



The Application of IFRS: Power and Utilities

Executive Summary

December 2008

Foreword

The global adoption of International Financial Reporting Standards (IFRSs) began in earnest in 2005 with the adoption of these standards in the European Union, and has continued apace with a host of countries either applying IFRSs directly or converging local standards with IFRSs. As the list of countries planning their adoption of IFRSs grows, a significant boost has been received by the U.S. Securities and Exchange Commission issuing its proposed “roadmap” for IFRS adoption by U.S. issuers.

The power and utilities industry exists to provide basic services of electricity and water to its residential and business customers. The industry has undergone tremendous change in recent years. There has been widespread adoption of privatised models, with deregulation and competition in areas such as wholesale generation and customer supply; this in turn has required the development of energy trading activities to buy and sell in wholesale markets and to balance power supplies against customer demands. The need for massive new investment in capacity and infrastructure has prompted cross-border investment in what were previously purely domestic operations.

Further, the power sector is being transformed by measures designed to address the climate change implications of carbon emissions. This involves major challenges for the sector including new emissions trading schemes, investment opportunities and risks arising from competing renewable and low carbon technologies, and new infrastructure requirements and methods.

All of these developments mean that financial reporting for the industry presents a range of specific issues. As outlined in this survey, power and utility companies have had to address numerous industry-specific matters both on transition to IFRSs and in dealing with subsequent IFRS developments. The industry has sometimes considered that IFRSs provide insufficient or inappropriate guidance for features of their business such as regulatory assets and liabilities, or emissions trading. In addition the industry’s energy trading activities, even if performed essentially for fulfilment and risk management reasons rather than speculation, often give rise to complex financial instrument accounting and presentation issues.

This survey discusses many of these industry accounting issues and provides illustrations of how companies have sought to address them. The excerpts illustrate examples of industry-specific accounting disclosures, including in some cases detailed explanation of the business and regulatory context in which accounting judgements are made.

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This executive summary has been drawn from *The Application of IFRS: Power and Utilities*, published in December 2008, and focuses on the results of a survey of the IFRS financial statements of 25 companies in the power and utilities sector across 16 countries. That publication was produced by the KPMG International Financial Reporting Group, in collaboration with KPMG in the UK and KPMG in Russia. To order a copy, go to www.kpmgifrg.com or www.kpmgglobalenergyinstitute.com.

This executive summary should be read in conjunction with that publication in order to understand more fully the findings from the survey. In addition, that publication includes disclosures made by companies in their consolidated financial statements that we believe may be useful in assessing the type of information being disclosed in practice.

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1. Property, plant and equipment



Most aspects of the utility value chain – generation, transmission and distribution, if not necessarily customer supply – are capital intensive, and hence the accounting for property, plant and equipment is a key issue for the sector. In addition, technological changes in the industry and new environmental requirements, such as the Large Combustion Plant Directive in the European Union, have a significant impact on the management of property, plant and equipment; areas affected include expenditure to meet environmental and health and safety standards, and the useful lives of assets.

Maintenance and shutdowns occur frequently in the power and utilities industry, with power stations being subject to a regular programme of planned maintenance and overhaul shutdowns. This is due not only to physical wear and tear on equipment, but also to safety requirements.

Key messages from our survey group

A majority of companies elected to capitalise borrowing costs in respect of “qualifying assets”. A revised standard that requires such borrowing costs to be capitalised is effective for annual periods beginning on or after 1 January 2009.

While the majority of companies did not refer to component accounting in respect of significant components of property, plant and equipment, most companies discussed the treatment of maintenance and overhaul costs in the context of subsequent expenditure on property, plant and equipment.

Only one company had a policy of revaluing property, plant and equipment. However, a significant minority of companies had measured property, plant and equipment at “deemed cost” upon the adoption of IFRSs.

A number of companies recognised contributions from customers towards infrastructure or transmission facilities as deferred income. These companies stated explicitly that the contribution was recognised in profit or loss over the life of the asset.

A majority of companies disclosed an accounting policy for government grants related to assets; most of these companies presented the grants as deferred income in the balance sheet.

2. Decommissioning and environmental provisions



In most jurisdictions power and utility companies are faced with legal or regulatory obligations to decommission plants and restore sites to a given standard. These costs are likely to be a significant item of expenditure, with the process of estimating the provision being complicated by the long lives of the plants and changing regulatory requirements.

