Project ***Rate-regulated Activities***

Topic **Analysis of intangible assets**

Purpose of this agenda paper

1. This paper provides an analysis of intangible assets and the application of relevant IFRSs. This analysis is prepared based on directions provided by the Board at its July 2010 meeting deliberating the *Rate-regulated Activities* (RRA) project.

2. This paper includes the following sections:

   (a) Intangible assets in accordance with IAS 38 *Intangible Assets*;

   (b) Intangible assets in the context of IFRS 3 *Business Combinations* (as revised in 2008);

   (c) Intangible assets in the context of IFRIC 12 *Service Concession Arrangements*;

   (d) Other relevant matters; and

   (e) Staff summary and recommendations.

IAS 38 *Intangible Assets*

Intangible assets in general

3. IAS 38 states, in part [emphasis added]:

   Intangible assets

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

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

Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in IASB *Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

> 9 Entities frequently <u>expend resources, or incur liabilities, on the acquisition, development, maintenance or enhancement of intangible resources</u> such as scientific or technical knowledge, design and implementation of new processes or systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles). Common examples of items encompassed by these broad headings are computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights.
>
> 10 Not all the items described in paragraph 9 meet the definition of an intangible asset, ie identifiability, control over a resource and existence of future economic benefits. <u>If an item within the scope of this Standard does not meet the definition of an intangible asset, expenditure to acquire it or generate it internally is recognised as an expense when it is incurred.</u> However, if the item is acquired in a business combination, it forms part of the goodwill recognised at the acquisition date (see paragraph 68).

4. The staff notes that a regulatory asset in the context of the RRA project is 'created' as a result of the entity incurring costs in excess of its anticipated costs used to determine the current period rates charged to customers for the sale of goods and services. That is, the excess costs are not incurred for the purpose of creating an asset for recovery in the future, but rather are incurred as part of providing the goods and services sold in the current period.

5. Paragraph 18 of IAS 38 specifies the criteria for the recognition of intangible assets:

> The recognition of an item as an intangible asset requires an entity to demonstrate that the item meets:
>
> (a) the definition of an intangible asset (see paragraphs 8–17); and
>
> (b) the recognition criteria (see paragraphs 21–23).
>
> This requirement applies to costs incurred initially to acquire or internally generate an intangible asset and those incurred subsequently to add to, replace part of, or service it.

Definition of an intangible asset

6. Paragraphs 8–17 of IAS 38 provide definitions and relevant supporting information. <u>IAS 38 defines an intangible asset as 'an identifiable non-monetary asset without physical substance.'</u> In the staff's opinion, the significant aspects of the definition are:

(a) identifiability,

(b) non-monetary, and

(c) asset.

Identifiability

7. The concept of identifiability is discussed in paragraphs 11–12 of IAS 38. An intangible asset must be identifiable to distinguish it from goodwill. Paragraph 12 of IAS 38 states [emphasis added]:

> **An asset is identifiable if it either:**
>
> **(a) is <u>separable</u>, ie is <u>capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged</u>, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or**
>
> **(b) <u>arises from contractual or other legal rights</u>, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.**

8. In the staff's opinion, a regulatory asset as considered in the RRA project does not meet the identifiability requirements. In the staff's opinion, a regulatory asset as considered in the RRA project:

   (a) does not meet the separability requirement since incremental cash flows associated with an individual rate order from a regulator cannot be 'sold, transferred, licensed, rented or exchanged'.

   (b) does not 'arise from contractual or other legal rights'. Contractual or other legal rights are an integral aspect of regulations; however, the incremental value associated with a potential increase in future cash flows is not:

      (i) a contractual right to collect that future cash flow from until the customer purchases goods and services in a future period at an increased price (at which point it will satisfy the definition of a financial asset in accordance with IAS 39/ IFRS 9. Therefore, the entity has a contingent asset based on future sales.

(ii) a new intangible asset separately acquired by the entity. Rather, it may impact the value of an existing intangible asset (that may or may not be recognised in the financial statements of the entity).

