# FIXED ASSETS ACCOUNTING

**The utilities industry, exemplified by companies like CLP, is notably capital-intensive, requiring significant investments in fixed assets such as power plants, pipelines, transmission infrastructure, and digitalisation equipment. These assets are vital as they represent a large share of an entity's resources and are essential for generating profit. Recognising the significance of fixed assets accounting in the utilities sector is crucial for accurately capturing and managing these assets, thereby facilitating informed decision-making and financial reporting.**

## Why understanding on fixed assets accounting is important for CLP's stakeholders?

Fixed assets accounting is essential for evaluating a company's long-term investments. It provides vital information to investors, lenders, and creditors. Investors can assess a company's value, profitability, and growth potential. Lenders and creditors can evaluate collateral and assess creditworthiness. Additionally, this contributes to a better understanding of maintenance costs and the need for future capital investments. Overall, it is a crucial tool for making informed decisions and understanding a company's financial health and growth prospects.

The mini-series this year aims to provide readers with a general understanding of the fixed assets accounting framework while delving into certain specific areas. In accounting, the terms fixed assets and property, plant, and equipment are often used interchangeably. These terms refer to assets that are expected to be used for a prolonged period in the operations of a business, rather than being held for sale. Fixed assets represent tangible assets that:

- are held for use in the production or supply of goods or services, for rental to others, or for administrative purpose; and
- are expected to be used during more than one period.

### Certain notable fixed assets development and advancements for CLP in recent years:

**Hong Kong**

- D2 gas-fired generation unit at Black Point
- Offshore LNG terminal (via a joint venture)
- Upgrade of Clean Energy Transmission System
- Enhancement of the transmission and distribution network
- CLP Headquarters in Kai Tak

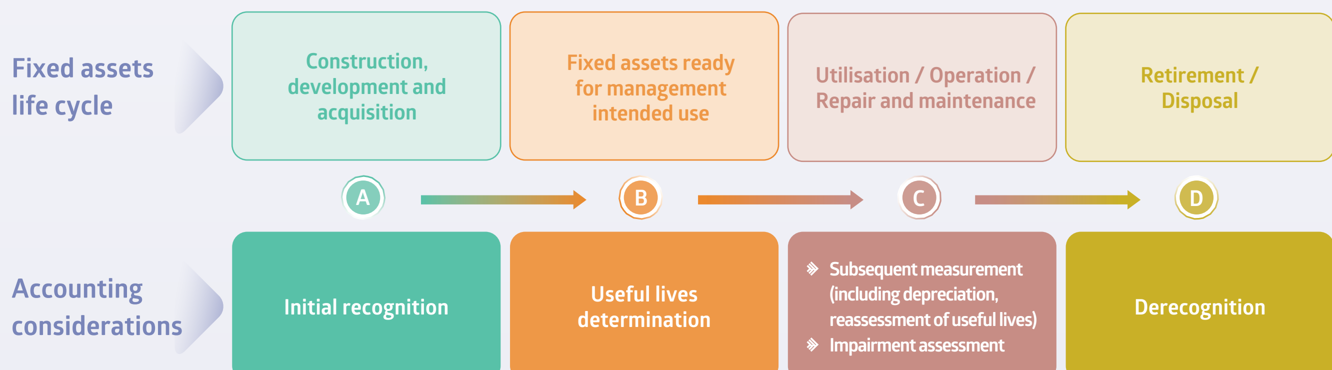
**Mainland China**

- Various renewable energy projects, primarily investment in wind and solar projects, including Sandu II, Bobai and Xundian II wind farms; Yixing, Gongdao and Huai'an Nanzha solar farms

**Australia**

- Generation plants enhancement and capital works (Yallourn and Mount Piper power station)
- Construction of the Tallawarra B power station and upgrade of the Tallawarra A power station
- Flexible capacity projects including battery energy storage systems

In the following part, we will briefly introduce the life cycle of fixed assets and the accounting considerations at each stage:



## A Initial recognition

Instead of recognising expenses as incurred, costs that satisfy the classification and recognition criteria of fixed asset will be capitalised. This ensures that costs are recognised in a manner that corresponds with the benefits received from the assets.

