IASB Meeting Agenda reference **12**

Staff Paper Date **June 2009**

Project	**Rate-regulated Activities**
Topic	**Sweep issues reflected in the pre-ballot draft**

Purpose of the agenda paper

1. This agenda paper discusses the following matters that were identified and included in drafting the pre-ballot draft of the exposure draft on *Rate-regulated Activities* to be published in July:

   (a) recoverability of regulatory assets and impairment testing

   (b) presentation of regulatory assets associated with other assets

   (c) transition

   (d) provisions for first-time adopters.

Recoverability of regulatory assets and impairment testing

2. Given the Board's decisions that regulatory assets and regulatory liabilities should be measured at the present value of expected cash flows both on initial recognition and subsequently, a discussion of recoverability and impairment would seem unnecessary. However, the staff noted in the discussion of the scope of the project at the April 2009 meeting, SFAS 71 in the United States has a scope criterion in addition to those the Board approved. We stated our view that this consideration was more appropriately included in measurement than scope.

3. Paragraph 5 (c) of SFAS 71 includes the following criterion:

> In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

This paper has been prepared by the technical staff of the IASB for the purposes of discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper and do not purport to represent the views of any individual members of the Board or the IASB.

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4. The concern addressed by this criterion is the combined effect on an entity's rates of all the regulator's decisions with respect to the recovery of individual costs. In other words, the regulator may permit the entity to recover a variety of previously incurred costs without regard to their combined effect. However, when the total effect of those costs on future rates is considered, the entity might conclude that at the rates implied by the inclusion of those costs, its total revenue might still not cover the all the costs because of reduced demand.

5. For example, an electrical distribution utility might conclude that if all the approved costs recognised as regulatory assets are included in its rates, its prices would be so high that customers would significantly reduce consumption or switch to alternative sources of energy. So, even though the entity may be the only source of electricity in the area, it must still consider the effects of substitution.

6. The staff thinks that this is an issue that should be addressed in the standard. Therefore, in the pre-ballot draft (paragraphs 15 and 16) we included a requirement for the entity to consider the overall recoverability of regulatory assets. Because the concern is the combined effect on rates, recoverability needs to be considered for the rates set by each regulator and should include related regulatory liabilities.

7. Regulatory assets and regulatory liabilities do not generate cash flows independently of other assets – the cash flows result from providing goods or services produced by other assets. Therefore, the pre-ballot draft (paragraph 17) treats a conclusion that it is not reasonable to assume rates will generate sufficient revenue to recover net regulatory assets as an indicator of impairment. The net regulatory assets are included in the related cash-generating unit and tested for impairment in accordance with IAS 36 *Impairment of Assets.*

8. Staff also considered whether to require any impairment identified by the IAS 36 test to be allocated first to the regulatory assets. However, we concluded that there was no compelling reason to alter IAS 36's normal allocation of impairment losses to the assets in the cash-generating unit. However, there is an additional consideration relating to the interaction of the allocation of the impairment to the

regulatory assets and their measurement in periods subsequent to the recognition of the impairment.

9. This question arises because, unlike most of the other assets in the cash-generating unit, the regulatory assets are to be measured at the present value of their expected future cash flows in all periods. The assets were not impaired on an individual basis prior to their inclusion in the CGU. Simple application of the measurement requirement of the RRA standard would result in the reversal of the previously recognised impairment, and then trigger the need for the entity to reperform the IAS 36 impairment test.

10. The staff concluded that this was not a satisfactory result. Consequently, we have included a requirement (paragraph 18) for the entity to adjust the estimated cash flows of each regulatory asset to reflect any allocated impairment loss. We have also added application guidance (paragraphs B15 to B19). This guidance explains that because a regulated entity should know precisely the amount and timing when each part of its costs will be included in its rates, its impairment test ought to indicate the periods in which it expects its future cash flows to be affected by the reduced demand. This means that it can determine the value in use for each of these assets.

11. The guidance also reminds entities that the allocation of an impairment loss cannot reduce an asset below the highest of fair value less costs to sell, value in use and zero. Consequently, no impairment loss should be allocated to assets that will be recovered in periods before the cumulative effect on rates affects demand.

12. If an impairment loss is allocated to a regulatory asset, the guidance requires the entity to use the expected future cash flows determined to apply the impairment loss to measure the asset in future periods. As a result, future measurement will be affected by changes in interest rates but the amount and timing of future cash flows would not be adjusted unless the conditions that led to the impairment no longer exist.

Question 1
Based on the analysis in paragraphs 2 to 12, the staff recommends that:

(a) an entity be required to consider the overall effect of regulatory assets on future rates and its ability to generate sufficient revenue to recover them

(b) to test the cash-generating unit in which the regulatory assets are included for impairment in accordance with IAS 36 if recovery of the net regulatory assets and regulatory liabilities is not reasonably assured

(c) to allocate any impairment loss to individual regulatory assets based on the period and amount by which estimated future cash flows are affected, and

(d) in subsequent periods to use the amount and timing of the estimated cash flows used in determining the amount of the impairment loss to measure the asset.

Does the Board agree?

Presentation of regulatory assets associated with other assets

13. The Board concluded at its meeting in May that an entity should recognise a regulatory asset for amounts the regulator permits to be included in rates associated with self-constructed assets. Those amounts may relate to indirect overheads and financing costs that would not be recognised as part of property, plant and equipment in accordance with IAS 16. The issue is whether those amounts must be presented separately as regulatory assets or whether they may be included as part of the cost of the PP&E.

