities (see paragraphs 23-44). A copy of the industry submission is appended to this Agenda Paper for convenience.

c. Summarises decisions reached to date and requests the IASB's approval to draft an Exposure Draft based on those decisions (see paragraphs 45-46).

d. Considers the comment period for an Exposure Draft (see paragraphs 47-50).

4. The issues raised by the AcSB staff were identified from consultations with Canadian and international constituents, as well as with the AcSB's IFRS Advisory Committee and members of the AcSB. The AcSB staff recommend that the issues be dealt with in sufficient time to be useful for the changeovers to IFRSs in the next few years. Accordingly, subject to IASB approval, AcSB staff propose to draft an Exposure Draft for balloting and issue in the next few months.

## Analysis

### Follow-up from March 2008

*Proposal to Introduce an Exemption from Reassessment of Prior Accounting when that Prior Accounting Required Assessments in the Same Manner as IFRSs, but at a Different Date*

5. In March 2008, AcSB staff recommended that IFRS 1 be modified so that entities are prohibited from re-assessing, at the date of transition to IFRSs, prior accounting when that prior accounting permitted prospective application in the same manner as IFRSs; the only difference being the effective date from which that accounting was applied. AcSB staff proposed that this could be accomplished by introducing the following principle into IFRS 1:

> "This IFRS prohibits a first-time adopter from reassessing, at the date of transition to IFRSs, prior accounting when that prior accounting permitted

prospective application in the same manner as IFRSs; the only difference being the effective date from which that accounting was applied."

6. At the March 2008 meeting, the IASB tentatively decided to proceed with the proposal, but requested that AcSB staff further analyse the concerns that were discussed. The following is a summary of those concerns, together with the AcSB staff response:

   a. *Concern*: The proposal would result in a lack of comparability globally and would give an incentive for countries to adopt, for example, IAS 17, Leases, one day before the adoption of IFRSs.

      *AcSB Staff Response*: There will be a lack of comparability anyway because of the different adoption dates of IFRSs. In addition, any incentive for countries to early adopt individual standards with the same requirements as IFRSs, which, presumably, result in better accounting, should be a positive thing. AcSB Staff do not see an incentive for countries to adopt an IFRS one day before the adoption of IFRSs.

   b. *Concern*: China had similar difficulties when it drafted its own standards similar to individual IFRSs. The proposal should apply also if the standards are "in principle" the same.

      *AcSB Staff Response*: It is too difficult to determine and enforce what constitutes 'similar standards.'

   c. *Concern*: The proposal is worth considering since more countries are adopting clones of IFRSs. However, the scope of the proposal should be narrower so that it does not capture "inappropriate" items and, possibly, other circumstances that cannot be foreseen at the present time.

      *AcSB Staff Response*: The proposal could focus on IFRIC 4 and IAS 17 as they are the standards for which the issue was initially identified. However, there are almost certainly other items for which this proposal would provide significant assistance in adopting IFRSs (one that comes to mind is aspects of assessing embedded derivatives). To focus on specific items would require the IASB to identify all of those items and to address this issue at each possible IFRS 1 amendment, possibly by introducing a policy to ensure that this issue is consistently addressed. Also, this

would result in the need for the IFRS 1 material relating to IFRIC 4 to be modified. The pertinent question is maybe one of whether it is more efficient to introduce a broader exemption and, if necessary, limit that if it were to be applied to inappropriate items, or to introduce a more specific proposal, that would require consideration for broadening each time similar circumstances are identified. AcSB staff think that introducing the broader exemption is the more efficient way to proceed.

d. *Concern*: It is important that the Board not do anything on the basis of concerns in one country that would create difficulties in others.

*AcSB Staff Response*: AcSB staff has taken this into consideration and has attempted to provide proposals with broad applicability to various jurisdictions. Also, AcSB staff notes that the initial conclusions of the IASB appear to favour a proposal that 'permits,' rather than 'prohibits,' applying an exemption, thus not restricting others from choosing not to apply the exemption.

7. IFRS 1 precludes an entity from reassessing estimates made at the date of transition under previous GAAP unless there is objective evidence that these estimates were in error. IFRS 1 also prevents an entity from undoing prior hedge accounting, even if that prior accounting did not meet the conditions in IAS 39. These examples too, seem to support the principle that when previous GAAP has required the same type of assessment as in IFRSs, then the previous assessment should not be modified on first-time adoption of IFRSs.