9. In the staff's opinion, the rate agreement does not give rise to the recognition of an intangible asset as it does not change the nature of the existing license. The staff notes that publicly available guidance from each of the four largest international accounting firms is consistent with the staff opinion that regulatory assets and liabilities should not be recognised in financial statements prepared in accordance with IFRSs.

10. Appendix A to this paper provides excerpts from the publicly available guidance from these firms related to the accounting for regulatory assets and liabilities.

11. More specifically, the staff notes that an approval by a regulator does not result in a new or separate cash flow stream for the entity. That is, a regulatory approval to increase (or decrease) future rates charged to customers for the sale of future goods and services is a change in the future cash flows of the existing operations/ revenue stream/ service offering, and thus a consequential change in the valuation of the license to provide goods and services to the customers in a jurisdiction. It is not a new, separable license or new, separate asset.

12. In the staff's opinion, a regulatory asset does not meet the requirement to be either separable or arising from a contractual or legal right. That is, the regulatory asset is not a new, separable intangible asset as specified in the existing requirements of IAS 38.

13. The staff acknowledges that the impact of regulators actions may impact the future probable cash flows of the entity. The staff notes that a change to current IAS 38 to permit the use of the revaluation model or other changes to IAS 38 may permit entities to recognise changes in the future economic benefits (ie probable cash flows) of intangible assets. Both of these potential changes to IAS 38 are discussed in detail later in this paper.

Non-monetary

14. The application guidance to IAS 32 *Financial Instruments: Presentation* states, in part:

> AG10 Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.
>
> AG12 Liabilities or assets that are not contractual (such as income taxes that are created as a result of statutory requirements imposed by governments) are not financial liabilities or financial assets. Accounting for income taxes is dealt with in IAS 12. Similarly, constructive obligations, as defined in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, do not arise from contracts and are not financial liabilities.

15. IAS 32 defines financial assets solely by reference to the existence or absence of an unconditional contractual right to receive cash. The staff note that the level of risk (or absence of risk) in the receipt of future economic benefits does not influence the classification of an asset as either monetary or non-monetary.

16. Additionally, the Basis for Conclusions on IFRIC 12 provides an analysis service concession rights and the determination of those rights as either financial assets or intangible assets. Appendix B to this paper provides relevant excerpts from the Basis for Conclusions on IFRIC 12. In summary, 'the IFRIC concluded that the fact that the operator's asset was low risk did not influence its classification…there are other industries in which price regulation is designed to provide the operators with substantially fixed returns–but the rights of operations in these other industries are not classified as financial assets as a result. The operator's asset is a variable term license, which would be classified as an intangible asset within the scope of IAS 38.' An analysis of the RRA project as compared to IFRIC 12 is discussed in detail later in this paper.

17. In the staff's opinion, a regulatory asset does satisfy the requirement of being a non-monetary asset.

Asset

18. Paragraph 8 of IAS 38 defines:

> An *asset* is a resource:
>
> (a) controlled by an entity as a result of past events; and
>
> (b) from which future economic benefits are expected to flow to the entity.

19. The definition of an asset in paragraph 8 of IAS 38 is consistent with the *Framework*. It is this definition that has been the centre of analysis by the staff and deliberation by the Board.

20. The staff notes the significant diversity of views that exists on whether the definition of an asset is satisfied. In the staff's opinion, the most significant point of contention is whether:

    (a) the entity 'controls' the resource and whether the entity can 'control' the inflow of future economic benefits, or

    (b) realisation of the future economic benefits in question are contingent upon future events that, while low risk and highly probable of occurrence, are not within the control of the entity.

21. The staff reminds the Board of the diversity in views on this key issue, but notes that the purpose of this paper is not to focus exclusively on the definition of an asset. A detailed analysis on whether the definition of an asset is satisfied is available in the July 2010 Board Papers 11–11I[1] (specifically, Paper 11A *Staff summary and questions for the Board* and Paper 11D *Comparison of RRA project to current IFRSs*). Rather, this paper focuses on an analysis of all requirements within the definition of an intangible asset.

