Grant Thornton

Board of Commissioners of Public Utilities
Newfoundland and Labrador Hydro

IFRS Changes associated with 2012 Capital Budget Application
Financial Consultants Report

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Introduction and Scope

On August 3, 2011, Newfoundland and Labrador Hydro ("the Company") ("Hydro") submitted an Application to the Board of Commissioners of Public Utilities ("the Board") requesting approval for the 2012 Capital Budget ("the Application"). For the purposes of the 2012 Capital Budget Application, the Company applied certain International Financial Reporting Standards ("IFRS") to its 2012 capital proposals. The Application described the impact of the IFRS requirements and identified five areas of the 2012 Capital Budget Application that are affected by the move to IFRS. The net impact on capital identified in the Application totaled a $3.3 million increase.

The Board has requested that we undertake a review of the information included in the Application relating to Hydro's proposed changes to its capital expenditure methodology as a result of incorporating the requirements of IFRS.

The scope of our review consisted of the following:

- Review the IFRS changes noted by Hydro in the 2012 Capital Budget Application;
- Ensure the IFRS changes noted are in accordance with the applicable IFRS standards;
- Review the calculations prepared by Hydro to reflect the IFRS changes;
- Ensure the changes have been appropriately reflected in the 2012 Capital Budget Application;
- Highlight any issues that arise that we feel require further investigation; and
- Prepare a report on our findings.

Background

The Canadian Accounting Standards Board (AcSB) requires publicly accountable enterprises to adopt IFRS for external financial reporting purposes. These financial reporting standards are required to be adopted by most publicly accountable enterprises in its interim and annual financial statements for fiscal years beginning on or after January 1, 2011. Certain rate-regulated entities, if they meet specified criteria, could defer the adoption of IFRS by one year to January 1, 2012. Hydro met these criteria and as such is adopting IFRS as of January 1, 2012.

One of the major impacts related to the transition to IFRS for rate regulated entities is property, plant and equipment.

Table – 1 "Treatment of IFRS-Related Issues in the 2012 Capital Budget Application", included in the *2012 Capital Projects Overview* in the Newfoundland and Labrador Hydro 2012 Capital Budget Application, indicates the net impact on capital of the changes that have resulted from the transition to IFRS is an increase to capital costs of $3,300,000 for 2012, as follows:

Major Overhauls and Inspections included	$ 6,800,000
Training costs excluded	(200,000)
Capital labour overheads excluded	(1,300,000)
Corporate overhead allocation excluded	(2,100,000)
Allowance for funds used during construction excluded	(2,600,000)
Interest during construction included	2,700,000
Net impact	$ 3,300,000

In addition, Hydro has noted it has replaced the capital labour overhead allocations with the cost of hours directly charged to capital projects by engineering managers and supervisors. This direct cost is embedded in the costs of capital projects presented in the 2012 budget. Hydro has not provided the dollar impact of these costs in the Application.

Observations and Findings

IFRS changes that impact amounts included in the Capital Budget Application

Hydro has noted five IFRS requirements that impact the overall 2012 capital budget:

1. The costs of major overhauls and inspections, which were previously recognized as operating expenses, must now be capitalized;
2. Training costs, which were previously capitalized, may no longer be added to capital costs, but are now included as operating expenses;
3. Capital Labour Overhead Allocation, which was previously included as a capital budget, may no longer be added to capital costs, but is now included as an operating expense;
4. Corporate Overhead Allocation, which was previously included in the capital budget, may no longer be added to capital costs, but is now included as an operating expense; and
5. The treatment of Financing Costs has changed – previously, an Allowance for Funds Used During Construction (AFUDC), which included both a debt and equity component, was included in the capital budget. Under IFRS only interest costs related to debt, Interest During Construction (IDC), can be capitalized.

We address each of these requirements in turn.

Major overhauls and inspections

Hydro has applied IFRS, specifically IAS 16 paragraphs 13 and 14, to include the costs of major overhauls and inspections in its Application. We reviewed the project justifications included in the Application for the major overhaul and inspection projects, and have concluded the costs identified by Hydro meet the criteria for capitalization.

Hydro has provided the following detail to support the costs of major overhauls and inspections in its 2012 capital budget.

Overhaul Turbine Unit 1 – Holyrood	$ 4,193,000
Condition Assessment and Life Extension Phase 2 – Holyrood	1,216,000
Overhaul Diesel Units – various sites	974,000
Overhaul Turbine/Generator Units – Granite Canal and Upper Salmon	457,000
	$ 6,840,000

Under the Company's previous accounting policy, these costs would have been written off in the year of overhaul/inspection to operating expenses.

Under IFRS, each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item is depreciated separately. It should be noted that the carrying amount of any major parts which may have been previously capitalized, and which are replaced during the 2012 overhauls, should be derecognized in Hydro's accounting records. Hydro is also required to determine an amortization period for the costs of the 2012 major overhauls and inspections that are capitalized. It is also important to note that at the time of the next major overhaul and inspection, any remaining carrying amount of the current overhaul and inspection will need to be written off in Hydro's accounting records.