8. AcSB staff think that there is limited benefit to requiring an entity to restate its accounting to reflect only a difference in assessment date, and likely significant cost. AcSB staff have identified two possible ways that the IASB might proceed with this proposal, to alleviate the need for an entity to reassess the accounting for a transaction based on facts and circumstances at the date of transition to IFRSs when previous GAAP had introduced the same accounting as IFRSs based on an assessment of facts and circumstances at an earlier date:[2]

[2] Note that we are, at this stage, using the wording from the March 2008 IASB Update, which we think preferable to that originally proposed in the March 2008 Agenda Paper.

a. Introduce a broad principle into IFRS 1 which addresses the issue; or

b. Create a rule-based proposal which specifically addresses issues identified, such as with IFRIC 4 and IAS 17 Leases.

9. *AcSB Staff Analysis:* Although alternative 'a' supports a principle-based approach to standard setting, there is a risk that it would capture "inappropriate" items. However, by creating a proposal that 'permits' rather than 'prohibits' applying an exemption, this can help to minimize the risk of restricting the ability of entities that do not wish to elect to use the exemption. Additionally, a more specific proposal would require some existing IFRS 1 material to be modified, such as that relating to IFRIC 4. It would also require the IASB to consider this issue at each possible IFRS 1 amendment and might require a policy to ensure that this issue is consistently considered. This creates a risk that circumstances where the exemption should be broadened could be overlooked.

10. *AcSB Staff Recommendation*: AcSB staff recommends that the following principle be added to IFRS 1:

> "This IFRS permits a first-time adopter not to reassess the accounting for a past transaction at the date of transition to IFRSs, based on facts and circumstances at that date, when previous GAAP had introduced the same accounting as IFRSs based on an assessment of facts and circumstances at an earlier date. A first-time adopter electing not to reassess its previous accounting in such circumstances, shall continue to use the assessment made in accordance with the previous GAAP."

*Proposal to Introduce a Principle Prohibiting Retrospective Fair Value Measurement*

11. In March 2008, AcSB staff recommended that a principle be added to IFRS 1 prohibiting retrospective fair value measurement unless the fair value information was determined or was available when IFRSs required the fair value to be determined. If fair values were not available, an entity would not restate those prior amounts and would continue to use, as the deemed cost of the asset or liability its carrying amount at that date under its previous GAAP. This would prevent the determination of fair values using hindsight and supports the basic principle, reflected both in IFRS 1 and in the transitional provisions of a number of other IFRSs, that "prohibits retrospective application of IFRSs in some areas,

particularly where retrospective application would require judgements by management about past conditions after the outcome of a particular transaction is already known."[3]

12. AcSB staff proposed that this could be accomplished by introducing the following principle into IFRS 1:

> "This IFRS prohibits a first-time adopter from retrospectively determining fair values prior to the date of transition to IFRSs, on initial adoption of IFRSs, if those fair values were not available at the date IFRSs required the fair value to be determined. If fair values were not available, an entity shall continue to use, as the deemed cost of the asset or liability, its carrying amount at that date under its previous GAAP."

13. In discussing this proposal in March, some IASB members suggested that the same effect as this principle might be achieved by more closely tying together the requirements of IFRS 1 with those in IAS 8 dealing with the impracticality of retrospective restatement.[4] In summary, IAS 8 states the following about impracticality of retrospective application of accounting policy changes:

    a. When it is impracticable to determine the period-specific effects of a new accounting policy or error for one or more prior periods, an entity applies the new accounting policy to the carrying amounts of assets and liabilities at the beginning of the earliest period for which retrospective application is practicable, which may be the current period, and makes a corresponding adjustment to opening equity. [IAS 8.24]

    b. When it is impracticable to determine the cumulative effect of a new accounting policy or error to all prior periods, an entity prospectively applies the new policy or error correction to the earliest date practicable. [IAS 8.25]

    c. IAS 8 defines 'Impracticable' as: "Applying a requirement is impracticable when the entity cannot apply it after making every reasonable effort to do so. For a particular

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[3] See, for example, IFRS 1, paragraph IN4.

