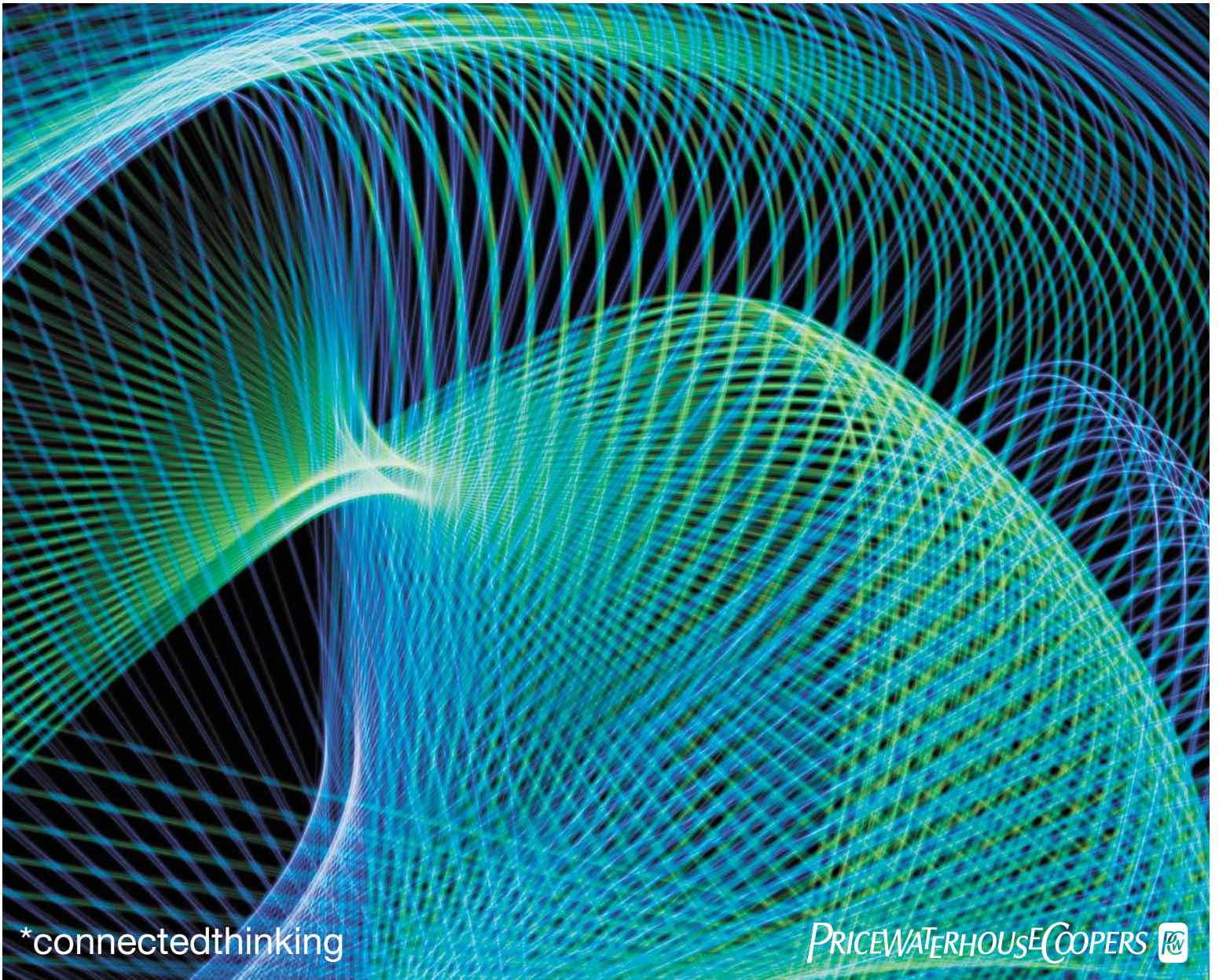


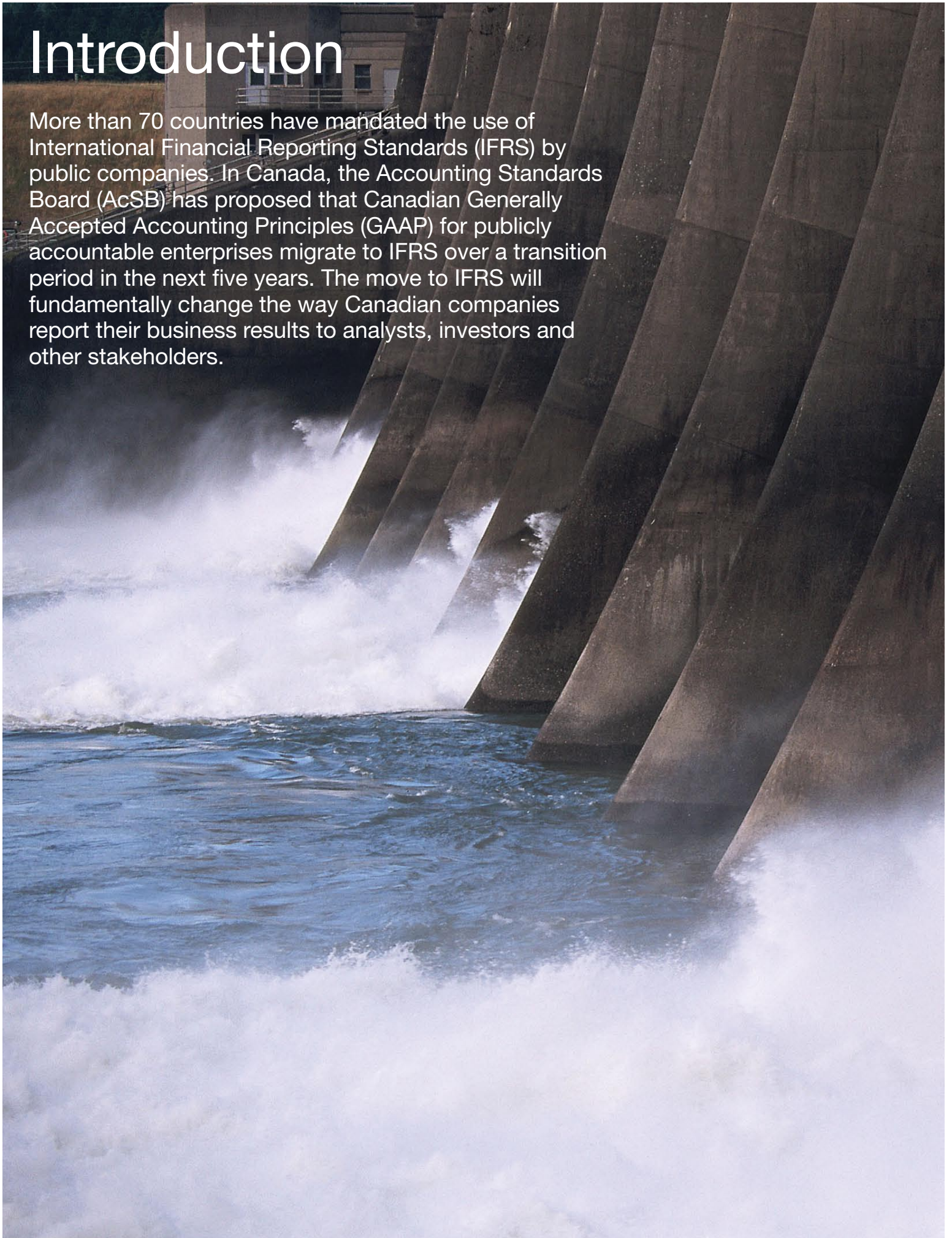
Putting IFRS in motion*

The potential impact of International Financial Reporting Standards (IFRS) on the Canadian utilities sector



Introduction

More than 70 countries have mandated the use of International Financial Reporting Standards (IFRS) by public companies. In Canada, the Accounting Standards Board (AcSB) has proposed that Canadian Generally Accepted Accounting Principles (GAAP) for publicly accountable enterprises migrate to IFRS over a transition period in the next five years. The move to IFRS will fundamentally change the way Canadian companies report their business results to analysts, investors and other stakeholders.



For many organizations, implementing IFRS may be quite a simple exercise, but for others it may be a highly complex process that goes well beyond the finance and accounting functions. Other business areas such as human resources, investor relations, business development and Information Technology (IT) departments will likely be involved in the IFRS conversion plan.

