ACCOUNTING POLICIES OF HEP D.D. ZAGREB ACCORDING TO INTERNATIONAL STANDARDS

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Abstract

The desire to meet the EU requirements in terms of accounting has resulted in a larger number of regulations pertaining to financial reporting of business entities in the Republic of Croatia. Although there are numerous regulations, they have to be respected in order to avoid adverse audit qualification. By adopting a new institutional framework for energy sector regulation in the Republic of Croatia, a good environment has been created for application of International Financial Reporting Standards, which are used for regulation of financial reporting within the HEP Group, as well as for the adjustment of accounting principles of HEP d.d. according to International Financial Reporting Standards, which is the subject of this paper.

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1. Introduction

In 2002 Croatia started applying the legislation regulating energy sector in market terms: Energy Act, Act on the Regulation of Energy Activities, Electricity Market Act, Gas Market Act, Act on the Oil and Petroleum Products Market. In December 2004, the Croatian Parliament adopted Amendments to the Energy Act, a new Electricity Market Act and a new Act on the Regulation of Energy Activities ("Official Gazette", 177/2004.).[1] By adopting the specified institutional frameworks, a good environment for implementation of International Financial Reporting Standards has been created, which are used for regulation of financial reporting within the HEP Group, as well as for adjustment of accounting principles of HEP d.d. according to International Financial Reporting Standards.

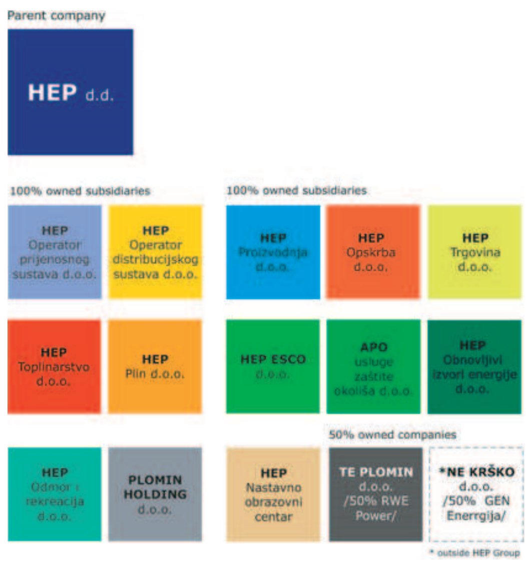
1 Annual report of HEP d.d. Zagreb for 2006, p. 15., http://www.hep.hr/hep/publikacije/godisnje/2006Godisnje.pdf, 26.09.2007

2. About HEP d.d.

In accordance with the Company Act, Hrvatska elektroprivreda (HEP) is registered as a stock corporation (d.d.) with seat in Zagreb, Ulica grada Vukovara 37. Based on the decision of the HEP Management board of November 21, 1994, Hrvatska elektroprivreda was established through modernization and restructuring of the former Public company (JP) Hrvatska elektroprivreda s.p.o., which ceased to exist following the foundation of today's HEP d.d.

Based on the available data from accounting policies of HEP d.d. of June 2007, Hrvatska elektroprivreda d.d. was registered in the file excerpt 1-7916, with decision reference number Fi-31673/94, made according to the decision of Commercial Court in Zagreb of December 21, 1994. Company identification number (MBS) – of Hrvatska elektroprivreda d.d. is 80004306, and the number of Hrvatska elektroprivreda d.d. in the State Bureau of Statistics is 3557049. The organization structure of HEP Group is given in Figure 1.

Figure 1. Structure of HEP Group d.d. Zagreb



Source: http://www.hep.hr/hep/grupa/shema.aspx, 18/09/2007

Hrvatska Elektroprivreda is organized in the form of a holding company with a number of daughter companies. The parent company of the Group, HEP d.d., performs the function of HEP Group corporate management and guarantees the conditions for the secure and reliable electricity supply to customers. Hrvatska Elektroprivreda (HEP Group) is a national electricity company which has been engaged in electricity production, transmission and distribution for more than one century, and with heat supply and gas distribution for the past few decades.[2] Stock capital of the Company amounts to 19.792.159.200,00 kuna, which at the time of the Company registration was equivalent to the value of 5.400.518.000,00 kuna, or EUR 2.711.254.684,93.[3] The stated amount is divided in 10.995.644 ordinary shares of nominal value of 1.800,00 kuna per share, or DEM 500,00.[4] The total amount of ordinary shares, in absolute amount, is owned by the Republic of Croatia.