[4] If this approach were to be pursued, it should be noted that IAS 8 addresses retrospective restatement for any prior periods, whereas in the case of IFRS 1 the comparative period is required to be presented using the same accounting policies as those used in the first IFRS reporting period. Therefore, for first-time adopters, impracticality of retrospective restatement would be applicable only for periods prior to the date of transition to IFRSs.

prior period, it is impracticable to apply a change in an accounting policy retrospectively or to make a retrospective restatement to correct an error if:

(a) the effects of the retrospective application or retrospective restatement are not determinable;

(b) the retrospective application or retrospective restatement requires assumptions about what management's intent would have been in that period; or

(c) the retrospective application or retrospective restatement requires significant estimates of amounts and it is impossible to distinguish objectively information about those estimates that:

(i) provides evidence of circumstances that existed on the date(s) as at which those amounts are to be recognised, measured or disclosed; and

(ii) would have been available when the financial statements for that prior period were authorised for issue from other information."

d. IAS 8 explicitly states that when applying a new accounting policy, hindsight should not be used to make assumptions about management's intentions in prior periods or when estimating prior period amounts. Specifically paragraph 53 of IAS 8 states: "Hindsight should not be used when applying a new accounting policy to, or correcting amounts for, a prior period, either in making assumptions about what management's intentions would have been in a prior period or estimating the amounts recognised, measured or disclosed in a prior period."

14. AcSB staff think that a broad linkage of IFRS 1 to IAS 8 would risk IFRS 1 capturing inappropriate items, since it would allow entities to make their own assessment of when restatement is impracticable. The IASB was concerned, in developing IFRS 1, that it did not think it appropriate for entities to make their own assessments as to whether particular circumstances would involve undue cost and effort. Rather, the IASB wanted to make that assessment, allowing for a more consistent evaluation. AcSB staff conclude that the risks of adding a broad exception to IFRS 1 outweigh any benefits and, thus, propose retaining the more focused proposal in paragraph 12, above, reworded slightly, as follows:

> "This IFRS prohibits a first-time adopter from retrospectively determining fair values as of dates prior to the date of transition to IFRSs when those fair values were not available when IFRSs required them to be determined. When a fair value was not available, an entity shall use in its place the carrying amount at that date under its previous GAAP."

*Oil and Gas Industry Issues*

15. In March 2008, the IASB tentatively decided on the following amendments to IFRS 1:

> "19A An entity may elect to measure oil and gas assets at the date of transition to IFRSs on the following basis:
>
> (a) exploration and evaluation assets at cost, less any impairment, determined in accordance with IFRS 6, *Exploration for and Evaluation of Mineral Resources*; and
>
> (b) other assets (i.e. those in the development or production phases) at the amount determined under the entity's previous GAAP, first adjusted by the difference between the decommissioning, restoration or similar liability as measured in accordance with IAS 37 and that recognised under the entity's previous GAAP. The adjusted amount is then allocated on a pro rata basis using reserve volumes or related values as of that date. An entity making this election does not apply paragraph 25E for these assets.
>
> The deemed cost for each oil and gas asset determined as above shall be tested for impairment at the date of transition to IFRSs. For purposes of this paragraph, oil and gas assets comprise only those used in the exploration, evaluation, development or production of oil and gas."

16. AcSB staff also indicated that it would consider the need for accompanying disclosure requirements. The following paragraphs consider that need.

17. Paragraph 44 of IFRS 1 requires specified disclosures when an entity uses fair value in its opening IFRS statement of financial position as deemed cost for an item of property, plant and equipment. This represents an adjustment to the amount that had been reported under previous GAAP and the disclosures provide information on the adjustment. An election under proposed paragraph 19A is not such an adjustment (unless there is an impairment, about which IAS 39 already requires disclosures).

18. IFRS 1 does not require disclosure that an entity has used any of the elections provided in IFRS 1, other than the fair value election referred to above. In many cases the use of an

election will be evident from the reconciliation of equity between that reported under previous GAAP and that under IFRSs, as required by paragraph 39 of IFRS 1.