While the principles are the same, the issues in this area for the nuclear industry are of a fundamentally different order because of the amounts and risks involved. The planning and costing for nuclear plant decommissioning and for long-term reprocessing, storage and waste disposal activities is a significant exercise often involving considerable estimation uncertainty.

The need for long-term cash funding, and not simply accounting provisions, to secure the proper discharge of decommissioning obligations is especially relevant to the nuclear industry. Special funding arrangements have been established in a number of countries to address this issue.

Key messages from our survey group

Almost all companies recognised a provision for decommissioning, and over a third of companies disclosed a separate environmental provision.

Nearly half of the companies disclosed the rate used to discount future cash flows in determining the amount of the provision. Amongst those companies that included such disclosure, the basis of the discount rate often was unclear, making comparison difficult.

The general level of disclosure in respect of decommissioning and environmental provisions varied significantly.

3. Leases



In any capital-intensive industry leasing can be an attractive method of acquiring assets for tax or financing reasons. The power and utilities industry is no exception, although leasing arrangements sometimes are constrained by regulatory requirements.

Lease accounting does not just apply to contracts in the legal form of a lease, which means that the substance of all commercial arrangements needs to be considered under IFRIC 4 *Determining whether an Arrangement contains a Lease*. This is particularly relevant to the power and utilities industry since many of the long-term commitments associated with the procurement or sale of power have lease characteristics.

For example, a power generator entering an overseas market may contract the long-term sale of its output to the national utility company. Such a long-term power purchase agreement (PPA) often will be necessary to secure project finance for the plant on economic terms and thus help meet the growing power requirements of the host country. While each PPA will be analysed according to its precise terms, those PPAs that provide for a “full payout” of the capital costs over the term of the PPA are likely to have characteristics of a finance lease.

Key messages from our survey group

All companies presented an accounting policy on leases.

Nearly half of the companies disclosed information about the impact of IFRIC 4 on transactions that they had entered into.

4. Service concession arrangements and other regulatory agreements



Power and utility companies often enter into service concession arrangements with governments and regulatory agencies to develop and provide services.

In many countries the government has the ultimate responsibility for delivering utility services to the public. The government may choose to provide the service themselves through the use of government-owned power and utility entities, or to outsource the service to private enterprise. Such outsourcing may be through privatising existing operations, or by entering into service concession arrangements with private enterprise. In our experience, governments increasingly are choosing to outsource some of these services to private enterprise. One reason is to leverage from the experience that these companies have in delivering the related services; another reason is for the government to avoid upfront cash expenditure in respect of core infrastructure such as power plants and transmission facilities such as power lines.

Power and utility companies generally are subject to operating licences or similar agreements with governments or regulatory agencies. Usually these agreements include clauses relating to the level of service required to be maintained by the company. Service or supply arrangements often are a key part of an operating licence. Largely this is because the continuity of supply is critical to both domestic and business customers, and the government ultimately is responsible for the provision of utility services. In the absence of guaranteed supply, the government might need to source additional supply capacity and deliver it to customers.

Key messages from our survey group

The majority of companies included disclosure about concession arrangements in their financial statements.

The impact of the adoption of IFRIC 12 *Service Concession Arrangements* was still being considered by over half of companies. Two companies had adopted IFRIC 12 before its effective date of 1 January 2008.

A minority of companies disclosed information about agreements with governments or regulators relating to service or safety requirements.

5. Revenue



A key issue for power and utility companies is revenue estimation because meter readings do not necessarily coincide with the reporting periods. Companies therefore develop routines to estimate revenue within acceptable bounds of accuracy.

In regulated environments the price charged to customers in one period may end up being more or less than the regulated tariff structure, for example because of volume changes. This can give rise to a compensating increase in prices in future periods (“under recovery”), or a decrease (“over recovery”). While these adjustments can be considered assets or liabilities in economic terms, normally they are not recognised as such under IFRSs (see section 8).

Key messages from our survey group

While all companies disclosed an accounting policy for revenue, a varying range of detail was provided. However, a majority of companies included an accounting policy for unbilled revenue.

While only a minority of companies disclosed an accounting policy on the recognition of connection fees, for many companies this may not have been a significant revenue stream.

6. Business combinations



Growth by acquisition has been an increasing feature of the global power and utilities market in recent years. The drivers behind this activity include opportunities to consolidate market share within domestic markets, and to enter new overseas markets when these are privatised or deregulated. Divestments required for regulatory reasons also create market entry opportunities for acquirers.

