30 Cannon Street, London EC4M 6XH, England
Phone: +44 (0)20 7246 6410, Fax: +44 (0)20 7246 6411
Email: iasb@iasb.org Website: http://www.iasb.org

International Accounting Standards Board

This document is provided as a convenience to observers at the Standards Advisory Council meeting, to assist them in following the discussions. It does not represent an official position of the IASB. Board positions are set out in Standards.

Note: These notes are based on the staff papers prepared for the SAC meeting. Paragraph numbers correspond to paragraph numbers used in the SAC agenda paper.

INFORMATION FOR OBSERVERS

SAC Meeting: **November 2008, London**

Project: **Possible Agenda Proposal on Accounting for the Effects of Rate Regulation**

(Agenda Paper 4)

Objective

1. The purpose of this paper is to seek the Standards Advisory Council's input on the advisability of preparing a proposal to add a project to the Board's technical agenda. The objective of the project would be to develop a standard, possibly similar to IFRSs 4 and 6, to provide guidance on assets and liabilities to be recognised as a result of the actions of rate regulators.

Background

2. In January 2008, the IFRIC was asked for the second time to consider whether the actions of a rate regulator can give rise to assets and liabilities that should be recognised in financial statements prepared in accordance with IFRSs. In this case the request came from the European Roundtable on the Consistent Application of IFRS. The National Standard Setters group has also discussed this

question at several of its meetings and requested that the IFRIC consider adding it to the IFRIC agenda.

3. In September in an education session, the IFRIC discussed a background paper outlining the issues and arguments the staff had considered to date. The purpose of that discussion was to determine if there was any other information the IFRIC wanted the staff to obtain before it made a recommendation on whether the IFRIC should add the issue to its agenda. An updated version of that background paper is available to SAC members who wish to review additional material. It is included on the IASB website as an Observer note for the November IFRIC meeting at http://www.iasb.org/NR/rdonlyres/59BD9DD4-6645-48FA-9DF4-94944CF53B23/0/0811ob6ARegulatoryassetsandliabilitiesBackground.pdf.

4. The staff's analysis and recommendations are set out in a paper for the November IFRIC meeting, included as an Appendix to this paper. In short, the staff concludes that the IFRIC should recommend that the Board add a project on accounting for the effects of rate regulation to its agenda. The staff will provide an oral update of the IFRIC's discussions and conclusions at the SAC meeting.

5. Since the issue was added to the IFRIC Issues list, the staff has received a steady stream of correspondence and requests for meetings from North American regulated entities. Although these came mainly from Canadian companies to begin with, the SAC should be aware that the North American industry is relatively integrated, with many cross-border investments. In particular, the industry associations that have contacted us recently represent member companies in both the US and Canada.

6. A specific standard, SFAS 71 (and subsequent modifications and interpretations), dealing with this topic exists in US GAAP. Although no similar standard exists in Canada, SFAS 71 has been widely used by analogy. Consequently, many billions of dollars of so-called 'regulatory' assets and liabilities are recognised in both countries. To the best of the staff's knowledge, no similar standard exists

elsewhere either, although it appears that in many jurisdictions entities either follow the accounting prescribed by the regulator or analogise to SFAS 71.

7. We have also received letters from analysts who specialise in covering this industry supporting the existing accounting. Thanks to Stephen Cooper, we have discussed the important factors in analysing European utilities with an industry analyst here as well.

8. Two points are especially worth noting:

- SFAS 71 does not exempt rate regulated entities from following other standards. Rather, it requires them first to follow all relevant standards and then to consider whether regulatory actions should result in the recognition of additional assets or liabilities.

- SFAS 71 was developed after the FASB completed the portion of its conceptual framework defining assets and liabilities. Thus, the FASB specifically considered the question of whether asset and liability definitions virtually identical to those in the IASB Framework were satisfied and, at that time, concluded that they were.