19. The allocation of the cost determined under the entity's previous GAAP (i.e., using the full cost method) will not result in a reconciliation item that must be disclosed in accordance with paragraph 39 (unless an impairment loss is recognised). However, the election to use proposed paragraph 19A will normally result in the oil & gas assets as a whole being measured at a higher amount than if they were reported using the IFRSs effective at the reporting date for its first IFRS financial statements. Users should be aware that the balance sheet amounts are not the same as if the election in proposed paragraph 19A had not been taken. AcSB staff therefore proposes the following additional disclosure:

> **"~~Use of fair value as d~~Deemed cost**
>
> 44A. Paragraph 19A provides an exemption for oil and gas assets. If an entity uses that exemption, it shall disclose that fact and the basis on which carrying amounts under previous GAAP were allocated."

*Derecognition of Financial Assets and Financial Liabilities*

20. In March 2008, AcSB staff recommended that the exception in IFRS 1 regarding derecognition of financial assets and financial liabilities be revised to refer to transactions that occurred prior to "the date of transition to IFRSs." The AcSB staff proposed that this could be accomplished by the following amendment to IFRS 1:

> "27. Except as permitted by paragraph 27A, a first-time adopter shall apply the derecognition requirements in IAS 39 prospectively for transactions occurring on or after the date of transition to IFRSs~~1 January 2004~~. In other words, if a first-time adopter derecognised non-derivative financial assets or non-derivative financial liabilities under its previous GAAP as a result of a transaction that occurred before the date of transition to IFRSs~~1 January 2004~~, it shall not recognise those assets and liabilities under IFRSs (unless they qualify for recognition as a result of a later transaction or event)."

21. At the March 2008 meeting, the following concerns were discussed regarding the above proposal:

    a. A basic principle underlying IFRS 1 is that an entity should recognise all assets and liabilities at the date of transition to IFRSs, unless there is a very compelling reason

not to do so. In particular, in the current environment, the IASB was not keen to provide an exception from this principle unless absolutely necessary.

b. Removing the January 1, 2004 date allows an entity to structure transactions immediately prior to the date of transition that will survive the transition period, in order to achieve a desired accounting result. AcSB staff acknowledged this concern in the March agenda paper, but proposed that developing principle-based accounting standards was preferable to developing rules, to inhibit structuring of transactions to achieve a particular accounting result.

c. One alternative discussed by the IASB in March was to change the January 1, 2004 date to a later date to assist those jurisdictions that adopted IFRSs at a later time. However, this would mean that the same difficulty would remain for entities adopting IFRSs in future years and possibly could require additional amendments in the future.

d. Another option suggested by an IASB member in March was to make the proposal narrower by replacing the 'date of transition to IFRSs' with '2 years prior to the date of transition to IFRSs'. It was argued, however, that it would essentially give the same answer as the AcSB staff proposal since companies need to prepare a year of comparatives anyway.

e. Some IASB members argued that since it is difficult for people to make retrospective determinations about past transactions, a more focused exemption would be better. For example, the exemption would apply only if there were practical difficulties in determining the results, such as having to estimate fair value using hindsight.

f. It was noted that the 2004 date in IFRS 1 was linked not to the 2005 changeover to IFRSs in Europe and elsewhere. Rather, it was a result of the timing of issuing IAS 39 and maintaining consistency with existing IFRSs for financial statement preparers that were not required to adopt IAS 39 retrospectively.

22. AcSB staff concludes that its proposal to introduce a principle prohibiting retrospective fair value measurement, as discussed in paragraphs 11-14 above, would provide some relief—for example, if a previously derecognised item is required to be brought back on balance

sheet. If an item required to be brought back on balance sheet is required to be measured at fair value on an ongoing basis, there is no issue—ongoing fair value measurement will be required anyway. [Sentence omitted from Observer Notes.]

**Non-IFRS-compliant Amounts in Property, Plant and Equipment of First-time Adopters**

*Issue*

23. The following issue was raised by the Canadian rate-regulated industry with regard to preparing the opening IFRS statement of financial position (see Appendix to this Agenda Paper for the letter and accompanying paper from the Canadian rate-regulated industry).

24. In accordance with their national GAAPs, some entities subject to rate regulation ("rate-regulated entities") have capitalised, as part of the historical cost of property, plant and equipment (PP&E), amounts not permitted to be capitalised in accordance with IAS 16, *Property, Plant and Equipment*, and IAS 23, *Borrowing Costs*. In order to comply with IFRS 1, these entities must either retrospectively restate their PP&E to remove previously capitalised amounts not in compliance with IFRSs, or elect to use the fair value of an item of PP&E at the date of transition to IFRSs as the item's deemed cost at that date. Due to the capital intensive nature of the industry, the age of many items of PP&E, and (as explained later in this Agenda Paper) the difficulty in obtaining fair value information for these items, neither of these alternatives is practicable in all cases.