Our experience in assisting numerous global companies that have already adopted IFRS shows that, for some, full conversion and adoption can take anywhere from two to five years, depending on the complexity of the organization.

Certain industries have a long and complex conversion process because significant accounting policy changes are required. It is often extremely difficult to extract the historical information necessary to make these changes and the accounting processes and systems have to be modified on a go forward basis.

One of the most significant challenges in converting from Canadian GAAP to IFRS is determining which GAAP differences will impact the organization. The AcSB intends to work towards eliminating existing differences between Canadian GAAP and IFRS over the transition period by adopting new standards that will continue to emerge as a result of global accounting standard setters' desire to harmonize frameworks. Organizations will need to be responsive to take these changes into account in their project plans.

This publication outlines some of the significant accounting differences that arise between Canadian GAAP and IFRS in the utilities sector.

Companies that have already implemented IFRS understand that the new standards may place a sizeable responsibility on management to be able to communicate effectively to the market in the new IFRS language.

Accounting under IFRS



The utilities sector (i.e., electricity, power generation, oil and gas distribution, pipelines and water utilities) is characterized by the need for big upfront investment, often with great uncertainty about outcomes over a long-term time horizon. The sector's geopolitical, environmental, energy and natural resource supply and trading challenges, combined with complex stakeholder and business relationships, has meant that the transition to IFRS has required some complex judgments about how to implement the new standards. One of the challenges of working with 'principles based' standards is that without a 'rulebook', management needs to spend more time explaining the judgments they have made to apply the principles.

Some of the more challenging issues with financial reporting impact include:

- Capital-intensive projects with long lead times;
- High-risk capital projects from which probable future economic benefits cannot be determined (i.e., in circumstances where rate-regulated accounting is not applicable);
- Price or rate-regulation and rate-recoverable costs; and
- Significant environmental obligations, such as decommissioning requirements and emission limiting schemes.

The variety and complexity of contracts in the industry present some key IFRS reporting issues for utilities. The following sections highlight the various considerations companies need to take into account.

The future of rate-regulated accounting under IFRS

The nature of the agreements that utility entities reach with regulators vary from country to country as they vary from province to province.

The Canadian utilities sector is characterized by regulation from federal and provincial governments and various federal and provincial regulatory bodies established by those governments. Organizations need a thorough understanding of the terms of the agreements in order to determine the appropriate accounting for these agreements.

Rate regulation can lead to the requirement from a regulator for a network utility entity to either reduce its rates or recover them in a future period. Just as an increase in prices will generally not result in the recognition of an asset, so a decrease in prices generally will not lead to the recognition of a liability. Currently, Canadian GAAP has permitted utilities to account for the impact of rate regulation through the recognition of regulatory assets and liabilities, which is the deferral of costs (revenue) to a future period to match with the higher (lower) rates recovered in that period, usually as a result of a decision approved by the regulator. There are no corresponding IFRS pertaining to rate-regulated accounting and the International Financial Reporting Interpretations Committee (IFRIC) has indicated that it does not have plans to add a project on accounting for rate regulation to its agenda. Hence, the general rules (in particular IAS 1, IAS 16, and IAS 38) shall be applied whereby only such items are recognized on the balance sheet that meet the recognition criteria set forth in these rules.

Further, rate-regulated accounting may permit recording tax items or employee future benefits on a cash rather than accrual basis which would not be permitted under the relevant IFRS guidance (IAS 12, IAS 19).

In March 2007, the AcSB released an Exposure Draft, Rate-Regulated Operations, proposing revisions to existing Canadian GAAP guidance on rate-regulated operations. In its absence, it is expected that Canadian utilities will consider the adoption of the relevant US GAAP standard, SFAS 71, Accounting for the Effects of Certain Types of Regulation. The IFRIC has commented that US GAAP recognition criteria pertaining to rate-regulated accounting are not consistent with IFRS. For many Canadian companies this may have a significant impact on the way they report their results.

[Rate-regulated accounting \(RRA\) as applied under Canadian GAAP, in the past, does not have corresponding guidance under IFRS. This raises the question of how regulators might view IFRS financial statements that do not apply RRA. For example, will they be sufficient for the regulators needs or will regulators require additional information to be provided? We suggest that companies should begin to consider dialoguing with regulators to determine their information needs.](#)

Emission rights and credits

The pace of regulatory action to curb emissions is intensifying around the world. Utility companies need to demonstrate that they have clear plans in place to exploit the shareholder value opportunities of the emissions trading schemes, as well as showing that they are able to manage the compliance aspects.