Based on our review, we note that capitalizing major overhauls and inspections is in accordance with the applicable IFRS standard and the cost of major overhauls and inspections included in the 2012 Capital Budget Application of $6.8 million is consistent with the estimated dollar impact identified by Hydro in its Application.

However, the Board may want to consider asking Hydro whether any previously recognized capital costs required derecognition as the result of capitalizing the inspection and overhaul costs. The Board may also consider asking Hydro the period over which these costs will be amortized.

Training costs

IAS 16 Paragraph 19 states that costs of staff training are not included in the elements of cost of property, plant and equipment.

As a consequence, Hydro has noted it has excluded staff training costs from the 2012 Capital Budget Application. In our review of the Application, we noted no specific budget item for staff training costs.

Hydro has provided us with a schedule of "Budgeted Training Costs" for 2012 amounting to $250,960. The reduction identified by Hydro in its overview was $200,000.

Based on our review, we note that excluding staff training costs from the capital budget is in accordance with the applicable IFRS standard.

Capital labour overhead allocation

IAS 16 Paragraph 19 states that administration and other general overhead costs are not included in the elements of costs of property, plant and equipment.

In prior years, Hydro included in its capital budgets an allocation, amounting to 10% of individuals working in the corporate office and 20% of individuals working in the field, to labour charged to capital. In its 2012 Capital Budget Application, it has not included any such overhead allocation.

In its place, it has included additional direct labour costs for Engineering Managers and Supervisors, which Hydro states it is now better able to identify as a result of realignment of the Project Execution and Technical Services group. The inclusion of direct labour costs for time spent on capital projects is in accordance with IFRS.

Hydro has provided us with a schedule of "Capital Labour Overheads" based on its 2010 actual capital expenditures which amounts to $1,305,336. The reduction identified by Hydro in its overview was $1,300,000.

No details have been provided of the dollar impact of the additional direct labour costs which are embedded in the costs of projects.

Based on our review, we note that excluding a Capital Labour Overhead Allocation, and including instead the direct labour costs of Engineering Managers and Supervisors, is in accordance with the applicable IFRS standard.

However, the Board may want to consider requesting from Hydro the detail of the additional direct labour costs which are embedded in the costs of projects.

Corporate overhead allocation

In prior years, Hydro included an allocation of time for support business units that did not charge time directly to capital, for example Accounts Payable, Inventory and Purchasing Services. Under IFRS, only costs directly attributable to property, plant and equipment can be added to costs – overhead costs are not included. Accordingly, in its 2012 Capital Budget Application, no corporate overhead allocation has been identified.

Hydro has provided us with a schedule, "Corporate Overhead Allocation 2012 Budget" which amounts to $2,090,904. The reduction identified by Hydro in its overview was $2,090,000.

Based on our review, we note that excluding a Corporate Overhead Allocation is in accordance with the applicable IFRS standard.

Allowance for funds used during construction (AFUDC)/interest during construction (IDC)

In applying the standards included in IAS 23, Hydro has replaced AFUDC, which included the cost of equity as well as debt, with IDC, which includes the cost of debt alone. This is in accordance with IFRS, which does not permit the capitalization of the cost of equity to property, plant and equipment.

The amount of costs excluded as a result of this change has been identified by Hydro as $2,600,000. No details supporting this calculation have been provided.

In the place of these costs, Hydro has identified the amount of $2,700,000 as being interest during construction. No details supporting this amount have been provided.

Based on our review, we note that excluding an "Allowance for Funds Used During Construction", which includes components of debt and equity, and instead including "Interest During Construction" which is based on debt alone, is in accordance with the applicable IFRS standard.

However, the Board may want to consider requesting the detail from Hydro to support the calculations of the "Allowance for Funds Used During Construction" and the "Interest During Construction"

Items for Further Investigation

During the course of our review and as noted above, there are certain areas with respect to the transition to IFRS which may require further investigation by the Board. Potential questions to ask the Company include the following:

- Do any previously capitalized costs require derecognition as the result of capitalizing inspection and overhaul costs as required under IAS 16?
- What is the amortization policy with respect to capitalized inspection and overhaul costs?

The comments in the 2012 Capital Budget Application do not indicate if Hydro has dealt with these transitional issues. The Board may want to investigate this further in its ongoing discussions with Hydro with respect to IFRS.

Also as part of our review, we requested further information from Hydro with respect to its calculation of the net impact of IFRS transition on its 2012 capital budget. At the time of writing this report we had not received the following requested information:

- The amount included in the 2012 Capital Budget Application related to the direct labour costs of Engineering Managers and Supervisors.
- Details of the calculation of the impact on the budget of excluding the Allowance for Funds Used During Construction (“AFUDC”).
- Details of the calculation of the impact on the budget of including Interest During Construction (“IDC”).

The Board may want to consider requesting this information from Hydro.

Conclusion

Based on our review, Hydro has correctly applied the new accounting standards under International Financial Reporting Standards in the preparation of its 2012 Capital Budget Application. However, we are unable to provide a conclusion with respect to the calculation of the dollar impact arising from the application of the new standards as a result of the outstanding information noted above.