2. Application of International financial reporting standards and International accounting standards in financial reporting of HEP d.d.

By signing the Stabilization and Association Agreement between the European Union and the Republic of Croatia, the Republic of Croatia has taken over the obligation to harmonize Croatian legislation with EU *acquis communautaire* and the obligation to harmonize the national framework of accounting standards with financial reporting standards. By entering of the new Accounting Act into force, large enterprises in the Republic of Croatia are given a new framework for preparing and presenting the key financial statements as these need to be adjusted to requirements established through introduction of International financial reporting standards.

Introduction of unique forms and norms in financial reporting requires adjustment of the existing reporting frameworks to new standards, bringing into line, in the first place, implementation of accounting policy. Accounting policies present the main guidelines in preparing financial statements, adjusted in accordance with International accounting standards and financial reporting standards.

3. Accounting policies of HEP d.d.

In June 2007, based on the Article 27 of the Articles of Association, HEP d.d. Zagreb adopted new accounting policies adjusted to all necessary standards and attitudes of the Croatian Financial Reporting Standards Board. Fundamental changes in accounting policies of HEP d.d will be named and used in the following text. The summary of the most relevant accounting policies, which

2 http://www.hep.hr/hep/grupa/default.aspx, 15.09.2007

3 The average exchange rate for euro in this calculation is 7,30 kuna.

4 The average exchange rate for DEM in this calculation is 3,60 kuna.

were consistently applied in this and in previous years, are explained below (only the most important policies are mentioned due to limited space).[5]

3.1. Presentations of financial statements

The financial statements have been are prepared in accordance with International Financial Reporting Standards ("IFRS") as published by the International Accounting Standards Board. The financial statements have been prepared on the historical cost basis except for certain financial instruments that were presented at revalued amounts. The financial statements are presented in thousands of Croatian Kuna (HRK'000), since that is the currency in which the majority of the Company's transactions are denominated. The financial statements have been prepared under the going-concern assumption.

3.2. Consolidation principles and methods

The consolidated financial statements consist of the financial statements of HEP d.d. and entities controlled by HEP d.d. (its subsidiaries). A listing of the Group's subsidiaries is provided in Note 35. Control is achieved where HEP d.d. has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. The results of subsidiaries acquired or disposed of during the year are included in the consolidated profit and loss account from the effective date of acquisition or up to the effective date of disposal. Where necessary, adjustments have been made to the financial statements of subsidiaries to bring their accounting policies into line with those used by other members of the Group. All important transactions and conditions among the companies – members of the Group have been eliminated during consolidation. Minority interests in the net assets of consolidated subsidiaries are shown separately from the Group's equity in them. Minority interests consist of the amount of those interests at the date of the original business combination and the minority's share in equity changes since the date of the combination.

Losses related to the minority's interest in the subsidiary's equity are allocated against the interests of the Group to the extent in which the minority has an obligation and is able to make an additional investment to cover the losses.

3.3. Investments in subsidiaries

Subsidiaries are those companies in which the Company (as parent) has control, i.e. power to manage financial and operational policies by making decisions on financial and operational policies in a subsidiary. Investments in subsidiaries

5 According to: Annual reports of HEP d.d. Zagreb for 2007, pp. 109-128, http://www.hep.hr/hep/publikacije/godisnje/2007Godisnje.pdf, 26.01.2009

are presented in the balance sheet at cost adjusted by any changes in the Company's share in the net assets of a subsidiary after acquisition, and for any value impairment of an individual investment.