Emission rights (i.e. allowances) are issued by government agencies and emission credits are certified by government and/or regulatory agencies. An Emission Trading Scheme (ETS) is already operating in the European Union and similar schemes have been or are being implemented in other parts of the world. These schemes are designed to achieve emission reductions in a cost-effective manner by providing the operators with the flexibility to choose whether to make emissions reductions themselves or to buy surplus allowances from other operators. Views on the impact of these ETSs vary widely, due to uncertainties about the allocation rules and the future trends of prices for both carbon and electricity.

Accounting standards have not yet been established, though attempts have been made in the past by the IASB and FASB. IFRIC 3 Emission Rights was finalized in December 2004, which permitted either one of two approaches to be adopted to account for emission rights under the cost model or the revaluation model in IAS 38 Intangible Assets. However, the EU refused to adopt IFRIC 3 into its legal framework and with considerable pressure from the business community, the International Accounting Standards Board decided to withdraw IFRIC 3 in June 2005. In the US, the Emerging Issues Task

Force (EITF) addressed the accounting issues in EITF Issue 03-14 to provide a comprehensive model for participants in cap-and-trade emissions reduction program providing guidance on various accounting issues, like the asset and liability recognition, measurement, presentation and disclosures of emission rights and credits. However, it was never finalized, and ultimately removed from the EITF's agenda.

There is limited guidance currently in Canadian GAAP. The impact of the various acceptable accounting treatments for emission rights and credits may be different depending on the treatment adopted, which could ultimately have significant impact on the financial performance of the company. IFRIC 3 provides a source of guidance for the utilities that are subject to an ETS. While the guidance in IFRIC 3 remains valid, entities are free to apply variations provided that the requirements of all relevant IFRS standards are met and consistently applied, until new accounting standards are issued.

Components approach

Large network or infrastructure assets comprise a significant number of components, many of which will have differing useful lives. Under IFRS, the cost of the significant components of these types of assets must be separately identified and depreciated to their residual values over their useful lives [IAS16.43-44]. Where property, plant and equipment is recognized for the first time, each material component of the greater asset must be recorded and measured separately. Identifying the significant components can be a complex process for very large, advanced plants. Some components can be identified by considering the routine shutdown or overhaul schedules for power stations and the replacement and maintenance routines associated with these. Utility companies should also consider whether those components are prone to technological obsolescence, corrosion or wear and tear, more severe than that of the other portions of the larger asset.

Although the Canadian rules are similar, the application of the IFRS model may require greater rigour than traditionally followed under Canadian GAAP, and the manner in which component depreciation is applied.

Impairment: Cash Generating Unit (CGU), Indicators

Impairments are recognized if the carrying amount of a CGU exceeds its recoverable amount. Recoverable amount is the higher of fair value less cost to sell (FVLCTS) and value in use (VIU) [IAS36.6]. The VIU calculation should reflect management's best estimate of the future cash flows expected to be generated from the assets concerned.

Impairment testing under IFRS may lead to more frequent recognition of impairments than under Canadian GAAP, as well as to a difference in the amount of the impairment loss. Canadian GAAP uses a two-step approach to test impairment. The first step is to compare undiscounted cash flows to book values of the assets. Use of undiscounted cash flows in the first step of the impairment test under Canadian GAAP may therefore delay the need for a write-down, compared to IFRS, which uses discounted cash flows to assess whether an impairment exists. Under Canadian GAAP, if undiscounted cash flows are less than book values, the second step is to write down the asset to its fair value.

Differences in IFRS may also arise in the amount of the write-down as IFRS requires an impaired asset to be written down to the higher of its fair value less selling costs or its value in use. Another distinction is that IFRS requires companies to reverse previous impairment write-downs if the conditions that caused that impairment no longer exist.

Processes will need to be established to identify and track impairment indicators on a more frequent basis, as well as track the original depreciated balances in the event of an impairment reversal.

The elimination of proportionate consolidation

The utilities sector is capital intensive. There is a long period of time between application to build an asset for generation and/or distribution, and positive cash flow. The demand for capital and long lead time often gives rise to a practice in the industry of sharing the burden and risk of construction and start-up with other industry players or governments.