Staff Analysis and Recommendation

9. As noted above, the staff's analysis and recommendation that the Board add a project to provide guidance on this topic are set out in the Appendix to this paper. The staff recommended that the IFRIC not add this issue to its agenda primarily for two reasons. First, given the indications already received, it does not appear likely that the IFRIC will be able to reach a consensus on a timely basis. Second, the issue relates to at least two current Board projects – the conceptual framework and insurance contracts. A third, pragmatic but no less important, reason is that this is really a standards project not an interpretive one, similar to service concessions.

10. The staff believes that such a project could be scoped and completed on a timely basis without affecting the successful completion of the MoU projects. Much of the research is already complete and capacity is available in the IFRIC team that would not require the diversion of staff from MoU projects.

11. Our basic recommendation is to develop essentially a ‘holding’ standard, similar to IFRSs 4 and 6, until the conceptual framework elements phase is complete and the Board can consider the issue in the light of its latest thinking. However, like IFRSs 4 and 6, we envision that such a standard would significantly improve financial reporting in the interim by clearly defining those types of regulation it applies to and eliminating current practice that is clearly unacceptable. For example, in some jurisdictions rate regulated entities simply follow the accounting prescribed by the regulator rather than adopting the SFAS 71 approach. However, it is possible that the project could develop a permanent rather than interim standard. If possible, that would be a more desirable outcome and the staff would aim to achieve it.

12. The key resource is thus Board time. We recognise that this is an extremely scarce commodity especially in the current environment. However, we believe that it is possible to manage the project to minimise the Board time consumed.

13. In order for the Board to add a project to its agenda it needs to consider a complete agenda proposal and consult with the SAC on the project priority and scope. Before we devote scarce staff resources to the development of a comprehensive project proposal for consideration by the Board, we are seeking the SAC’s preliminary reactions to this recommendation.

Question for the Standards Advisory Council

14. Does the Standards Advisory Council agree with the staff recommendation that the Board should consider adding a project to its agenda to develop a standard on accounting for the effects of rate regulation?

Appendix

Agenda paper 6 for the IFRIC meeting on 6 November 2008

Title: Regulatory assets and liabilities—Staff analysis and recommendation

INTRODUCTION

1. In January 2008, the IFRIC received a request to consider whether regulated entities could or should recognise a liability (or an asset) as a result of price regulation by regulatory bodies or governments. A project plan was presented and approved at the May 2008 IFRIC meeting. At its September 2008 meeting, the IFRIC held an education session and identified several matters that warranted further analysis and discussion in the paper. At that meeting, the discussion was educational and no decisions were made.
2. The objective of this meeting is to decide whether the issue should be added to the IFRIC agenda.

STAFF ANALYSIS

3. In this paper, the staff analyse in section A the issue of whether rate-regulated entities are different from other entities. In the following sections, the staff explore the issue in the confines of the *Framework* and existing IFRSs:
   - Section B—Interpretation of the *Framework*;
   - Section C—Analysis of the intangible asset model;
   - Section D—Cost plus contract in IAS 11;
   - Section E—Cross cutting issues with other standards or current projects.

Section A—Whether rate-regulated entities are different from other entities

4. During the education session held at the September IFRIC meeting, IFRIC members discussed whether rate-regulated entities are different from or similar to other entities. The IFRIC asked the staff to identify whether distinguishing features exist.

The key role of the regulator

5. The goal of rate regulation is to set 'just and reasonable rates'. Generally, rate regulation is imposed when an entity has a monopoly or a dominant market position that gives it excessive market power. In such situations, there is a lack of effective competition to constrain the prices that the entity can charge. To compensate, governments impose rate regulation by setting up a regulatory authority and giving it jurisdiction to approve the rates of a specific entity or categories of entities (for example, electric distribution utilities). Entities falling within the jurisdiction of the regulatory authority are not allowed to charge prices other than those approved by the regulatory authority.

6. In these circumstances, the staff think it can be argued that the regulator acts on behalf of the customers who individually have no bargaining power with the utility company. Agreements between a rate-regulated entity and its customers cannot be understood without reference to the regulation in place. Therefore, it can be argued that such agreements are different from agreements between an entity and its customers in a non-regulated environment. Another view is the one adopted by the Board in its revenue recognition project when it concluded that a customer contract did not need to include all the terms of relevant regulation for them to be considered in the accounting. Thus, it can also be argued that customer contracts in regulated entities are the same as those in a non-regulated environment in that surrounding terms imposed by legislation/regulation have to be considered. In either case, the staff believe that the effect of regulation needs to be considered as part of the agreement with the customer.