25. This issue is not necessarily exclusive to the rate-regulated industry, although the industry illustrates quite well the challenges the issue poses. [Sentences omitted from Observer Notes.]

*AcSB Staff Analysis*

*Nature and purpose of rate regulation*

26. Rate regulation is the control, by an authoritative body, of the rates (i.e., prices) charged by an entity for its services. The authority of a regulator is usually established by legislation and the regulator must operate within that legislation. While relatively few in number, rate-regulated entities tend to be large organisations providing essential public services.

They are often "natural" monopolies, due to the large capital investments necessary to supply the services, and the economies of scale achieved by a single supplier. Governments often impose rate regulation as a means of compensating for a lack of effective competition and protecting the entity's customers. At the same time, rates are designed with the financial well-being of the entity and its investors in mind. Regardless of the regulatory methodology employed (e.g., return on rate base or incentive/performance-based methodologies), the intent is to allow rate-regulated entities the opportunity to recover their costs and earn a fair return on investment.

*Effect of rate regulation on GAAP financial statements*

27. The goals and objectives of rate regulators are driven by regulatory principles that are different from generally accepted accounting principles. Therefore, the treatment specified by a rate regulator for a transaction or event for rate setting can differ from its treatment for financial reporting purposes. In order to reflect the economic effects of rate regulation, some national GAAPs (e.g., Canadian and US GAAP) require or permit rate-regulated entities to account for a particular transaction or event differently from how they would account for it in the absence of rate regulation. This sometimes results in entities recognising assets and liabilities that they would not recognise in the absence of rate regulation, or not recognising assets and liabilities that they would otherwise recognise. In the case of assets recognised solely as a result of the effects of rate regulation, these are sometimes recognised as stand-alone items on the entity's statement of financial position. Other times, they make up part of a larger asset. As explained beginning in paragraph 29, the latter situation presents a challenge for rate-regulated entities adopting IFRSs for the first time.

28. The adoption of IFRSs by Canadian rate-regulated entities raises a larger issue concerning the ability of these entities to continue the accounting described in the preceding paragraph once they are reporting in accordance with IFRSs. This Agenda Paper does not deal with this issue. However, AcSB staff understands that the IASB's International Financial Reporting Interpretations Committee will soon consider whether it should add an issue to its agenda to address the application of IFRSs to rate-regulated operations. The transitional

issue this Agenda Paper focuses on is independent of this larger issue and, because it involves the application of IFRS 1, requires immediate resolution.

*The transitional issue — PP&E in the opening IFRS statement of financial position*

29. The transitional issue faced by rate-regulated entities concerns PP&E and arises because some of the amounts that have been capitalised in accordance with an entity's national GAAP and are not IFRS-compliant have been embedded as part of the total cost of an item of PP&E, rather than being recognised as a separate asset.

30. For rate-setting purposes, it is the practice of many rate regulators to allow the inclusion of an "allowance for funds used during construction" (AFUDC) in the cost of PP&E acquired, constructed, or produced over time. AFUDC includes the actual cost of debt incurred during the period of acquisition, construction, or production, as well as an imputed cost of equity. In accordance with their national GAAPs, many rate-regulated entities include AFUDC as part of the cost of the relevant item of PP&E when preparing their GAAP financial statements.

31. Rate regulators sometimes also allow the inclusion in PP&E of costs related, but not directly attributable, to bringing an asset to the location and condition necessary for it to be capable of operating in the manner intended by management (an example is indirect overheads). Again, it is the practice of some rate-regulated entities to include non-directly attributable costs as part of the cost of the relevant item of PP&E when preparing their GAAP financial statements.

32. The inclusion, in PP&E for GAAP purposes, of an equity component of AFUDC and of non-directly attributable costs is not in accordance with IAS 23 and IAS 16.[5] An imputed cost of equity is not a historical cost. Rather, it is an economic cost. IAS 23 does not deal with the actual or imputed cost of equity. In the case of indirectly attributable costs, these

[5] PP&E of a rate-regulated entity may comply with the entity's national GAAP, but not IFRSs, in other ways besides the ones discussed in this Agenda Paper. The two instances of non-compliance with IFRSs included in this Agenda Paper were identified by the Canadian rate-regulated industry as being the most pervasive and troublesome for first-time adopters. As is evident from the discussion below, the nature of this transitional issue is such that the need for the relief sought is unaffected by the number of instances of non-compliance with IFRSs, i.e., this need would exist even with only one such instance.

are not an element of cost as specified in IAS 16. Instead, they are historical costs required to be expensed as incurred in accordance with IFRSs.