The current definition of a joint venture in IAS 31 under IFRS does not adequately address the difference between an interest in a joint venture entity and a venturer's interest in individual assets and liabilities of a joint arrangement. The IASB has undertaken a research project on joint venture accounting and are expected to issue an exposure draft in the third quarter of 2007. We understand the IASB has provisionally decided to remove the option of proportionate consolidation for accounting for joint venture entities and to consider the definition of a joint venture and its main characteristics. This may result in Canadian companies being required to change to equity accounting under IFRS depending upon the characteristics of the joint venture agreement or the joint control arrangements.

Decommissioning

Power generation and other utilities create environmental change in the ordinary course of business and may be required to perform some kind of decommissioning or environmental restoration work at the end of the useful life of a plant or other installation. Based on the regulations in effect, there may also be environmental obligations arising from contamination of land, sometimes even if it owns this land. Decommissioning provisions are updated at each balance sheet date for changes in the estimates of the future cash flows and changes in the discount rate [IAS37.59].

The effect of the time to expected decommissioning will be reflected in the discounting of the provision under both IFRS and Canadian GAAP. However, under IFRS, the obligation must be discounted at each balance sheet date using the current market-based discount rate whereas under Canadian GAAP, downward revisions in the amount of cash flows would be discounted using the rate applied on initial recognition. Although such interest rate driven changes in the discounted liability do not affect earnings in the period of change (the difference is added to, or deducted from, the cost of the related assets), there could be an impact on balance sheet related ratios and key figures such as debt/equity ratios or capital employed.

[IAS 37 provides guidance on how to account for existing decommissioning, restoration and similar liabilities. These types of liability arise for utilities \(particularly for nuclear facilities\).](#)

Financial instruments and hedge accounting

Although many aspects of IFRS on financial instruments and hedge accounting are similar to the equivalent Canadian standards, some differences remain. For example, while Canadian standards allow transaction costs related to financial assets and liabilities (other than those classified as held for trading) to be either expensed as incurred or, if certain criteria are met, added to the carrying value of the financial asset or liability as a matter of accounting policy, IFRS do not allow this choice. Instead, under IFRS, these transaction costs must be added to the carrying value of the financial asset or liability.

As International and Canadian standard setters consider improvements to standards on financial instruments and hedge accounting, it is expected that any improvements would likely converge.



Conversion is not just a technical accounting exercise

IFRS will present unique challenges for senior management, human resources, treasury and taxation functions, IT and many other areas across the organization beyond the finance and accounting function. IFRS may impact existing management reporting including budgets, forecasts, performance measures, bonus structures, key performance indicators and debt covenants. Furthermore, new procedures should be considered to ensure IFRS implications are addressed as part of the approval process for all new strategic investments.

This publication does not provide a complete list of GAAP differences that Canadian utility companies need to consider upon transition to IFRS. Each individual company will have unique circumstances that require sound judgment and expert advice. Advanced planning and an in-depth diagnostic of how IFRS will effect your company's financial reporting will reduce the risk associated with compliance and lower the overall cost of transition.

| IFRS across the organization | | |
|--|--|--|
| <p>Implementation Resources</p> <ul style="list-style-type: none"> • Need for resource over 12 - 18 months • Competing projects • Not just a finance issue <p>Training and Education</p> <ul style="list-style-type: none"> • All finance staff will need some training • Broader awareness of the issues • Other business professionals within organization • Executives need to be able to understand and explain the “new” numbers | <p>Acquisitions</p> <ul style="list-style-type: none"> • Need for IFRS figures for due diligence • Models required for annual goodwill impairment tests <p>Financing/Refinancing</p> <ul style="list-style-type: none"> • Impact of IFRS on earnings or asset-based debt covenants <p>Remuneration</p> <ul style="list-style-type: none"> • Impact of earnings volatility on profit-based bonus plans | <p>Systems and Processes</p> <ul style="list-style-type: none"> • Need for different/new data • New systems <p>SOX/ICOFR Certification</p> <ul style="list-style-type: none"> • Process/control documentation updates <p>Investor Relations</p> <ul style="list-style-type: none"> • Preparing analysis for the impact of IFRS <p>Management Reporting</p> <ul style="list-style-type: none"> • Budgets, forecasts, management accounts and KPIs (Key Performance Indicators) need to be on an IFRS basis |