Recognition criteria for an intangible asset

22. As noted in paragraph 9 of IAS 38, even presuming all requirements within the definition of an intangible asset are met, an entity is precluded

[1] Observer notes available at: http://www.ifrs.org/NR/rdonlyres/A1B77347-208A-4FD9-8265-1BEC83C7783D/0/RRAAP11to11I.zip

from recognising an intangible asset unless the recognition criteria in paragraph 21 of IAS 38 are satisfied, which states:

> **An intangible asset shall be recognised if, and only if:**
>
> **(a) it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and**
>
> **(b) the cost of the asset can be measured reliably.**

23. Paragraph 25 of IAS 38 provides guidance that an intangible asset that is separately acquired, the purchase price will normally provide evidence of the expected future economic benefits and the reliability of the costs. However, this is premised on the new acquisition of an intangible asset and not on the incurrence of additional costs related to an existing intangible asset.

24. Paragraph 30 of IAS 38 provides guidance on the treatment of costs incurred after an intangible asset is ready for its intended use. In the staff's opinion, this guidance is relevant for the incurrence of costs incurred subsequent to the acquisition by the entity of the right to operate and sell goods and services in a jurisdiction. Paragraph 30 of IAS 38 states:

> Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management. Therefore, costs incurred in using or redeploying an intangible asset are not included in the carrying amount of that asset. For example, the following costs are not included in the carrying amount of an intangible asset:
>
> (a) costs incurred while an asset capable of operating in the manner intended by management has yet to be brought into use; and
>
> (b) initial operating losses, such as those incurred while demand for the asset's output builds up.

25. In the staff's opinion, costs incurred upon initial acquisition of a new intangible asset (ie license) to operate in a jurisdiction where the entity had not previously been permitted to operate will qualify for capitalisation provided all other requirements are satisfied. However, in the staff's opinion, consistent with paragraph 30 of IAS 38 all costs incurred during the use of an existing intangible asset (ie license) do not qualify for capitalisation and should be expensed as incurred.

Other intangible asset issue

Enhancement to an existing intangible asset

26. In the context of entities with activities subject to rate-regulation, the regulatory assets in question could be seen as costs incurred to enhance an existing intangible asset. However, as noted in paragraph 11 of this paper, the nature of the intangible asset (ie the right to operate in a jurisdiction) has not changed. Regulatory assets do not result in the entity being able to operate in a new jurisdiction or the length of time the entity is permitted to operate does not change.

27. Therefore, consistent with paragraphs 68–70 of IAS 38 expenditure on an intangible item shall be recognised as an expense when it is incurred unless it forms part of the cost of the intangible asset that meets the recognition criteria (discussed earlier in this paper) or is acquired in a business combination and not separately recognised (in which case it becomes part of the goodwill at acquisition date).

Intangible assets in IFRS 3 *Business Combinations* (revised 2008)

28. Paragraphs 33–34 of IAS 38 discuss the accounting for intangible assets acquired as part of a business combination. Those paragraphs refer to IFRS 3 (revised 2008) and note the consistency between the standards in that all intangible assets are recognised provided they meet the definition of an intangible asset and are identifiable (ie separable or arising from contractual or legal rights). In the case of an acquisition through a business combination, the recognition criteria are presumed to be satisfied since the entity has paid cash or other assets to acquire the business that includes the intangible asset and therefore, the purchase price will normally provide evidence of the expected future economic benefits and the reliability of the costs.

29. In the staff's opinion, costs incurred either as part of a business combination or separately to acquire a new intangible asset (ie license) to operate in a jurisdiction where the entity had not previously been permitted

to operate may qualify for recognition in the statement of financial position provided all other requirements are satisfied.