33. In order to comply with IFRS 1 as it exists today, many rate-regulated entities[6] would be required either to:

    (a) retrospectively restate PP&E to remove any amounts previously capitalised in respect of an equity component of AFUDC and non-directly attributable costs; or

    (b) elect to use the "fair value as deemed cost" exemption.

    Each of these options is discussed below.

*Restatement*

34. Once AFUDC (including an imputed return on equity) and non-directly attributable costs have been included in the total cost of PP&E, they are no longer tracked separately. Restating an entity's PP&E to remove the two items in question and arrive at new carrying amounts would require information that, in all likelihood, given the age of some assets, is no longer available and could not be reasonably estimated without undue cost and effort. In many cases, rate-regulated entities have asset accounts going back several decades. Even if the required information was available or capable of being reasonably estimated, restatement would prove extremely difficult, costly and time-consuming. The entity would be required to re-compute depreciation, interest and overhead capitalisation rates, and gains or losses on disposition or retirement, and re-test the revised carrying amounts for impairment. Although entities not subject to rate regulation would also be required to adjust PP&E for any inconsistencies with IAS 16, the task would be especially onerous for rate-regulated entities because they are so capital intensive.

35. AcSB staff is of the view that, while the items in question clearly do not qualify for capitalisation in accordance with IFRSs and should not be included in the cost of an item of PP&E on a go-forward basis, the costs and efforts of removing amounts capitalised up to

[6] AcSB staff understands that, for the most part, rate-regulated entities in Europe did not face this transitional issue. (For example, in the electricity industry, many of the utilities were already IFRS-compliant and were able to carry forward their previous PP&E carrying values for IFRS purposes. On the other hand, the water industry was not fully IFRS-compliant in respect of PP&E. There, however, the issue was that the industry had not followed "component accounting.")

the date of transition to IFRSs would significantly exceed the benefit to stakeholders. Hence, it does not view restatement as a feasible option.

*Fair value as deemed cost*

36. In accordance with IFRS 1, an entity may elect to measure an item of PP&E at the date of transition to IFRSs at its fair value and use that fair value as its deemed cost at that date. A rate-regulated entity could choose this election and use it only in respect of items of PP&E containing amounts previously capitalised in respect of AFUDC and non-directly attributable costs.

37. However, the nature of these items of PP&E is such that they are often unique and of use only within the industry. Thus, fair value information is not readily available. Entities that are adopting IFRSs for the first time in the near future, and that use the fair value as deemed cost election, will have little time to value all items of PP&E that were acquired, constructed or produced over time, in order to prepare their opening IFRS statement of financial position. The valuation exercise would be very time-consuming for most entities, given the capital-intensive nature of the industry and, thus, the large number of in-service assets, standby equipment, operating reserves, facilities, construction-in-progress and variety of other assets requiring valuation. A further complication is the fact that many of these assets were self-constructed, making the establishment of fair value at a point in time extremely difficult. Finally, 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 verification issues. For these reasons, electing to use the fair value as deemed cost option of IFRS 1 may not be practicable for all rate-regulated entities.

*Recommendation*

38. The transitional issue described above may be one that first-time adopters not subject to rate regulation also face. Like Canadian rate-regulated entities, other first-time adopters may have previously capitalised amounts in accordance with their national GAAP over and above what would be capitalised in accordance with IAS 16 (the number and nature of any such instances will, most probably, differ from the rate-regulated examples described above), and find both restatement and the fair value as deemed cost election impracticable.

39. A possible solution to this transitional issue, and the one recommended by AcSB staff, is to amend IFRS 1 to include an additional exemption permitting all first-time adopters facing the issue to elect to use the IFRS transition date carrying amount of an item of PP&E containing previously capitalised amounts not compliant with IFRSs as the item's deemed cost at that date. Entities so electing would be required to undertake impairment testing at the transition date in order to ensure that their opening IFRS statement of financial position did not overstate PP&E.

