



Power & Utilities IFRS Webcast Series presents:

IAS 16 – Property, Plant, and Equipment

Presenters: Charlie Muha and Rhonda Watts
Moderator: Bill Graf

December 12, 2008

Audit • Tax • Consulting • Financial Advisory •

About the presenters



Charlie Muha, Deloitte & Touche LLP

Charlie Muha is a partner in Deloitte & Touche LLP and the AERS leader for Deloitte's Energy & Resources Group. He has more than 30 years of professional experience in the U.S. and overseas, including 17 years as Lead Client Service Partner for Deloitte's most significant energy clients. Formerly a member of the national public utilities group in Washington, D.C., Charlie has served as a member of the AICPA Public Utilities Committee and is a contributing author to *Accounting for Public Utilities*.



Rhonda Watts, Deloitte & Touche LLP

Rhonda is a senior manager in Deloitte's Regulatory & Capital Markets Consulting, Energy & Resources Group. Rhonda has experience in fixed asset accounting, recovery and regulatory issues related to utility companies.

Rhonda has spent the past 12 years focused on assisting clients in conducting depreciation studies, consulting on capital asset recovery and accounting issues related to property, plant and equipment in the utility industry. She is currently working with a client on "componentization" of certain assets related to power generation.

Agenda

PP&E componentization and depreciation

Revaluation vs. cost

Borrowing costs

Dismantlement, removal and restoration costs

Impairment

Leases

Transition

Closing

Questions and answers

IAS16 property, plant and equipment (PP&E)

- IFRS requires that components of PP&E be determined
- Depreciation is calculated separately for each significant part of an item of PP&E
 - IAS 16 does not prescribe what constitutes an item of PP&E but under the cost model each part of an item of PP&E with a cost that is significant to the total cost of the item must be depreciated separately
 - Significant individual components are to be depreciated over their respective useful lives
 - Significant parts that have the same useful life and depreciation method, may be grouped in determining depreciation
 - Separate depreciation of the remainder of the item (parts of the item that are not individually significant)
 - Major maintenance meets asset recognition requirements under IFRS and needs to be identified as separate component (a major maintenance component must be estimated out of the initial acquisition cost)

PP&E – componentization of assets

- Regulated utilities already identify retirement units which are similar to components
- Regulated utilities generally follow composite depreciation which is based on an average of the depreciable lives of each retirement unit included in the composite asset
- Under composite depreciation, gain or loss is generally not recognized upon retirement of the unit of property; any implied gain or loss is deferred in accumulated depreciation and included in the depreciation of the replacement retirement unit
- Under IFRS the retired component is derecognized and gain or loss from derecognition is recognized in profit or loss
- Under IFRS derecognition gains are not classified as revenue

PP&E – componentization of assets (*continued*)

- Review of residual value and useful life to be performed annually
 - Revision treated as change in accounting estimate (prospective – IAS 8). This is consistent with U.S. GAAP

- What can you do now to prepare?
 - Depreciation study provides an opportunity to evaluate current property assets and consider the componentization approach as interim step to IFRS adoption
 - Individual sub-accounts reflective of components could be developed and implemented now
 - Useful life determinations for sub-accounts/components
 - Associated accumulated depreciation can be allocated through theoretical reserve calculations

PP&E – componentization of assets *(continued)*

- Evaluate useful life estimates with operations personnel giving consideration to factors that impact useful life determination:
 - Actual operating and maintenance data compared to manufacturer data
 - Component failure rates
 - Obsolescence factors
 - Changes in materials
 - Historical retirement experience

PP&E – measurement after recognition

- Depreciation method
 - Reflects the pattern in which the asset's future economic benefits are expected to be consumed
 - Straight-line method
 - Diminishing balance method
 - Sum-of-the-units
 - Reviewed at least at each closing (if revision, treated as change in accounting estimate)

PP&E – measurement after recognition *(continued)*

- Depreciation

- Depreciation begins when the asset is available for use (i.e., capable of operating in the manner intended by management)
 - Includes costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition
- Depreciation does not cease when the asset becomes idle or is retired from active use and held for disposal

PP&E – measurement after recognition *(continued)*

- Depreciation
 - Each significant part depreciated separately
 - Significant parts having the same useful life and depreciation method may be grouped in determining the depreciation charge
 - Separate depreciation of the remainder of the item (i.e., parts of the item that are individually not significant)
 - Depreciable amount: – residual value
 - Residual value and useful life reviewed at least at each closing (if revision, change in accounting estimate, i.e., prospective – IAS 8)