3.4. Investments in associated companies

An associated company is an entity over which the Group has significant influence, but not control or joint control. Significant influence means participation in the financial and operating policy decisions in the associated company, but it does not imply control or joint control over financial or operating policies. The results and assets and liabilities of associated companies are incorporated in these consolidated financial statements using the equity method of accounting except investments in associated companies held for sale that are accounted in accordance with IFRS 5 „*Non-current Assets Held For Sale and Discontinued Operations*". Investments in associated companies are carried in the consolidated balance sheet at cost as adjusted by changes in the Group's share of the net assets of the associated company after acquisition and corrected by any impairment in the value of individual investments. Losses of an associated company that exceed the Group's interest in that associated company (which includes any long-term interests that, in substance, form part of the Group's net investment in the associated company) are not recognised, unless the Group has a legal or constructive obligation or made payments on behalf of the associated company. Any amount of the acquisition cost that exceeds the Group's share of the fair values of the identifiable assets of the associated company at the date of acquisition is recognised as goodwill. Goodwill is included in the book value of investment and impairment is estimated as part of the investment. Any deficiency of the cost of acquisition, i.e. discount at acquisition, below the Group's share of the fair values of the identifiable net assets of the associated company at the date of acquisition is credited to profit and loss account in the period of acquisition. Where transactions are made between a member of the Group and an associated company, profits and losses are eliminated to the extent of the Group's interest in the relevant associated company.

3.5. Property, plant and equipment

Property, plant and equipment are specified according to their purchase value reduced by accumulated depreciation and any loss arising from reduction in asset value, except for land, which is specified according to its purchase price. The estimated useful lives, residual values and depreciation methods are reviewed at the end of each year with the effect of any changes in estimate calculated on expectation basis. Fixed assets in use are depreciated by use of the straight-line method as it is presented in Table 1.

Table 1: Depreciation in HEP (in years)

BUILDINGS	2006	2007
Hydroelectric power plants (Dams, embankments, buildings and other structures and facilities)	20 – 50	20 – 50
Thermal power plants (buildings and other facilities)	33 – 50	33 – 50
Facilities and plants for transmission and distribution of electricity (transformer stations, over- and underground transmission lines, dispatch centres, etc.)	8 – 33	20 – 40
Water and steam pipelines and other thermal power generation and transmission plants and facilities	33	33
Gas pipelines	20 - 25	20 - 25
Administrative buildings	50	50
Plants and equipments		
Hydroelectric power plants	10 – 25	10 – 33
Thermal power plants	6 – 25	6 – 25
Electricity transmission plants and facilities (electric parts of transformer stations and transformers, electric parts of transmission lines)	8 – 33	15 – 40
Electricity distribution plants and facilities (electric parts of transformer stations and transformers, electric parts of distribution lines, measuring instruments, meters and other equipment)	8 – 33	8 – 40
Thermal power stations, hot-water pipelines and other equipments	15 – 30	15 – 30
Gas meters and other gas network equipment	5 – 20	5 – 20
Other equipment and vehicles		
IT equipment	3 - 20	5 - 20
Computer software licences	5	5
Telecommunications equipment	5 – 20	5 – 20
Motor vehicles	5 – 8	5 – 8
Office furniture	15	10

Source: Annual report of HEP d.d. Zagreb for 2007, p.116, http://www.hep.hr/hep/publikacije/godisnje/2007Godisnje.pdf, 26.01.2009

In 2007, the Company reviewed the useful lives of its non-current assets in accordance with IAS 16. Considering the development of new technologies as well as the global practice in estimating the useful lives of energy facilities, and based on experience, condition of energy facilities and information about reliability of plants and availability of energy facilities, the Company established that the useful lives of the canals, hydro power plants, production equipment at the power plants, transformer stations and grids should be extended. A decrease in the useful life of office furniture from 15 to 10 years was suggested. The initial costs of property, plant and equipment contain the purchase price, including customs duties and non-refundable taxes and all direct costs related to bringing an asset to the condition and location for its use. Expenditures incurred after putting the property, plant and equipment into use are charged to expense in the period in which they are incurred. In situations where it can be clearly observed that the expenditures have resulted in an increase in the future economic benefits that will be obtained from the use of property, plant and equipment beyond its originally assessed potentials, the expenditures are capitalised as an additional cost of property, plant and equipment. Costs that are capitalized include costs of periodic, planned larger, significant inspections necessary for further operation. The gain or loss arising from disposal or withdrawal of property, plant and equipment is determined as the difference between the revenues from sale and principal of the asset and are credited to the profit and loss statement.