The cost of fixed assets shall be recognised as an asset if, and only if:

(a) it is probable that future economic benefits associated with the (expense) item will flow to the entity, and
(b) the cost of the (expense) item can be measured reliably.

The purpose of recognising fixed assets is to acknowledge that these items can generate future economic benefits for the entity that exceed what would have been gained had the assets not been acquired. In essence, all costs related to the purchase and direct preparation of assets intended for use by management are classified as capital expenditures and recorded as fixed assets, with common examples including:

- Costs associated with external materials or purchases (including replacement cost) ········ 1
- Directly attributable costs to bringing the assets to the location and condition necessary for them to be capable of operating in the manner intended by management
- Delivery charges
- Borrowing costs ········ 2
- Internal costs (including staff costs) ········ 3
- Asset retirement obligations ········ 4

The following are some considerations related to the initial recognition:

### 1 Periodic replacement of an asset

In the case of large-scale utility assets, there is often a need to periodically replace specific components over their useful lives to ensure they operate effectively. Generally, if the replacement component is substantial and meets the fixed asset criteria, it should be recognised as such. Conversely, minor components, often spare parts, would be recorded as inventory and expensed when consumed.

### 2 Borrowing costs

When entities seek external financing for capital-intensive assets, borrowing costs may factor into the total expenditure associated with these assets. Accounting standards stipulate that only borrowing costs directly attributable to the acquisition or construction of qualifying assets should be capitalised as part of the fixed assets. Qualifying assets are typically defined as fixed assets that demand a significant amount of time to become operational, usually interpreted as a period of one year or longer. Once an asset meets these criteria, the borrowing costs can be capitalised, whether they arise from specific borrowing or general borrowing that is directly attributable to the assets.

### 3 Internal costs

Besides the external costs, there are internal costs associated with fixed assets. These costs mainly consist of staff expenses that directly contribute to asset construction or development, can be capitalised if recognition criteria are met. Cost incurred to hire additional staff for overseeing or developing the fixed assets can typically be fully capitalised, while costs incurred by existing staff can also be capitalised if a reliable system accurately records their time spent and associated expenses for specific fixed assets. These costs are capitalised until the asset is ready for its intended use by management.

### 4 Asset retirement obligations

Asset retirement obligations, also known as dismantling cost or reinstatement cost, are a crucial aspect of fixed assets. These costs represent the legal, contractual, or constructive obligations that arise from acquiring or constructing fixed assets and lead to unavoidable future cash outflows for the entity at the end of asset's life.

Determining the existence of asset retirement obligations is complex, especially in cases where there are no explicit contractual obligations but rather a general obligation for retirement or reinstatement. The obligation is recognised as a liability on the financial statements when it is highly probable that cash outflows will occur. Simultaneously, an equivalent amount is recorded as part of the fixed assets. Key factors influencing the estimated amount include the timing and expected cost of the expenses, changes in requirements, and compliance with regulatory and environmental policies. Given the complexity, entities may seek external expertise or refer to historical patterns of expenses to form reasonable estimates. These estimates are subject to change and require regular reassessment.

Apart from the accounting standards, companies might be required to also comply with the mechanisms set by the regulatory framework. For example, CLP Power Hong Kong Limited and Castle Peak Power Company Limited must adhere to the Scheme of Control ("SoC") and make a periodic charge and accrue in the statement of financial position a liability balance to be utilised in discharging asset decommissioning cost if and when incurred. Thus these companies will assess if the provision of liability would be sufficient in addressing the probable obligations.

## B Useful lives determination

When fixed assets are ready for use, entities are required to exercise their accounting judgement in determining the useful lives and the residual values of the fixed assets, selecting the appropriate depreciation method, and starting to recognise depreciation charges.