PP&E – capitalization of costs

- Generally consistent with U.S. GAAP
- Purchase price, import duties and purchase taxes, less trade discounts and rebates
- Directly attributable costs of bringing asset to the location and condition necessary for it to be capable of operating in the manner intended by management
- Cost to dismantle and remove an asset and restore site
- Do not include G&A costs typically capitalized by regulated utilities

PP&E – major inspection (overhaul)

- Cost of major inspection
 - Does not include the cost to replace significant parts identified
 - Is treated as a separate significant part whose cost (services, small parts, labor, etc.) is deducted from the remainder of the item of PP&E (i.e., part with the longest useful life) → so they are not recorded in addition to the costs of the assets
- U.S. GAAP provides for three methods
 - Expensed as incurred
 - Deferred and amortized over the period until the next overhaul
 - Accounted for as part of the cost of the asset

Example of component and major inspection

- Construction of a power plant in Y1
- Total cost: 1000
 - Major part A: 150/useful life of 10 years
 - Major inspection: 100 (estimation)/every 5 years
 - Useful life of the remainder: 30 years
- First major inspection performed at closing Y4/cost of 105

Example (continued)

Required accounting entries for Y1 and Y4

Y1	DR	CR
DR PP&E – Major part A	150	
DR PP&E – Major inspection	100	
DR PP&E – Remainder	750	
CR Cash		1000
Closing Y1		
DR Depreciation charge	60	
CR PP&E – Major part A		15
CR PP&E – Major inspection		20
CR PP&E – Remainder		25

Example (continued)

Closing Y4

	DR	CR
Item depreciation Y1 + additional depreciation on original major inspection cost+ new major inspection cost		
DR Depreciation charge	20	
CR PP&E – Major inspection		20
DR PP&E – Major inspection	105	
CR Cash		105

PP&E – initial adoption

- Exposure draft – additional exemptions for first-time adopters – proposed amendments to IFRS 1 issued on 9/25/08
 - Exempt retrospective application of IFRS for operations subject to rate regulation if impracticable
 - Retrospective application on adoption
 - Equity AFDC
 - Administrative and other overheads
 - Intercompany profit
 - Exempt companies with existing leasing contracts accounted for in accordance with IFRIC 4
 - Comments must be received by January 23, 2009

Revaluation model conditions

- Accounting policy applied consistently
- Fair value can be measured reliably
- Used for an entire class of PP&E
 - Grouping of assets of a similar nature and use in an entity's operations, such as
 - Land and Land Rights
 - Structure & Improvements
 - Turbogenerators
 - Towers & Fixtures
 - Station Equipment
 - Line Transformers
 - Motor vehicles
 - Furniture & Office Equipment
- Revaluations made with sufficient regularity
- Items within the same class of PP&E revalued simultaneously



PP&E – borrowing costs (IAS 23)

- IAS 23 (revised 2007) effective January 1, 2009
- Interest and other costs incurred in connection with the borrowing of funds – broader definition than SFAS 34
 - Interest on bank overdrafts and short-term and long-term borrowings
 - Amortization of discounts or premiums relating to borrowings
 - Finance charges in respect of finance leases recognized in accordance with IAS 17 – Leases

PP&E – borrowing costs (IAS 23) *(continued)*

- To be capitalized if directly attributable to acquisition, construction, or production of an asset that necessarily takes a substantial period of time to get ready for its intended use or sale (qualifying asset)
 - Power generation facilities
 - Manufacturing plants
- Measurement depends on whether
 - Funds are borrowed specifically
 - Funds are borrowed generally

Funds borrowed specifically and generally

- Funds borrowed specifically
 - Capitalize actual borrowing costs incurred on that borrowing during the period
 - Less any income on the temporary investment of those borrowings
- Funds borrowed generally
 - Calculate capitalization rate as the weighted average borrowing costs applicable to the borrowings outstanding during the period, other than borrowings made specifically
 - Apply capitalization rate to expenditures on the qualifying asset
 - Compare amount calculated to actual borrowing cost incurred during the period
- Capitalize lesser of the two amounts

PP&E – dismantlement, removal and restoration costs

- Both standards have similar initial treatments including frameworks that provide for a present value approach in measuring the liability obligation
- Risk-adjusted discount rates applied to decommissioning provisions are reset at each reporting date under IFRS based on current best estimates
- IFRS does not require assumption of third-party profit in settlement cost
- May need increased monitoring of valuation inputs and their effects
- Recognition under “Constructive Obligation” as well as “Legal”
- Accretion is recognized as interest expense

PP&E – dismantlement, removal and restoration costs *(continued)*

- Constructive obligation:
 - “... an obligation that derives from an entity’s actions where:
 - by an established pattern of past practice, published policies or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities; and
 - as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities.”