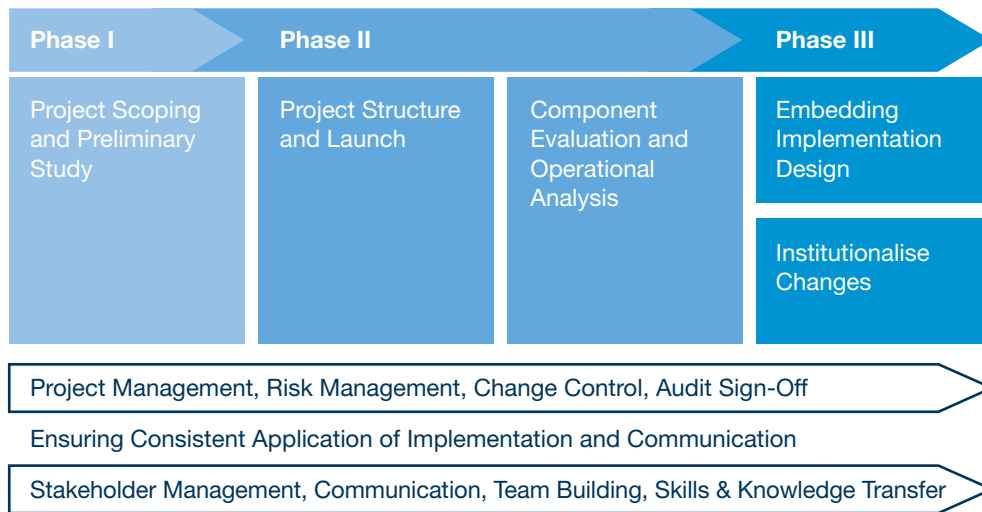
How we can help

The most viable approach to IFRS conversion will vary from one organization to another.

Our experience has shown that a critical success factor for IFRS conversion is a well-planned implementation which is started several years in advance of the required convergence date.



Phases of IFRS Implementation



PwC has unparalleled global experience helping many of the world's largest public companies adopt IFRS and has assisted with IFRS conversion projects for a wide range of public companies across all industries. PwC provides:

- Initial diagnostic of Canadian/IFRS accounting differences;
- Advice on selection of appropriate accounting policies;
- Development of an IFRS implementation plan;
- Communication strategies and change management;
- IT and process improvements;
- Competitor benchmarking;
- M&A target accounting conversion assistance;
- Valuation advice under IFRS fair value and impairment models; and
- Tax planning considerations on conversion to IFRS.

Our multi-disciplinary approach, diversified experience, and effective and efficient implementation methodology can help you plan ahead and manage the size and complexity of your conversion.

Global Capital Markets Group

Our Global Capital Markets Group (GCMG) leads GAAP conversions for a wide range of organizations—from large complex financial services institutions requiring detailed analysis to desktop reviews for local reporting requirements. Since its formation, the Group has dominated the financial services conversion markets for both IFRS and US GAAP.

Our GCMG in Canada, led by Geoff Leverton, is part of a Global team of IFRS conversion experts comprising over 80 partners and staff specializing in multi-GAAP environments and the related conversion implications. This team has worked almost exclusively on IFRS conversions over the last three years and has played a leading role in developing the firm's conversion methodology. The team is also able to draw on the firm's wider technical and industry resources.

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Other IFRS resources

PricewaterhouseCoopers has published the following publications on International Financial Reporting Standards and corporate practices. They are available from your local PricewaterhouseCoopers office and can be found at www.pwc.com/ifrs.

- Real Time – Delivering International Reporting Standards in the Oil & Gas & Utilities Industries
- IFRS Pocket Guide
- Financial instruments under IFRS
- IAS 39 – Achieving hedge accounting in practice
- IFRS Disclosure Checklist 2006
- IFRS Measurement Checklist 2006
- IFRS News – Shedding light on the IASB’s activities
- Applying IFRS – PwC’s authoritative guidance on the interpretation and application of IFRS. The interactive tool includes links to over 1,000 real-life solutions, as well as direct links to applicable text in the IFRS standards and interpretations.

www.pwc.com/ca/ifrs