Different rate-setting mechanisms

7. Some argue that the ability to charge a higher or lower price is not a differentiating feature. In fact, all entities have this ability and it does not give rise to an asset or a liability. For example, as a result of a new competitor entering the market, an entity may decide to decrease its prices and such a decision does not give rise to the recognition of a liability.

8. The staff note that regulated entities are not allowed to charge rates other than those approved by the regulatory authority. The use of higher or lower future rates to collect excess costs (or refund excess profits) is often a practical consideration given that the exact population of customers in an entity's service territory (the customer base) is changing over the time. It may also be a mechanism used by the regulator to shield customers from significant variability in rates. For example, an entity may be entitled by the regulation to collect/remit differences between actual and estimated costs from customers. The regulator may require the receivable to be collected in rates over time rather than in a separate billing immediately after the difference arises. Therefore, the staff's view is that the rate-setting mechanism is specific to the regulation and differs from pricing decisions in a non-regulated environment.

Section B—Interpretation of the *Framework*

Asset Definition

9. An asset is defined in paragraph 49 of the *Framework* as follows:

    An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

10. Regarding the issue of regulatory assets, some who do not support the recognition of regulatory assets argue that the utility does not have control over the recoverability of the future economic benefits because it does not control whether the customers will use the service.

11. The staff disagree with this argument for a number of reasons. First, the staff note that the background discussion in the current *Framework* notes that control over the future economic benefits is sufficient for an asset to exist, even in the absence of legal control. Second, during phase B of the project on the conceptual framework, the US FASB and the IASB agreed that some constituents misinterpret the term ‘control’ and use it in the same sense as that used for purposes of consolidation accounting, ie the *power* to obtain benefits. That is consistent with the manner in which control is discussed in the reporting entity phase of the joint conceptual framework project, in which the Boards have concluded that the definition of control should contain both a power element and a benefits element, together with a link between the two.

12. The conceptual framework project team think that that notion of control over an entity differs from the manner in which control is used in the definition of an asset. In many examples involving the definition of an asset, an entity will have power, as well as the ability to obtain cash inflows. For example, in the case of some economic resources owned by an entity, the entity has the power to cause cash inflows to arise from those resources either from sale or use. However, in other examples, the entity need not have the power to cause the cash inflows to arise (that is, while the power criterion is *a sufficient condition*, it is not a *necessary condition*). The key notion is that the entity has access to a resource and can limit others’ access to that resource.

13. For example, assume an entity has contractual rights to future music revenues from future recordings. The staff thinks that the entity has an asset, even though it might have no power to require future recordings to be made or, if made, to require customers to buy those recordings. So long as future recordings are made and copies sold, the entity will get cash inflows from them. In the case of established customer relationships, an entity does not have the power to force its existing customers to continue to do business with the entity but if they do, the entity will obtain future cash inflows. The entity has an asset resulting from the existing relationship between the entity and the customer that can result in future cash

inflows to the entity. The staff note that this conclusion is already reflected in accounting for business combinations.

14. For these reasons, the US FASB and the IASB agreed to remove the misunderstood notion of control and to focus the definition of an asset on whether the entity has some rights or privileged access to the economic resource.

Liability Definition

15. An liability is defined in paragraph 49 of the *Framework* as follows:

    A liability is 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.

16. Regarding the issue of regulatory liabilities, some argue that there is an obligation, arising from the arrangement with the regulator, but the existence of the obligation depends on the occurrence of uncertain future events: the future sales. If a sale is made in the future period, a rebate will, in effect, be paid. Therefore, the obligation is not a present obligation but a contingent liability that depends on the future sales.