IAS 36 impairment of assets

- Applies to all assets other than:
 - Financial assets within the scope of IAS 39 (financial instruments)
 - Assets arising from employee benefits
 - Investment property measured at fair value
 - Inventories
 - Non-current assets classified as held for sale
 - Deferred tax assets and deferred acquisition costs
 - Biological assets related to agricultural activity measured at fair value less sale costs
 - Assets arising from construction contracts

When is an asset impaired?

- An asset is impaired when its carrying amount exceeds its recoverable amount
 - A one-step test
- If there is any indication that an asset may be impaired, recoverable amount shall be estimated for the individual asset. If it is not possible to estimate the recoverable amount of the individual asset, an entity shall determine the recoverable amount of the Cash-Generating Unit (CGU) to which the asset belongs (the asset's cash-generating unit).
- Indicators similar to SFAS 144
- CGU should be the smallest identifiable group of assets that generates cash flows independent of other assets

Recognition of impairment loss

- Recognized in profit or loss immediately
- Unless the asset is carried at revalued amount, then debit to related revaluation surplus to the extent the amount does not exceed the revaluation surplus
- If impairment loss > carrying amount
 - Recognize as liability only if required by other standards
- Depreciation charge is calculated on the revised carrying amount
- If impairment indicator no longer exists, reverse impairment charge

IAS 17 overview of key concepts

- Definition of “lease”
 - An agreement whereby the lessor conveys to the lessee, in return for a payment or series of payments, the right to use an asset for an agreed period of time.
- Finance lease
 - A lease that transfers substantially all the risk and rewards incidental to ownership of an asset. Title may or may not eventually be transferred.
- Operating lease
 - A lease other than the finance lease.

IAS 17 overview of lease classification

Indicator	IFRS	U.S. GAAP
Ownership is transferred to lessee at end of lease term	Finance lease indicator	Capital lease criteria
Bargain purchase option exists	Finance lease indicator	Capital lease criteria
Lease term is for majority of asset's economic life	Finance lease indicator	Capital lease criteria if > 75% of asset's economic life
PV of minimum lease payments (MLP) = substantively all of the FV of the leased asset	Finance lease indicator	Capital lease criteria if =/> 90% if fair value of asset
Leased assets are specialized in nature – only lessee can use them without major modification	Finance lease indicator	Not specified
<ul style="list-style-type: none"> ▪ Lessor's losses borne by lessee on cancellation ▪ Gains and losses from the fluctuation in FV of residual fall to the lessee ▪ Lessee has ability to continue the lease for a secondary period at below-market rentals 	Finance lease indicators	Not specified

Transition

Conversion is complicated and takes time

- Begin assessing components and separate life determinations now
- Evaluate fixed asset accounting systems
- Use of indexes such as Handy-Whitman and/or depreciation/valuation specialists for component and cost determinations

Efforts best served by focusing on topical areas

- IAS 16
- IAS 17
- IAS 23
- IAS 36
- IAS 37

Coordination is key

- Provide comments to IFRS (i.e., E.D. on first-time adoption exemptions)
- Participate in Industry task force groups
- Look to U.S. utility companies already reporting under IFRS

Don't underestimate the need for training

- Keep informed as new issues are addressed

Closing remarks

The background of the slide is a solid medium blue color. Overlaid on this background is a pattern of dark blue puzzle pieces. The pieces are scattered across the right side and bottom of the slide, with some overlapping. The puzzle pieces are of various shapes and sizes, creating a textured, geometric pattern.

Closing

- IFRS is becoming the global standard
- Take a balanced, reasoned approach to IFRS: It will be prudent to plan ahead
- Consider the various impacts and associated costs and benefits
- Don't underestimate the implementation lead times involved
- Now is time to perform an assessment to evaluate the impact IFRS may have and what strategy your company will follow for adoption

Deloitte resources

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

Deloitte resources *(continued)*

- www.deloitte.com/us/ifrs
 - Recent publications on IFRS issues
 - IFRS trainings
 - Resource library
 - Podcasts and Dbriefs
 - IFRS and U.S. GAAP pocket comparison
- DART (subscription only)
 - IFRS research materials
 - Q&A on key differences between U.S. GAAP and IFRS



Questions and answers

Power & Utilities IFRS Webcast Series

Don't miss the final webcast in this series

December 19, 2008

Regulatory Assets/Liabilities

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