14. SFAS 71 paragraph 15 includes the following requirement:

> In some cases, a regulator requires an enterprise subject to its authority to capitalize, as part of the cost of plant and equipment, the cost of financing construction as financed partially by borrowings and partially by equity. A computed interest cost and a designated cost of equity funds are capitalized, and net income for the current period is increased by a corresponding amount. After the construction is completed, the resulting capitalized cost is the basis for depreciation and unrecovered investment for ratemaking purposes. In such cases, the amounts capitalized for rate-making purposes as part of the cost of acquiring the assets shall be capitalized for financial reporting purposes instead of the amount of interest that would be capitalized in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*. Those amounts shall be capitalized only if their subsequent inclusion in allowable costs for rate-making purposes is probable. The income statement shall include an item of other income, a reduction of interest expense, or both, in a manner that indicates the basis for the amount capitalized.

15. The Board made a similar accommodation with respect to complementary intangible assets in paragraph 37 of IAS 38:

> The acquirer may recognise a group of complementary intangible assets as a single asset a group of complementary intangible assets provided the individual assets in the group have similar useful lives. For example, the terms 'brand' and 'brand name' are often used as synonyms for trademarks and other marks. However, the former are general marketing terms that are typically used to refer to a group of complementary assets such as a trademark (or service mark) and its related trade name, formulas, recipes and technological expertise.

16. Some staff believes that the SFAS 71 is a reasonable cost-benefit accommodation. Amounts recognised as separate regulatory assets rather than included in the regulatory rate base as PP&E will be amortised to income using the same methods over the same useful lives as the PP&E. Those staff believe that users are mainly concerned with the total amount of PP&E the regulator will permit the entity to include in rates, rather than its component parts.

17. Other staff believe that regulatory assets and regulatory liabilities recognised as a result of this IFRS do not have the same characteristics as assets and liabilities recognised in accordance with other IFRSs. Therefore, those staff believe that all regulatory assets and regulatory liabilities should be presented separately from assets and liabilities recognised in accordance with other IFRSs.

18. The pre-ballot draft presently includes a requirement (paragraph 21) for an entity to present all the amounts the regulator permits to be included in the cost of self-constructed assets property, plant and equipment or internally generated intangible assets as a part of those assets rather than as separate regulatory assets.

Question 2
Based on the analysis in paragraphs 13 to 18, the staff recommends that an entity should be required to include all the amounts the regulator permits to be included in the cost of self-constructed assets or internally generated intangible assets as part of the related asset. Does the Board agree?

Transition

19. The staff thinks that a retrospective transition is preferableas we expect that entities will have sufficient detail in their regulatory accounts to permit them to

determine the amounts the regulator permitted/required to be included in rates. However, we believe that retrospective application would be impracticable in accordance with IAS 8 for two reasons:

(a) Although entities may have information about the amounts the regulator finally permitted/required, most entities currently using IFRSs do not account for regulatory assets and regulatory liabilities in accordance with the proposals in the exposure draft. The Board proposes requiring an entity to use a probability weighted estimate of expected future cash flows. Those probabilities would not have been determined if regulatory amounts were not recognised and estimating them for retrospective application would require the use of hindsight.

(b) As noted in the first section above, the staff proposes requiring an impairment test if it is not reasonable to assume that total future revenue will recover the entity's regulatory assets. If no regulatory amounts were recognised, no impairment test would have been performed.

20. Therefore the staff recommends the Board require prospective application from the beginning of the period in which the standard is applied.

Question 3
Based on the analysis in paragraph 19, the staff recommends that the Board require the standard to be applied prospectively to regulatory assets and regulatory liabilities existing at the beginning of the period in which it is applied. The adjustment would be to opening retained earnings at the beginning of that period. Does the Board agree?

Provisions for first-time adoption

21. The exposure draft *Additional Exemptions for First-time Adopters* published in September 2008 proposed a specific exemption for items of property, plant and equipment held for use in operations subject to rate regulation. That exemption was required because 'the carrying amount of such items sometimes includes amounts that were determined under previous GAAP but do not qualify for capitalisation in accordance with IFRSs.' The 'amounts that do not qualify' referred to in the proposal are the indirect costs and financing costs regulators permit to be included in the cost of self-constructed property, plant and equipment for rate-making purposes.

22. In May the Board discussed the responses to the September 2008 exposure draft and agreed with the staff recommendation that those responses should be taken into account in finalising this exposure draft. The project staff recommended that the definition of a rate-regulated operation should be conformed with the scope of this project.

23. In May the Board also concluded that the costs of self-constructed assets the regulator permits to be included in rates should be recognised as regulatory assets. Consequently, the only remaining issue for first-time adopters is one of presentation because amounts recognised as PP&E in accordance with previous GAAP might be required to be presented as regulatory assets in accordance with this standard. If the Board agrees with the staff recommendation in Question 2, this difficulty is also eliminated.

24. If the Board does not agree with the staff recommendation in Question 2, the staff thinks the Board should proceed to make a consequential amendment to IFRS 1 as part of this project. That amendment (a draft of which is included in Appendix C) would permit entities not to restate PP&E to recognise separately amounts that would qualify for recognition as regulatory assets. There would no longer be a need for a definition of rate regulated operations in IFRS 1 or a separate impairment test.

Question 4
Based on the analysis in paragraphs 21 to 24 and Question 2, the staff recommends that no additional exemption in IFRS 1 is necessary for first-time adopters with rate regulated activities. Does the Board agree? If not, does the Board agree with the proposed exemption in paragraph 24 (as drafted in Appendix of the pre-ballot draft)?

Other issues

Question 5
Are there any issues other than those the staff has identified in paragraph 1 that the Board wishes to discuss at the June Board meeting?