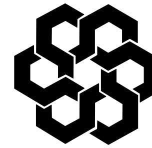

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410 Fax: +44 (0)20 7246 6411
E-mail: iasb@iasb.org Website: www.iasb.org

International Accounting Standards Board

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: **May 2008, London**
Project: **Project plan for agenda request on rate regulated liabilities (Agenda Paper 7A)**

A Introduction

1 In January 2008, the IFRIC received a request on whether regulated entities could or should recognise a liability (or an asset) as a result of price regulation by regulatory bodies or governments (see Appendix 1 to this paper).

2 The staff is aware that another group is intending to request an Interpretation with the same or similar scope and have been awaiting receipt of that request.

3 In the interim, the staff have undertaken preliminary research and have developed a project plan for making a recommendation to IFRIC on an agenda decision (see Section C of this paper).

B Background

4 In June 2005, the IFRIC published a tentative agenda decision on regulatory assets. This tentative decision was finalised and published in IFRIC Update in August 2005 (see Appendix 2 to this paper). In its final agenda decision, the staff note that the IFRIC re-affirmed its decision not to take a project on regulatory assets onto its agenda. However, it did make some changes to the draft wording that was published in June 2005.

5 The IFRIC was not specifically asked whether IFRS permitted the recognition of regulatory assets and liabilities. Rather, the IFRIC was asked whether US SFAS 71 *Accounting for the Effects of Certain Types of Regulation* could be applied under the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* for selection of an accounting policy in the absence of specific guidance in IFRSs. In response to this question, the IFRIC noted that, because SFAS 71 is a US standard, it was not clear whether applying it would always result in accounting that was consistent with all of the relevant IFRSs.

6 The IFRIC had discussed the possible recognition of regulatory assets as part of its project on service concessions. As a result of its consideration of the issues at that time, the IFRIC concluded 'that entities applying IFRSs should recognise only assets that qualified for recognition in accordance with the IASB's *Framework for the Preparation and Presentation of Financial Statements* and relevant accounting standards, such as IAS 11 *Construction Contracts*, IAS 18 Revenue, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*.' In other words, the IFRIC thought that an entity should recognise regulatory assets to the extent that they meet the criteria to be recognised as assets in accordance with existing IFRS. Whether the assets are labelled as 'regulatory' should not affect their recognition.

7 The IFRIC therefore concluded that any Interpretation would do little more than inform constituents that, when deciding how to account for regulatory assets, they should consider existing accounting standards. Because there appeared to be nothing to be gained from producing such an Interpretation, the IFRIC decided not to take the issue onto its agenda. In summary, the IFRIC agenda decision does not preclude the recognition of regulatory assets and liabilities. It does require entities to apply existing standards, including the *Framework*, carefully to items it is considering recognising and does not permit the automatic application of the requirements of SFAS 71.

8 In January 2008, the IFRIC received another request to provide guidance on regulatory liabilities on the grounds that this issue was not addressed by the IFRIC and more generally that the accounting for regulatory assets and liabilities is widespread, has practical relevance and there is significant divergence in practice.

C Project plan

9 Paragraph 24 of the Handbook for the IFRIC states that the IFRIC assesses proposed agenda items against the following criteria (an issue does not have to satisfy all to qualify):

(a) The issue is widespread and has practical relevance.

(b) The issue indicates that there are significantly divergent interpretations (either emerging or already existing in practice). The IFRIC will not add an item to its agenda if IFRSs are clear, with the result that divergent interpretations are not expected in practice.

(c) Financial reporting would be improved through elimination of the diverse reporting methods.

(d) The issue can be resolved efficiently within the confines of existing IFRSs and the *Framework*, and the demands of the interpretation process. The issue should be sufficiently narrow in scope to be capable of interpretation, but not so narrow that it is not cost-effective for the IFRIC and its constituents to undertake the due process associated with an Interpretation.

(e) It is probable that the IFRIC will be able to reach a consensus on the issue on a timely basis.

(f) If the issue relates to a current or planned IASB project, there is a pressing need to provide guidance sooner than would be expected from the IASB's activities. The IFRIC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRIC requires to complete its due process.

10 So far, the staff understands that criteria (a), (b) and (c) would be met. There seems to be more uncertainty about criteria (d) and (e) depending on how the scope is defined. The issue is also a revenue recognition issue but criterion (f) is unlikely to be met.