17. The staff note that during phase B of the project on the conceptual framework, the US FASB and the IASB agreed that their respective definitions of a liability place too much emphasis on identifying both the specific past event and the future outflow of economic benefits, instead of focussing on the economic obligation that presently exists. An economic obligation is something that is capable of resulting in cash outflows *or reduced cash inflows*, directly or indirectly, alone or together with other economic obligations. Obligations link the entity with what it has to do because obligations are enforceable against the entity by legal or equivalent means.

18. Therefore the staff believe that, based on the latest IASB decisions, it could be argued that rate-regulation creates an economic obligation when an entity is obligated to decrease its future rates according to a cost-of-service regulation. However, the staff acknowledges that this view is not necessarily based on some existing interpretations of the current *Framework*.

Assets and liabilities

19. In considering whether the existence of rate regulation can result in the recognition of assets and liabilities, the staff believe that some constituents have focussed too much on the entity's transactions with individual customers. The essence of the argument that neither assets nor liabilities exist as a result of rate regulation is that both depend on the existence of future customer transactions that the entity cannot compel.

20. The staff note that IAS 37 specifically states that '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.' In the case of rate regulated entities, any asset or obligation arises in relation to a specifically identifiable group–the customer base. Although the individual members of that group may change over time, the relationship the regulator oversees is the one the entity has with the group. The cash flows the regulator monitors are those arising from transactions with the group as a whole.

21. The staff also note that, in some regulatory regimes, particularly those in which the customers are other businesses, the entity is assured by regulation that its costs will be recoverable from the group of entities that use the service. In the extreme, if only one customer utilised a gas pipeline in a year, the pipeline operator's costs would be recoverable from that one customer.

Section C—Analysis of the intangible asset model

22. Supporters of the recognition of regulatory assets argue that the analogy with IFRIC 12 *Service Concession Arrangements* is quite straightforward.

23. The staff note that paragraph 17 of IFRIC 12 states that 'the operator shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service. A right to charge users of the public service is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service.' Thus, in IFRIC 12 the IFRIC concluded that an unconditional right to receive future revenues from customers was not necessary for the operator to recognise an asset. The staff also note that the discussion in

paragraphs BC50 and BC51 suggests that the IFRIC considered contractual arrangements in which the price charged by the operator varies by regulation designed to ensure that the operator received a substantially fixed return and concluded that such arrangements would not meet the definition of a *financial* asset.

24. The staff also note paragraph BC52 states that :

> However, the IFRIC concluded that the fact that the operator's asset was low risk did not influence its classification. IAS 32 does not define financial assets by reference to the amount of risk in the return—it defines them solely by reference to the existence or absence of an unconditional contractual right to receive cash. There are other examples of licences that offer the holders of the rights predictable, low risk returns, but such licences are not regarded as giving the holder a contractual right to cash. And there are other industries in which price regulation is designed to provide the operators with substantially fixed returns—but the rights of operators in these other industries are not classified as financial assets as a result. <u>The operator's asset is a variable term licence, which would be classified as an intangible asset within the scope of IAS 38</u>. [Emphasis added]

However, in the last sentence of that paragraph, the staff's view is that the IFRIC considered the nature of the asset arising from the amount paid to construct or acquire the infrastructure and concluded that the licence was an intangible rather than financial asset. The IFRIC did not consider the effect of a future change of prices by regulation.

25. Others argue that the rate regulation does not give rise to the recognition of an intangible asset as it does not change the nature of the existing licence. First, the staff note that, in most cases, the license is not recognised as an intangible asset as it would be when it is acquired in circumstances such as IFRIC 12 or a business combination. Second, the staff's view is that the nature of the service provided under the licence may not have changed but the rates charged for that service have been altered by the regulation. The change in the amount or timing of future cash flows arising from regulation under the license affects its fair value. Because IAS 38 generally does not permit revaluation at fair value, the carrying amount of the licence would not be altered by the effect of a future change of prices by regulation. Rather, it can be argued that, in some circumstances, the effect of a future change of

prices by regulation may trigger recognition of a separate intangible asset, ie the so-called 'regulatory' assets.