30. However, in the staff's opinion, consistent with paragraph 30 of IAS 38 all costs incurred during the use of an existing intangible asset (ie license) do not qualify for capitalisation and should be expensed as incurred. Additionally, IAS 38 precludes the capitalisation of costs incurred in researching and developing internally generated intangible assets unless specific criteria listed in paragraph 57 of IAS 38 are satisfied.

Intangible assets in IFRIC 12 *Service Concession Arrangements*

31. In the staff's opinion, the recognition of an intangible asset at inception of a service concession arrangement is consistent with the guidance in both IAS 38 and IFRS 3. That is, consistent with paragraph 25 of IAS 38, the acquisition of an intangible asset by an entity is generally an event that supports the recognition of the costs incurred at that date.

32. Additionally, unless the revaluation model permitted in IAS 38 is selected, an entity is precluded from remeasuring an existing intangible asset and paragraph 30 of IAS 38 requires that the 'Recognition of costs in the carrying amount of an intangible asset ceases when the asset is in the condition necessary for it to be capable of operating in the manner intended by management…'

33. Therefore, IFRIC 12 requires the recognition of a newly acquired intangible asset that results from the expected future cash flows that are probable to flow to the entity as a result of entering into a new service concession arrangement with a grantor. Subsequent changes in the estimated value of the intangible asset, including additional costs incurred, are not recognised in the carrying amount of the intangible asset except for the amortisation of the intangible asset over its useful life or if the requirements of IAS 36 *Impairment of Assets* dictate the intangible asset is impaired.

34. Appendix B to this paper includes relevant excerpts of the Basis for Conclusions to IFRIC 12 that provides the Committee's rationale for

determining, in general, whether an item is an intangible asset (as compared to a financial asset).

Other relevant matters

Emissions trading schemes

35. The staff believes it is worthwhile to discuss the similarities and differences between regulatory assets in the context of the RRA project and emissions trading schemes (ETS) allowances (in a cap and trade scheme). Both regulatory assets and ETS allowances are a result of the interaction between the entity and a regulatory/ governmental entity and in both cases, the regulator provides something of value to the entity. However, in the staff's opinion, those are the only similarities between the two projects and there are several notable differences.

36. ETS allowances may be given by the government or regulator to an entity for no monetary consideration. In ETS the Board has tentatively decided that the future use of the ETS allowance will impact its valuation, but does not affect the existence of the newly acquired separable ETS allowance or recognition at acquisition of that ETS allowance.

37. Conversely, regulatory assets are increases in the future rates permitted to be charged to customers. Regulatory assets are approved (ie provided) by the regulator to capture the variances between the actual costs incurred in the current period and the costs that were estimated at the beginning of the period to occur in the period. Regulatory assets are not newly acquired assets, they are generally adjustments to an existing rights to operate in a jurisdiction and are not separable from the entity's underlying license to operate in a jurisdiction.

Extractive Activities discussion paper

38. The discussion paper *Extractive Activities* (Extractives DP) published in April 2010, includes the concept in paragraph 3.18 of the Extractives DP that 'Legal rights do not exist in isolation. Associated with legal rights is information about the property…Thus, information about a property does

not represent a separate asset but is an integral part of the legal right asset, being the right to explore for an extract minerals or oil and gas.'

39. Paragraph 3.20 of the Extractives DP notes that 'Detailed exploration and evaluation activities usually begin after the legal rights have been obtained…Over time, exploration and evaluation will provide more information, thereby reducing geological and economic uncertainty. Information that is generated during development and production will reduce this uncertainty further. Thus, the information attribute of the legal rights asset will continue to be modified.' The staff notes that the DP also includes a significant section requesting views on different measurement attributes being considered by the Board.

Use of the remeasurement model

40. In the staff's opinion, the Board could consider an amendment to IAS 38 to expand the remeasuremet model to permit remeasurement, at each reporting period, of the existing license to operate in a jurisdiction. In the staff's opinion, the Board would need to consider how this change to IAS 38 would be implemented. Currently, IAS 38 permits use of a revaluation model, but only an active market exists to obtain the fair market valuation at each reporting period.