11 The staff suggest the following timetable:

July 2008 IFRIC meeting	Preliminary discussions on the scope and the issue Assessment of whether the issue should be added to the IFRIC's agenda
If the IFRIC decides to add the issue: Sept. 2008 IFRIC meeting Nov. 2008 IFRIC meeting Jan. 2009 IFRIC meeting	 Scope Issues Issues and drafting
Q1 2009 Q3 or Q4 2009	Issue a draft Interpretation Redeliberation and issue final Interpretation

12 For the July 2008 IFRIC meeting the staff intend to:

- ☞ Complete its research to identify the different sorts of regulations, accounting practices and views about the issue;
- ☞ Look at IFRIC 12 *Service Concession Arrangements* to identify potential analogy;
- ☞ Seek to define a scope that is sufficiently narrow for the IFRIC to be able to address efficiently and sufficiently broad to be useful; and
- ☞ Provide a recommendation as to whether the issue should be added to the IFRIC's agenda.

D Questions for the IFRIC

13 Do you have any comments on the project plan proposed by the staff?

14 Do you have any recommendation in respect of the project plan, the scope or the issue?

15 The staff welcome inputs from IFRIC members on this issue.

Appendix 1: Submission

Background

In many countries, private sector utility companies are regulated, in the public interest, to ensure that their pricing provides an appropriate and fair balance between the interests of shareholders and customers. Generally, prices would be set based on agreed budgets for costs and revenues for the next period, and profit shortfalls and surpluses in one period would be recovered through price adjustments in future periods or other contractual mechanisms.

Under some accounting frameworks, such entities are permitted or required to defer losses, or excess costs, as 'regulatory assets' that will be recovered through future price increases. Similarly, they may be permitted or required under some accounting frameworks to defer excess profits as 'regulatory liabilities' for amounts that will be returned to customers through decreases in tariffs in future years.

Such an approach to regulatory assets and liabilities is applied, for example, under US GAAP in FAS 71 *Accounting for the Effects of Certain Types of Regulation.*

IFRS do not provide specific guidance on regulatory assets/liabilities and in particular on recovery/return of costs/cost reductions through future increases/decreases in regulated tariffs and therefore the question arises as to whether, under the GAAP hierarchy in IAS 8, the guidance under FAS 71 for regulatory assets/liabilities would also apply under IFRS.

During its discussions on service concessions, the IFRIC considered a paper, based on the guidance in FAS 71, on the accounting treatment under IFRS of regulatory assets and liabilities, but no firm conclusions were reached except that any regulatory asset would need to meet the definition of an asset in the IASB's Framework and other IFRSs.

Because IFRIC's view that FAS 71 may not be applicable under IFRS related to regulatory assets only, the position with respect to regulatory liabilities remained unclear. The remaining part of this document therefore will focus on regulatory liabilities.

In practice, there is still divergence of views with respect to the accounting treatment of regulatory liabilities. And although the issue is limited to a selected number of companies that operate in regulated industries, such as the utilities sector or air traffic control, it is an issue in several countries and therefore raises the question of consistency of application on a cross-border basis.

Fact pattern

Company X, the owner of electricity transmission infrastructure and related assets, has been appointed as a Transmission System Operator ("TSO") in a particular country. The Company operates under license and is compensated for its operating services on the basis of regulated prices.

The TSO is appointed by the Government and such appointment is valid for a period of 20 years. The Electricity Law provides that only one system operator is authorised to manage and operate the transmission system.

As required by EU law, the local electricity market is monitored and controlled by independent regulators. The regulator is required to approve the prices that the company charges to its customers for access to the network. Pricing structures are defined in the law and related guidelines, determined on a 'cost-plus' basis based on budgets. Once approved, prices are published and apply to all customers. Prices are not negotiable with individual customers.

The regulator also requires the company to abide by any specific provision of the law or any related regulations, failing which it can impose administrative fines.

To ensure optimal operation, necessary investments and viability of the company's network and to allow it to provide an appropriate return to shareholders, prices are set to allow the company to achieve a fair return on its invested capital and recovery of all reasonable costs incurred, including borrowing costs.

At the end of each year, the company reports deviations between the actual results and the budgeted results. In the fact pattern under discussion, the company's actual results were significant above budget, i.e. the company made an excess profit significantly above the rate of return set by the regulator.