26. Others also argue that the regulator may sometimes reverse a previous decision or its decision may be challenged or overturned by the government. The staff note that, in general, IFRSs account for the contractual arrangements in place at a particular time. If the terms of the arrangement subsequently change, the effects of the change are recognised in the period of the change.

Section D—Cost plus contract in IAS 11

27. At the education session held in September, an observer questioned whether an analogy with a cost plus contract could be drawn.

28. The staff note that paragraph 3 of IAS 11 defines a cost plus contract as 'a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.' Under a cost-of-service regulation, the allowable costs and the fixed return are not determined by the customers themselves but by the regulator acting on their behalf.

29. Therefore, the staff think that it could be argued that, from the perspective of the regulated entity, the contracts with the customers together with the cost-of-service regulation have, in substance, economic effects similar to cost plus contracts directly negotiated with customers in a non-regulated environment. In both environments (regulated or not), an entity has the same ability to be reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

Section E—Cross cutting issues with other standards or current project

IAS 12 Income Taxes

30. The staff note that paragraph 5 of IAS 12 states that 'temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.' Temporary differences may be either taxable temporary differences or deductible temporary differences. Paragraph 24 of IAS 12 states that 'a deferred tax asset shall be recognised for all deductible temporary

differences to the extent that it is probable that taxable profit will be available against which the deductible temporary difference can be utilised, unless…'

31. Some argue that regulatory assets and liabilities and deferred tax assets and liabilities both reflect temporary differences that are expected to reverse and therefore should follow the same accounting treatment.

Insurance contracts

32. In its Discussion Paper *Preliminary Views on Insurance Contracts*, the Board summarised its preliminary views reached in chapter 4—Policyholder behaviour, customer relationships and acquisition costs as follows:

> 173 The Board has reached the following preliminary views:
>
> (a) An insurer has an asset relating to its ability to derive net economic benefits from future premiums that the policyholder must pay to retain guaranteed insurability. Guaranteed insurability is a right that permits continued coverage without reconfirmation of the policyholder's risk profile and at a price that is contractually constrained.
>
> (b) The insurer should recognise that asset, and measure it in the same way as the related insurance liability (ie at current exit value).
>
> (c) *That asset is part of a customer relationship, not a contractual asset*. Nevertheless, the insurer should present that asset as part of the related insurance liability. The insurer need not separate that asset from the liability for recognition, measurement or presentation. (emphasis added)
>
> […]

33. The staff note that insurers cannot compel the payment of future premiums but virtually all existing models, and the Board's preliminary conclusions, would include them in either as separate contract acquisition assets or in the measurement of insurance contracts.

ASSESSMENT OF THE AGENDA CRITERIA

34. In accordance with the IFRIC's due process, IFRIC members assess the proposed agenda item against the following criteria (the issue does not have to satisfy all the criteria to qualify for the agenda):

(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.

35. The staff's view is that criteria (a), (b) and (c) are likely to be met. Rate regulation is widespread and significantly affects the economic environment of regulated entities. IFRSs do not specifically address regulatory assets and liabilities. Views are mixed (and strongly held) as to how IFRSs should apply. While divergence does not seem to be significant in practice at present, it may emerge in the future as a result of those divergent views.

36. As outlined in this paper, resolving the issue would require interpreting the definitions of assets and liabilities set out in the *Framework* and their interaction with one or more IFRSs. The staff's view is that the issue is complex and would be more efficiently resolved by the Board than by the IFRIC. This project seems to be

really a standards project not an interpretative one, similar to service concessions. Therefore, criterion (d) is unlikely to be met.

37. From the previous discussions (May and September 2008 IFRIC meetings), it seems that the views are mixed among IFRIC members as to whether regulatory assets and liabilities could or should be recognised. For that reason, the staff think it is unlikely that the IFRIC will be able to reach a consensus on a timely basis. Therefore, criterion (e) is unlikely to be met.

38. Finally, although the issue is not specifically being considered in an active Board project, it relates to more than one active Board project – insurance contracts and the conceptual framework.

STAFF RECOMMENDATION

39. The staff recommend that the IFRIC should not add this item to its agenda but should refer the issue to the Board for it to be added to the Board's agenda.