40. AcSB staff considers this a reasonable solution for the following reasons:

    (a) The IASB has already recognised the challenges inherent in restating PP&E for purposes of the transition date opening IFRS statement of financial position, and has provided some relief through the fair value or revaluation as deemed cost exemption. More recently, it has provided additional relief in the form of the borrowing costs exemption, which allows first-time adopters to apply the transitional provisions set out in paragraphs 27 and 28 of IAS 23, as revised in 2007 (these provisions require prospective application of IAS 23 when its application constitutes a change in accounting policy, but allow an entity to designate an earlier effective date if it so chooses). The exemption proposed in paragraph 39 would provide the additional relief required by entities when the existing exemptions don't apply or are impracticable. Like the fair value or revaluation as deemed cost and the borrowing costs exemptions, it would meet the overall objectives of IFRS 1 by avoiding excessive costs and still providing a reasonable starting point for accounting for PP&E in accordance with IFRSs.

    (b) In accounting for their PP&E, first-time adopters facing this issue have been following essentially the historical cost model in IAS 16, but have included non-qualifying amounts that are, most probably, insignificant in relation to their total capital assets. The PP&E balances of these entities are, in all likelihood, closer to what would result from a strict application of IAS 16 than the results produced by applying the exemptions already provided in IFRS 1.

41. The proposed exemption might be worded as follows:

> "An entity with items of property, plant and equipment containing amounts previously capitalised in accordance with previous GAAP but not permitted to be capitalised in accordance with IFRSs may, as a matter of accounting policy, elect to use the carrying amount of each such item at the date of transition to IFRSs as its deemed cost at that date, when it is otherwise impracticable for the entity to comply with this standard. For this purpose, "impracticable" is as defined in IAS 8. The deemed cost for each item for which this election is used shall be tested for impairment at the date of transition to IFRSs."

42. Alternatively, the IASB could decide to restrict the use of the recommended election to rate-regulated entities. Paragraph BC44 of the Basis for Conclusions to IFRS 1 states that the use of fair value as deemed cost has been restricted to assets such as PP&E, for which reconstructing costs is likely to be of limited benefit to users and particularly onerous. AcSB staff notes that this rationale is particularly relevant to rate-regulated entities. Investors look to a rate-regulated entity's prospective cash flows more than anything else when valuing the entity. These cash flows are determined by the entity's approved rates for the future, which, in turn, are designed to recover the historical cost of PP&E plus a reasonable return. For this reason, AcSB staff notes that the likelihood of impairment at the transition date is lower for rate-regulated entities than for others.

43. A new exemption intended to apply only to rate-regulated entities might read as follows (note that the condition regarding impracticability is not required in this case because, as demonstrated above, it is met in the case of rate-regulated entities):

> "A rate-regulated entity with items of property, plant and equipment containing amounts previously capitalised in accordance with previous GAAP but not permitted to be capitalised in accordance with IFRSs may, as a matter of accounting policy, elect to use the carrying amount of each such item at the date of transition to IFRSs as its deemed cost at that date. For this purpose, an entity subject to rate regulation is an entity that provides regulated services or products to customers at prices established by a regulator or other authorised body that are designed to recover the cost of providing the services or products (and earn a fair return on investment). When an entity chooses to use this election, the deemed cost for each such item of property, plant and equipment shall be tested for impairment at the date of transition to IFRSs."

44. [Paragraph omitted from Observer Notes.]

**Summary of staff recommendations**

45. The following summarises the proposed amendments to IFRS 1:

*Proposal to Introduce an Exemption from Reassessment of Prior Accounting when that Prior Accounting Required Assessments in the Same Manner as IFRSs, but at a Different Date*

> "This IFRS permits a first-time adopter not to reassess the accounting for a past transaction at the date of transition to IFRSs, based on facts and circumstances at that date, when previous GAAP had introduced the same accounting as IFRSs based on an assessment of facts and circumstances at an earlier date. A first-time adopter electing not to reassess its previous accounting in such circumstances shall continue to use the assessment made in accordance with the previous GAAP."

*Proposal to Introduce a Principle Prohibiting Retrospective Fair Value Measurement*

> "This IFRS prohibits a first-time adopter from retrospectively determining fair values as of dates prior to the date of transition to IFRSs when those fair values were not available when IFRSs required them to be determined. When a fair value was not available, an entity shall use in its place the carrying amount at that date under its previous GAAP."

