

# Planning Ahead for International Financial Reporting Standards

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# Overview

- What are International Financial Reporting Standards, and why adopt them?
- Issues facing regulators, utilities and consumer
- Major impacts

# What are International Financial Accounting Standards (IFRS)

- The International Accounting Standards Committee Foundation (IASC) is an independent, not-for profit private sector organization working in the public interest. Its principal objectives are:
  - to develop a single set of high quality, understandable, enforceable and globally accepted international financial reporting standards (IFRSs)
  - To advance the use the standards;
  - to take account of the financial reporting needs of emerging economies and small and medium-sized entities (SMEs); and
  - to bring about convergence of national accounting standards and IFRSs
- The IASB is the independent standard-setting body of the IASC Foundation.
- IASB is the international counterpart of the Financial Accounting Standards Board (FASB)

# SEC Rationale for Adopting IFRS

- Securities and Exchange Commission (SEC) issued its “Roadmap” toward adopting IFRS.
  - “Roadmap” addresses transition to adoption of IFRS beginning in 2011 with full compliance in 2014
  - Final rule expected in mid-2010
  - Applicable to “issuers”-- entities that file a Form 10-K or registration statement with the SEC
- As capital markets have become increasingly global, U.S. investors’ have increased access to international investment opportunities.
- U.S. investors would benefit from an enhanced ability to compare financial information of U.S. companies with that of non-U.S. companies.
- A single set of global accounting standards enhances this comparability
- IFRS is viewed as the best uniform platform on which companies can report and investors can compare financial information.

# Potential for Major Impacts on Regulated Utilities, Regulators and Customers

- IFRS currently does not differentiate between regulated and non-regulated companies
- US GAAP permits accounting for the economic effects of regulatory decisions as prescribed by Financial Accounting Standards Board in FAS-71
  - FAS 71 allows regulators to defer recovery of incurred costs and liabilities by creating regulatory assets and liabilities.
  - Immediate income statement recognition is required under IFRS unless pending IASB Exposure Draft (ED) on *Rate-regulated Activities* is accepted
- Allowance for Funds Used During Construction is expensed under IFRS
- First time adopters are permitted to reestablish the value of assets (property plant and equipment)—rate base could increase or decrease relative to original cost
- Increased volatility in income
  - Depreciation expense is more granular, component parts of property, plant and equipment instead of using a composite rate (e.g., a single composite rate for a power plant)
  - Other construction related capitalized under US GAAP might be expensed under IFRS
  - Last-in first-out accounting not permitted
  - Operating leases may be reclassified as capital leases
- Long-lived asset susceptible to more write-downs
  - IFRS impairment test based on net present value of cash flow
  - US GAAP based on nominal cash flow relative to carrying amount of asset
  - Changes in asset values leads to changes in income

# Effects on Regulation

- IFRS Without Adoption of *Rate-regulated Activities* Exposure Draft
  - If regulatory accounting exposure draft is not adopted regulatory assets and liabilities must be eliminated from IFRS balance sheet; (i.e., immediate recognition)

***“the future direction of the project is very uncertain and significant changes to the ED are possible. Entities affected by the proposals, particularly those in converting countries, should closely monitor development of the project as the Board addresses the comments received.” Ernst & Young IFRS Outlook, December 2009***

- Choosing to preserve the flexibility under FAS 71 will require the utility to keep 3 sets of books regulatory, GAAP and IFRS.
  - Increases financial reporting costs; lacks transparency between IFRS and regulatory books
- IFRS with Adoption of Exposure Draft on Accounting for Regulation
  - *Rate-regulated Activities* Exposure Draft applies only to traditional cost of service regulation
  - Other requirements of IFRS lack flexibility
- Critical for regulators and stakeholders to recognize accounting practices will change
  - Stakeholders seek agreement on transition plan and regulatory accounting changes (See, Ontario Energy Board, *Transition Project Work Plan* and *OEB Report of the Board on Transition to IFRS*)
  - Identify regulators’ and utility transition costs

# Implications for Asset Values and Income

- ***IFRS Requirements***

- Regulatory assets and liabilities, under IFRS' proposal, will be measured at the present value of cash flows, which might result in a reduction in the book value of assets, liabilities, and equity.
- More difficult to meet asset impairment test for long-lived assets because of present value method, will result in reduction of assets and equity
- Asset retirement obligations subject to more management discretion as IFRS calls for the measurement to be “management’s best estimate” rather than fair market value
- AFUDC is not capitalized under current IFRS but is expensed as incurred.

- ***Consequences***

- Book value of assets, liabilities and equity will change & fluctuate
- Capital structure per IFRS books will change
- Changes in asset values lead to changes in income, greater volatility in earnings

# Consequences for All Stakeholders

- Likely requires three sets of books the during transition
  - Increased accounting/compliance costs
  - Requires regulatory accounting be decided first
  - Audited financial statements not reliable starting point in rate case if regulatory accounting departs from IFRS
- Capital structure will have to be revisited as asset valuations changes
- Increased volatility in earnings might require changes in the range of earned returns permitted under incentive rate mechanisms

# Will IFRS Affect Utilities' Financial Condition

- ***Cost of service***
  - Principle: accounting does not drive ratemaking; accounting reflects economic effects of ratemaking (FAS 71).
  - Rates will be affected unless regulatory accounting deviates from IFRS
- ***Cost of capital***
  - Cost of debt: Not affected substantially according to credit agencies
  - Cost of equity: The absolute dollar amount will change unless
    - Regulatory accounting determines rate base according to the traditional measure rather than using IFRS

# Preparing for the Transition

- Develop consensus on how to handle the transition and eventual implementation
- Identify internal staff requirements, training etc.
- Be aware of ratemaking issues
  - Consequences of not adopting certain IFRS requirements
  - Utility incremental transition costs
- Maintain awareness within regulatory community; share experiences; share knowledge and expertise