3.7. Accounts receivable and prepayments

Account receivables are specified at invoiced amounts. Since July 1, 2002, the subsidiary HEP Distribucija d.o.o. has been providing electricity distribution services, keeping record and collecting the related receivables from tariff-based customers, and HEP Opskrba d.o.o. has been providing electricity distribution services to eligible customers for the account of HEP d.d. since February 26, 2003. The risk of collectability of receivables from the sale of electricity is borne by HEP d.d., and, based on the estimate of HEP's management, an allowance for bad and doubtful receivables is made. All accounts receivable in bankruptcy and receivables claimed through court are fully written off. Management conducts correction of doubtful receivables based on a review of the overall ageing of all receivables and a review of significant individual amounts receivable. As the collectability of certain receivables over a longer term is not certain, the Company makes an allowance for unrecoverable amounts, based on a reasonable estimate and past experience through longer period, in order to write off those amounts as it is shown in the Table 2:

Table 2: Write-off rate in HEP d.d.

Aging of past due date	**Write off percentage**
61 - 90 days	5%
91 - 120 days	10%
121 - 365 days	20%
Over one year	100%

Source: Annual report of HEP d.d. Zagreb for 2007, p.120, http://www.hep.hr/hep/publikacije/godisnje/2007Godisnje.pdf, 26.01.2009

Outstanding receivables claimed through court and receivables from those buyers which are in the bankruptcy procedure (the principal debt and interest) are fully written off, regardless of the number of past due days. Such write-offs are charged to value adjustment of assets and credited to the allowance account on short-term receivables.

3.8. Inventories

Inventories consist mainly of material and small inventory, and are specified at the lower value determined by comparing an average weighted price reduced by value adjustment for obsolete and excessive inventories and net expected selling price. Management conducts adjustment of inventories value based on individual amount included in inventories. Procurement cost includes invoiced price and other costs directly caused by bringing inventories to a certain location and condition.

3.9. Provisions

Provisions are recognized only when the Group has a present obligation (legal or constructive) as a result of a past event and it is likely that an outflow of resources will be required to settle the obligation, and when the amount of the obligation can be reliably estimated. Provisions are reviewed at each balance sheet date and adjusted according to the latest best estimate. Where the effect of discounting is significant, the amount of the provision is the present value of the expenditures that are expected to be required to settle the obligation. Where discounting is used, the increase in provisions that reflects the passing of time is recognized as interest expense.

3.10. Revenue recognition

Revenue is earned primarily from the sale of electricity to households, industrial and other users in the Republic of Croatia. These activities constitute the main income source of the Group's operating income. Electricity sales are recognised based on the management's best estimate of the actual consumption of the energy delivered to customers. Interest income is recognised on an accrual basis, based on the principal settled and at the applicable effective interest rate. The Company revised its estimate related to recognition of interest in 2007, as it was determined by the analysis of collected amounts that there is no significant difference between interest accrued and interest collected

4. Conclusion

Financial market liberalization, strengthening of control mechanisms, and ever more frequent fluctuation on capital market as well as instability of national economies were factors that gathered the work group of International Accounting Standards Board in order to develop unique guidelines and accounting policies that would make financial reporting easier. Guided by this idea, International financial reporting standards were introduced in the global accounting practice at the beginning of 2005 and end of 2006, and this act marks the beginning of a new age in accounting - modern accounting. The listed standards make it possible to keep up with globalization and integration processes, which are growing stronger in every aspect and affect all spheres of social and economic life, with a single goal – harmonization of financial reporting.

The desire to meet requirements of the European Union in terms of accounting has resulted in a more legislation regulating financial reporting of business entities in the Republic of Croatia. Although there are numerous regulations, they have to be respected in order to avoid adverse audit qualification. Guided by this idea, financial statements of HEP Group d.d. audited by an independent audit company have shown a high level of adjustment and harmonization with all of the above listed regulations and norms.

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