The regulator evaluates the actual results and resulting deviations and, by regulation, requires the company to hand back its excess profit achieved in the current period through price adjustments in the next period.

IFRS analysis

The hierarchy in paragraphs 10 and 11 of IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors requires that accounting policies be determined in first instance based on requirements and guidance of Standards and Interpretations dealing with similar and related issues and the definition and principles in the Framework, and in second instance by reference to the pronouncements of any other GAAP provided that its conceptual framework is similar to the IFRS Framework.

In order to determine whether it is appropriate to recognise a regulatory liability under IFRS, it is necessary to consider other current standards that require the recognition of a liability. In doing so, it is also necessary to consider whether such a liability would meet the definition in the IASB's Framework. The alternative approaches, together with an analysis under each relevant standard, would be:

- deferred income under IAS 18

- financial liability under IAS 32
- provision under IAS 37

Analysis under IAS 18

View 1 – No deferred revenue

There is an arrangement with the regulator on the pricing of services to be provided by the company to its customers, and this arrangement will result in reduced revenues in future periods. However the services are provided to customers under separate contracts. Revenue under those contracts is recognised under IAS 18 when the services are provided. Since those contracts do not provide for surplus revenues to be returned to the individual customer, it is likely that the amount of revenue under each contract can be reliably measured, and it is probable that the amounts due from each customer will be received. Therefore it is doubtful whether there is a strong basis for deferring the recognition of revenue or income under IAS 18 or IAS 11.

View 2 – Deferred revenue

The arrangement sets out (in the license or concession agreement) a fixed or determinable amount of total revenue that the company is permitted to earn during the term of the arrangement. The company charges individual customers on a periodic basis essentially as a collection mechanism. However, under IFRSs the company should estimate the total revenue it will earn from the arrangement and the totality of the services it will be required to perform, and recognise revenue as it performs the services. If at any point in time the proportion of total revenue that the company has collected from individual customers exceeds the proportion of total services that it has provided, then the company should not recognise the excess receipts as revenue but has deferred income.

Analysis under IAS 32

No financial liability

IAS 32.11 defines a financial liability as: *"any liability that is: [...]*
(a) a contractual obligation:

> *(i) to deliver cash or another financial asset from another entity; or*
> *(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or [...]"*

The arrangement with the regulator that requires the return of excess profits to customers may or not be a contractual arrangement. However, even if it is a contractual arrangement, the contract would not meet the definition of a financial liability because the utility company has no obligation to deliver cash either to the regulator or to its customers. In most cases, the obligation will simply be to reduce future prices, and if a customer stopped using the service, no rebate would be paid.

Note: in some arrangements, the regulator may have the power to require the company to pay cash to the regulator if revenues exceed a defined amount, or if the company's return exceeds a defined level. In such cases, the company may have a financial liability due to the regulator. Even if the usual practice is for the regulator to direct the company

to re-invest excess proceeds, or re-set prices, the company will have a financial liability if the regulator has the power to require the company to deliver cash.

In other arrangements, the company may be obliged to rebate cash to individual customers, such that a financial liability exists as a result of an explicit or implicit inclusion of the requirements in the regulation into the terms of the contract with each customer.

Analysis under IAS 37

IAS 37.10 defines a liability as: *"a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits".*

View 1 – No obligation or contingent liability only

Under one version of this view, there is an obligation, arising from the arrangement with the regulator, but the existence of the obligation is contingent on an uncertain future event: the future sale. If a sale is made in the future period, a rebate will, in effect, be paid. The obligation would therefore meet the definition of a contingent liability in IAS 37.10 (a): "a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity".

Alternatively, it can be argued that the obligating event is the future provision of electricity to customers. If no customer purchased any utility service the following years, then the company would retain the gain on the operating costs. Under this approach, there is no obligation under IAS 37, either contingent or otherwise.

IAS 37.18 provides that: "Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore no provision is recognised for costs that need to be incurred to operate in the future."

An interesting comparison might be with a warranty provision that, in accordance with IAS 37, is recognised as a liability when an entity has an obligation to repair or replace merchandises sold to customers during a specified period of time. This is also an obligation that a company incurs towards a large number of customers ("public at large"). However the past obligating event, the sale of a good to the customer, has already occurred which supports the recognition as a liability.