While capitalised costs are classified as fixed assets, they differ from operating expenses, which are charged immediately. Known as capital expenditures, capitalised costs are viewed as expenses from a lifecycle perspective, and their recognition is spread out over time through depreciation. This approach aligns the asset values with their anticipated useful lives and the additional benefits they produce. The Accounting Mini-Series in 2021 Annual Report discusses the related considerations, including how sustainability factors impact this process.

## C

### 1 Subsequent measurement

After the initial recognition, entities commonly adopt the cost model, including CLP, as their accounting policy. Under the cost model, fixed assets are carried at their original cost minus accumulated depreciation and impairment losses. Subsequent costs incurred are capitalised only if they meet the recognition criteria. Otherwise, these costs, which typically pertain to repairs and maintenance needed to maintain the original expected benefits of the assets, are expensed during the period in which they are incurred. However, if a significant improvement is made to existing fixed assets resulting in additional economic benefits or prolonged economic lives, such as major inspections or maintenance programs, these costs may still be eligible for capitalisation if they meet the recognition criteria.

### 2 Impairment assessment

Accounting focuses on assessing whether the recognised assets are recoverable and whether their carrying value remains supportable. When applying the cost model for subsequent measurement, it becomes crucial for management to determine if the carrying value of fixed assets remains supportable and capable of generating future economic benefits that would allow for the recovery of that carrying value. This may involve identifying impairment triggers and conducting a comprehensive impairment assessment. If it is determined that the assets are not recoverable, impairment charges will be recognised. This expectation arises because financial statement users rely on the assumption that the entity's future profitability will enable the recovery of the carrying amount of the fixed assets. As a result, financial statement users closely examine any impairment charges, as they can offer valuable insights into the entity's future prospects or profitability, even though they are typically classified as non-cash items.

## D Derecognition

Once a fixed asset is disposed of or is no longer expected to generate future economic benefits, it will be derecognised. If consideration is received during the disposal, any resulting gain or loss should be recognised at the time control is transferred. In some cases, even if an asset is fully depreciated but still in use, it may not be derecognised. This may lead to the presence of both cost and accumulated depreciation of the same amount on the books. This situation occurs because the assets are still usable beyond their presumed useful lives.

**CLP adheres to the aforementioned mechanism for accounting for its fixed assets.**

### Other relevant considerations in CLP

#### 1 How does fixed assets accounting impact the return?

Utility companies often operate in regulated environments where their rates and tariffs are determined by regulatory authorities. In Hong Kong, the SoC regulations govern the permitted return for electricity providers. These regulations aim to strike a balance between allowing providers to earn a fair and reasonable rate of return on their capital investments while also safeguarding public interests. The permitted return is periodically reviewed to ensure fairness and alignment with current market conditions. As such, having precise fixed assets accounting enables CLP Group companies to accurately calculate the costs related to their infrastructure investments.

#### 2 Classification of CLP Headquarters in Kai Tak

In this year's financial statements, you will observe an increase of HK$1.1 billion in fixed assets within the buildings category, alongside a rise of HK$2.6 billion in the leasehold land category under right-of-use assets, which is related to the acquisition of a subsidiary. The acquisition fundamentally entails the purchase of the entire interest in Sanon Limited (Sanon), which owns the property currently housing CLP Headquarters located in Kai Tak. While Sanon holds legal title and owns the property, it leases the office floors and car parks to other CLP entities to support the operational requirements of the Group. In Sanon's standalone financial statements, it classifies the property as investment properties as its main purpose is to generate rental income. Conversely, from the perspective of the consolidated financial statements of CLP Holdings Limited, which has consolidated Sanon, the property is regarded as being for self-use or owner-occupied purposes. The costs related to the assets will be recovered through the future economic benefits generated by the Group. Consequently, these will be classified as fixed assets (Note 9) and right-of-use assets (Note 10) in the consolidated financial statements.

Fixed assets represent a key financial statement line on the statement of financial position and are the core profit generating assets for participants in utility industry. Understanding fixed assets accounting provide valuable insights for the financial statements users in evaluating the financial results and position of the entity.