The level of business combination activity will be affected cyclically by the availability of capital, and perceptions of the success of prior acquisitions. Over recent years some companies have enjoyed successful acquisition strategies either at home or overseas, while others have stumbled visibly.

Typical issues arising in accounting for a business combination that are more specific to power and utility acquisitions include:

- allocating fair values to property, plant and equipment, taking account of the regulatory environment and long-term market prospects;
- identifying the value associated with customer relationships in retail markets, which may be an important source of post-acquisition value not recognised previously; and
- valuing long-term and sometimes complex fuel and power purchase or sale contracts.

While power and utility acquisitions often will be “asset rich”, there still may be significant goodwill. Goodwill may be attributable to synergies, for example cost-saving and rationalisation when consolidating operations in a market, or to growth opportunities not reflected in the value of existing assets and liabilities.

Key messages from our survey group

The most common fair value adjustments were to property, plant and equipment, intangible assets and deferred tax balances.

Goodwill was recognised on nearly all of the business combinations reported in the latest financial year; the majority of companies disclosed the factors giving rise to goodwill.

7. Amortisation of intangible assets



Most power and utility companies have intangible assets on their balance sheets. Items such as customer relationships typically arise from a business combination (see section 6), whereas items such as concessions and licences often are acquired as separate assets.

A significant amount of judgement is required in accounting for intangible assets, firstly in determining whether the asset has a finite or indefinite useful life, and then in determining an appropriate amortisation period for those with finite useful lives.

Key messages from our survey group

Nearly all companies recognised intangible assets other than goodwill, with the most common being emission allowances, software, licences, and concessions / rights / trademarks.

The amortisation period of intangible assets with finite useful lives varied significantly.

8. Regulatory assets and liabilities



Tariff regulation is a key feature of the power and utilities industry, intended to ensure a balance between the prices charged to consumers for basic services, and a fair return to companies for the capital invested. Although the operational decisions made by companies in the industry reflect this economic reality, generally it is not reflected in the accounting. An asset cannot be recognised simply because the regulator has agreed that future customers should pay a higher tariff; and similarly, a liability cannot be recognised simply because the regulator requires that customers pay a lower tariff in the future.

This apparent disconnect between the industry business model and the accounting under IFRSs has been a source of concern for power and utility companies in countries that have yet to adopt IFRSs. At the time of going to print, the International Financial Reporting Interpretations Committee (IFRIC) has tentatively declined to add the issue to its agenda as an interpretive issue. However, shortly after the IFRIC meeting, the Standards Advisory Council to the International Accounting Standards Board (IASB) expressed support for the IASB taking on a project.

Key messages from our survey group

None of the companies recognised an asset in respect of cost overruns to be recovered through increased prices in the future, or a liability in respect of over-recoveries from past customers that will be passed to customers through a future decrease in prices.

9. Impairment of non-financial assets



Against the background of significant capital expenditure and investment, the need to consider potential impairment regularly is an important matter for power and utility companies.

While power and utility companies often operate in stable and predictable business environments, impairment issues can stem from fundamental changes in regulated markets that impact previous cost recovery models, or structural changes in deregulated markets, particularly those affecting future market prices. Different competing power generation technologies may become more or less attractive because of relative changes in fuel input costs or evolving environmental requirements.

The identification of appropriate cash-generating units, at which level impairment testing is performed, can be a complex judgemental issue in a group of assets managed as a portfolio. Additionally, the selection of robust medium- and long-term assumptions to assess the value of assets often involves significant uncertainty.

Key messages from our survey group

All companies disclosed an accounting policy on impairment.

The majority of companies disclosed what constituted a cash-generating unit.

The majority of companies recognised an impairment loss in the latest reporting period.

The level of disclosure in respect of discount rates and the uncertainties that existed when assessing impairment varied significantly.

10. Emission allowances and carbon trading schemes



There are many different country and jurisdiction-specific carbon trading schemes. This section focuses on “cap-and-trade” schemes, of which a key example is the European Union’s (EU’s) Emission Trading Scheme (EU ETS), which was introduced in 2005. Power and utility companies are broadly subject to the scheme, and comprise some of the largest emitters.

The threat of climate change and the reductions promised to the international community by the members of the EU as part of the Kyoto Protocol resulted in the implementation of the EU ETS to assist member countries to meet these promises. The EU scheme was separated into 3 phases.

Phase 1 ran from 2005 to 2007, during which period emitters who were subject to the scheme were required to record their actual emissions, and received free allowances from member country governments. There was a widespread belief that most member countries distributed allowances at a level that resulted in companies not having to reduce emissions.