Another relevant comparison might be sales discounts. In the consumer products business, at the end of year N, suppliers and retailers negotiate trade agreements for year N+1 whereby the level of discounts for next year are determined and will contractually apply to both parties. These are negotiated based on the achievement/performance of the ending year and a significant amount of future sales might, from past experience, be highly likely. However these discounts are costs relating to future sales and in that instance they do not meet the definition of a liability.

Under this view, depending on what is considered to be the obligating event, there is either no obligation or a contingent liability. IAS 37.27 precludes the recognition in the balance-sheet of contingent liabilities. However IAS 37.86 requires disclosures at the

balance-sheet date for each class of contingent liability. In this particular context, an appropriate disclosure would be necessary to provide the user of the financial statements with the appropriate information.

View 2 - Provision

Under View 2, the obligation of the company to return the excess profit to customers via future decreases in tariffs meets the definition of a liability. It is important to note that under this view, the party to whom the obligation is owed is 'the public at large' (or the entire present and future customer-base), unless there are specific contractual arrangements that would require a rebate to be paid to individual customers.

IAS 37.20 provides that: "*An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large*".

From the perspective of the public at large, the definition of a liability would be met as:

- A past event has taken place: the excess charge to customer, as a result of the difference between the budgeted costs and revenues and the actual figures;
- The past event, based on the contractual arrangement with the regulator, gives rise to a present obligation to return the gain to present and future customers; and
- The outflow (reduction in future revenue inflows) is probable.

An additional argument in favour of this view is by reference to IAS 18.

IAS 18.7: "*Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in increases in equity, other than increases relating to contributions from equity participants.*"

Under this view, it can be argued that amounts to be returned to customers in the future will never flow or be available to the entity except on a temporary basis (any excess cash received this year will be returned next year) and as such do not meet the definition of equity in the Framework paragraph 49: "Equity is the residual interest in the assets of the entity after deducting all its liabilities".

IAS 18.20: "*When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognized by reference to the stage of completion of the transaction at the balance sheet date. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:*

- *the amount of revenue can be measured reliably;*
- *<u>it is probable that the economic benefits associated with the transaction will flow to the enterprise;</u>*
- *the stage of completion of the transaction at the balance sheet date can be measured reliably; and*
- *the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.*"

Under this view, the amount of revenue can be measured reliably. However, it is not probable that the portion of the economic benefits relating to the excess profit will flow to the enterprise, as the regulations governing the activity requires a transfer back to customers of that portion of revenue in future fiscal years. It would not be a true and fair presentation of the performance of the company not to recognise this liability.

This view is in accordance with US GAAP FAS 71 which requires recognition of a liability.

In more extreme cases, regulated prices may be reduced prospectively to such an extent that the company estimates that it will record losses over the residual term of its license. In such circumstances, the license may become an onerous contract for which the company should provide.

*** end of paper ***

Appendix 2

Extract from the August 2005 IFRIC Update:

IAS 38 Regulatory asset

The IFRIC considered a request for guidance for operations subject to price regulation. The request concerned situations in which a regulatory agreement allowed the entity to increase its prices in future years to recover outflows of economic resources during the current or previous years. The IFRIC was asked whether US SFAS 71 Accounting for the Effects of Certain Types of Regulation could be applied under the hierarchy in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors for selection of an accounting policy in the absence of specific guidance in IFRSs

The IFRIC observed that it had previously discussed whether a regulatory asset should be recognised in the context of service concession arrangements, either as deferred costs or as an intangible asset to reflect an expectation that the entity will recover these costs as part of the price charged in future periods. It had concluded that entities applying IFRSs should recognise only assets that qualified for recognition in accordance with the IASB's Framework for the Preparation and Presentation of Financial Statements and relevant accounting standards, such as IAS 11 Construction Contracts, IAS 18 Revenue, IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets.

The IFRIC had noted that SFAS 71 required entities to recognise regulatory assets when certain conditions were met. However, the IFRIC had concluded that the recognition criteria in SFAS 71 were not fully consistent with recognition criteria in IFRSs, and would require the recognition of assets under certain circumstances which would not meet the recognition criteria of relevant IFRSs. Thus the requirements of SFAS 71 were not indicative of the requirements of IFRSs.

Since it already had concluded that the special regulatory asset model of SFAS 71 could not be used without modification, the IFRIC noted that expenses incurred in performing price-regulated activities should be recognised in accordance with applicable IFRSs and decided not to add a project on regulatory assets to its agenda.