41. Additionally, the Board would need to consider the accounting consequences of an expansion of the revaluation model including whether this change to IAS 38 will properly address the concerns of constituents who state that the recognition of regulatory assets (and liabilities) is necessary to capture the underlying economics of an entity with activities that are subject to rate-regulation.

42. If a license to operate in a rate-regulated environment is used as an example (and assuming all other accounting entries are created to account for the anticipated costs of the entity), the related accounting consequences for the unanticipated costs would be:

    (a) Day 0 – Initial recognition, at cost, of the intangible asset (license to operate) upon initial acquisition (debit) (consistent with current IAS 38).

(b) Day 1 –

  (i) Incur unanticipated costs (and anticipated costs) in the current period and account for those costs in accordance with existing IFRSs (eg fuel costs are accounted for in accordance with IAS 2 *Inventories*),

  (ii) Increase (debit) in value of the intangible asset as a result of the regulator permitting an increase in the rates charged for the future sale of goods and services in a future period (with an offsetting credit in other comprehensive income for the revaluation increase), and

  (iii) Amortisation (debit) in the statement of income of a portion of the carrying amount of the intangible asset (with a corresponding decrease in the carrying amount of the intangible asset).

(c) Day 2 –

  (i) Incur unanticipated costs (and anticipated costs) in the current period and account for those costs in accordance with existing IFRSs,

  (ii) Increased revenues charged to customers and recognised as revenue at an increased rate previously authorised by the regulator,

  (iii) Amortisation (debit) in the statement of income of a portion of the carrying amount of the intangible asset (inclusive of the increased value recognised in Day 1) (with a corresponding decrease in the carrying amount of the intangible asset), and

  (iv) no recycling from other comprehensive income to the statement of income of the revaluation increase.

43. The overall impact of the above accounting treatment would be that increases in the value of the intangible asset would be recognised directly into other comprehensive income through the revaluation reserve (and not recycled into the statement of income) while the amortisation of the entire

intangible asset would be recognised, over time, in the statement of income).

44. The staff questions whether it is appropriate to expand the potential use of multiple measurement models in IFRSs that will result in different accounting treatments for the same economic item (ie a license to operate). Additionally, in the staff's opinion, it is unlikely that many entities would use a revaluation model measurement option if permitted.

Comprehensive project to address intangible assets

45. The staff note the Research and Other Projects section of the IASB's Work Plan states:

> In December 2007 the IASB decided not to add a project on **intangible assets** to its active agenda. National standard-setters are carrying out research for a possible future project. The Australian Accounting Standards Board has published a discussion paper Initial Accounting for Internally Generated Intangible Assets.

46. The Board's decision is captured more fully in the December 2007 IASB Update that states, in part:

> ***Intangible assets***
>
> The Board decided not to add a project on intangible assets to its active agenda. The Board acknowledged the importance of addressing the accounting issues relating to intangible assets, noting concerns with current requirements that lead to inconsistent treatments for particular types of intangible assets depending on how they arise. However, the Board noted that properly addressing the accounting for intangible assets would impose a large demand on the Board's limited resources. Instead, the Board expressed a desire that the research work begun as part of the development of the agenda proposal should continue until the Board could consider it again for addition to the active agenda. Consideration will now be given to determining the scope and a process for continuing such research work.

47. The discussion paper *Initial Accounting for Internally Generated Intangible Assets*[2] published in October 2008 by the Australian Accounting Standards Board (AASB) incorporates a significant amount of additional work based on the discussions with and comments from National Standard Setter member organisations in addition to the

[2] AASB discussion paper available at:
http://www.aasb.com.au/admin/file/content105/c9/ACCDP_IGIA_10-08.pdf

information reviewed by the IASB and FASB when the IASB decided not to add an active project to its agenda.

48. Appendix C to this paper includes the Executive Summary of the AASB's Discussion Paper *Initial Accounting for Internally Generated Intangible Assets*.