Phase 2 is in operation from 2008 to 2012, and is expected to be quite different from Phase 1. The level of free allowances distributed by member country governments has been lowered, and more industries are subject to the second phase of the scheme. Some member governments also plan to implement an auction scheme or partial payment by emitters for the allowances.

In our experience, the first phase of the scheme did not have a significant accounting impact on power and utility companies, as the allowances received covered actual emissions in most cases. In contrast, in 2008 (in the second phase of the scheme) a number of large power and utility companies have made statements in their financial statements, market reports or annual reports about the potential impact of the EU ETS on their results currently and in the future.

In December 2007 the IASB announced that it was activating its project on the accounting for emission allowances, and that it would be a joint project with the U.S. Financial Accounting Standards Board. In May 2008 the IASB tentatively decided that the project would have a broad scope and deal with the accounting for emission allowances in general, and would not be constrained by current IFRSs. The timing of the project remains uncertain.

Key messages from our survey group

The majority of companies disclosed an accounting policy for emission allowances.

The majority of companies with a stated accounting policy recognised emission allowances received free from the government at a nominal amount.

Most companies did not recognise a provision in respect of emission obligations.

11. Derivatives and commodity price risk



This section focuses on commodity price risk, which is key to the operations of power and utility companies; other exposures include foreign exchange risk and interest rate risk. Derivatives are used frequently within the industry to manage these risks. Larger power and utility companies often have an energy trading division through which risks are managed and energy trading conducted.

The impact of diverse and uncontrollable factors such as the temperature means that volatility in energy markets can be significant and unpredictable. Power and utility companies seek to manage these exposures, and for many companies this will be a key area of focus. With the increasing diversity of both insurance-based and derivative products to manage these risks, power and utility companies must keep Boards and investors informed and educated. They need strong governance processes to minimise any exposure to fraud or large losses such as those that contributed to the downfall of companies such as Enron.

In our experience, power and utility companies encounter complexity when accounting for derivatives. Contracts in the power and utilities industry often contain features that might give rise to embedded derivatives, for example long-term supply contracts of electricity may be linked to commodity prices or contain terms that represent net settled or settleable written options. And as most power and utility companies are susceptible to the financial impact of weather conditions, often they manage this price risk by entering into either weather derivatives or insurance contracts that pay out in response to extreme weather conditions.

While many power and utility companies enter into transactions that hedge their risk exposures, not all of these transactions will be treated as accounting hedges. Hedge accounting is voluntary and the decision to apply hedge accounting is made on a transaction-by-transaction basis. A company's risk management disclosures generally contain appropriate explanation of economic hedges that do not qualify for hedge accounting.

Key messages from our survey group

Nearly all companies used derivatives in risk management activities.

For companies that disclosed a sensitivity analysis in respect of commodity price risk, a value at risk analysis was not the preferred disclosure.

The majority of companies that disclosed a sensitivity analysis considered electricity price or energy / power price to be a significant risk.

12. Segment reporting



Power and utility companies organise their operations to align with strategic and operational goals. These are influenced by the company's history, geography, location, the impact of regulation on the markets in which they operate and legislation. These operations may be based on different lines of business or be more aligned to geographic locations. The dominant organisational factor assists companies in determining segments for the purposes of financial reporting.

Key messages from our survey group

The most common primary segment reporting format was business segments.

A majority of companies had multiple business segments and multiple geographical segments.

Three companies had adopted IFRS 8 *Operating Segments* before its effective date of 1 January 2009.

13. Critical judgements and key sources of estimation uncertainty



Power and utility companies make a number of key estimates and judgements that are industry-specific. One of the most important areas for power and utility companies is estimates involving property, plant and equipment, including decommissioning provisions and impairment. Power and utility companies make assumptions about the useful lives and output of plants, which are based on strategic operating models and business decisions. These can change as demand and supply fluctuates, and can have a significant operational as well as a financial impact on the company.

Another key estimate involves revenue recognition, and the estimate of unbilled revenue (see section 5). Revenue is an important representative measure of business growth and success, especially for power and utility companies with significant retail operations.

Judgements made by management relate primarily to matters of accounting policy selection and application. In contrast, estimates can vary based on the underlying assumptions made by management. To the extent that both of these potentially can have a significant impact on the financial statements, this information is required to be disclosed to allow users to more fully understand the financial statements.

Key messages from our survey group

The most common area of disclosure in respect of critical judgements and estimation uncertainty was impairment.

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