*Oil and gas industry issues*

> "19A An entity may elect to measure oil and gas assets at the date of transition to IFRSs on the following basis:
>
> (a) exploration and evaluation assets at cost, less any impairment, determined in accordance with IFRS 6, *Exploration for and Evaluation of Mineral Resources*; and
>
> (b) other assets (i.e. those in the development or production phases) at the amount determined under the entity's previous GAAP, first adjusted by the difference between the decommissioning, restoration or similar liability as measured in accordance with IAS 37 and that recognised under the entity's previous GAAP. The adjusted amount is then allocated on a pro rata basis using reserve volumes or related values as of that date. An entity making this election does not apply paragraph 25E for these assets.[7]
>
> The deemed cost for each oil and gas asset determined as above shall be tested for impairment at the date of transition to IFRSs. For purposes of this paragraph,

[7] AcSB Staff comment: IFRS 1.25E provides relief from the requirement in IFRIC-1 to add or deduct specified changes in a decommissioning, restoration or similar liability to or from the cost of the asset to which it relates; the adjusted depreciable amount of the asset is then depreciated prospectively over its remaining useful life.

oil and gas assets comprise only those used in the exploration, evaluation, development or production of oil and gas."

**~~Use of fair value as d~~Deemed cost**

44A. Paragraph 19A provides an exemption for oil and gas assets. If an entity uses that exemption, it shall disclose that fact and the basis on which carrying amounts under previous GAAP were allocated.

*Non-IFRS-compliant Amounts in Property, Plant and Equipment of First-time Adopters*

Relief available to any qualifying first-time adopter:

"An entity with items of property, plant and equipment containing amounts previously capitalised in accordance with previous GAAP but not permitted to be capitalised in accordance with IFRSs may, as a matter of accounting policy, elect to use the carrying amount of each such item at the date of transition to IFRSs as its deemed cost at that date, when it is otherwise impracticable for the entity to comply with this standard. For this purpose, "impracticable" is as defined in IAS 8. The deemed cost for each item for which this election is used shall be tested for impairment at the date of transition to IFRSs."

Alternatively, relief restricted to rate-regulated entities:

"A rate-regulated entity with items of property, plant and equipment containing amounts previously capitalised in accordance with previous GAAP but not permitted to be capitalised in accordance with IFRSs may, as a matter of accounting policy, elect to use the carrying amount of each such item at the date of transition to IFRSs as its deemed cost at that date. For this purpose, an entity subject to rate regulation is an entity that provides regulated services or products to customers at prices established by a regulator or other authorised body that are designed to recover the cost of providing the services or products (and earn a fair return on investment). When an entity chooses to use this election, the deemed cost for each such item of property, plant and equipment shall be tested for impairment at the date of transition to IFRSs."

Question to the Board:

46. Do you agree with each of the above recommendations, subject to drafting?

**Comment Period for Exposure Draft**

47. Paragraph 97 of the IASB Due Process Handbook (April 2006) says:

> "The IASB normally allows a period of 120 days for comment on its consultation documents. For exposure drafts, if the matter is exceptionally urgent, the document is short, and the IASB believes that there is likely to be a broad consensus on the topic, the IASB may consider a comment period of no less than 30 days. For major projects, the IASB will normally allow a period of more than 120 days for comments. …"

48. As noted earlier in this Agenda Paper (see paragraph 4), AcSB staff think it important that the issues be dealt with in sufficient time to be useful for the changeovers to IFRSs in the next few years. AcSB staff anticipate that, if the IASB were to approve the above recommendations at the May meeting, an Exposure Draft would not be ready for publication until, say, August 2008.

49. The AcSB staff propose that the Exposure Draft comment period be 90 days. AcSB staff do not expect the document to be long or complex and it is likely to be issued at a time of year when most respondents are not unduly busy. Furthermore, a 90 day comment period would permit analysis of comments and finalisation of amendments to IFRS 1 as early as possible in 2009, to permit entities adopting IFRS in 2009, and those planning for adoption in subsequent years, to be aware of the final amendments as early as possible.

Question to the Board:

50. Do you agree that the Exposure Draft should have a 90-day comment period?