49. In the staff's opinion, the AASB's discussion paper and comments received from other National Standard Setter member organisations could be utilised as a starting point to comprehensively analyse the accounting for intangible assets in accordance with IFRSs. This starting point should significantly decrease the length of time required to finalise a comprehensive project on intangible assets. This path would also result in the Board making decisions on the comprehensive project thereby ensuring consistent accounting treatment for various types of intangible assets.

50. In the staff's opinion, a comprehensive project on intangible assets could incorporate the research performed to date on related projects including *Rate-regulated Activities*, *Extractive Activities* and potentially *Emission Trading Schemes*. This would permit staff resources and Board agenda resources to be combined for efficiency. It would also permit the creation of detailed application guidance and illustrative examples specific to fact patterns common in different industries, while remaining consistent with the overall decisions reached by the Board on the comprehensive project.

Staff summary and recommendations

51. In the staff's opinion, the impact of regulators may have an economic impact on entities subject to rate-regulation. In the context of the RRA project, this impact will frequently be an increase (or decrease) in the value of an existing (recognised or unrecognised) intangible asset.

52. In the staff's opinion, regulatory assets do not meet definition of a financial asset. Additionally, in the staff's opinion, regulatory assets are not separate intangible assets, as defined in IAS 38.

Appendix A – Excerpts from International Accounting Firm Publications

A1. Deloitte *iGAAP* 2010 states, in part [emphasis added]:

> ***3.2.4 Regulatory assets***
>
> In August 2005, the IFRIC considered a request for guidance on operations subject to price regulation, specifically where a regulatory agreement allows an entity to increase its prices in future years to cover outflows of economic resources incurred in current or previous years. An example of such an agreement is set out as example 3.2.4 below.
>
> 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. The IFRIC concluded that assets should only be recognised if they qualify for recognition in accordance with the IASB's *Framework for the Preparation and Presentation of Financial Statements* and relevant Standards such as IAS 11, IAS 18, IAS 16 and IAS 38. Therefore, the determination as to whether a regulatory asset should be recognised will be based on the facts of each individual arrangement.
>
> In December 2008, the IASB decided to add to its technical agenda a project on rate regulated activities (see 14.3).
>
> **Example 3.2.4 Regulatory assets**
>
> Company X, an electricity producer, operates in Country B. Electricity producers in Country B are subject to government regulation of electricity charges. Company X has incurred operating losses in the two years ending 20X0 as a consequence of the regulatory pricing mechanism.
>
> The government of Country B subsequently approves a regulatory agreement allowing the electricity producers to increase their prices in future years to offset losses incurred for the previous two years ending 20X0.
>
> Company X should not recognise an asset and associated revenues at the end of 20X0 for the recovery of past operating losses through invoicing future consumption at higher prices. In order to recover operating losses incurred, electricity companies are required to produce electricity for their clients in the future. Even though it is arguable that electricity companies will recover the operating losses, Company X has not, at the end of 20X0, provided the service for which the customers will be paying and, therefore, the regulatory asset cannot be recognised as it does not qualify for recognition as an asset in accordance with the *Framework for the Preparation and Presentation of Financial Statements*. Moreover, customers can choose not to purchase electricity from this producer even if electricity is produced. In other words, it is not just a matter of producing electricity for clients in the future but clients purchasing electricity.
>
> Consequently, the authorisation given by the government to increase prices in the future is merely a pricing mechanism that regulates prices for the following periods, and does not give rise to an asset and additional revenue

in the current period (i.e. 20X0). The recovery of the operating loss is included in the calculation of the price the regulated entity may charge to its customers and should be recognised only when such revenues are received or receivable.

A2. Ernst & Young *International GAAP* 2010 states, in part [emphasis added]:

Chapter 15 *Intangible assets*, 3.1 Regulatory assets

In many countries the provision of utilities (e.g. water, natural gas or electricity) to consumers is regulated by the national government. Regulations differ between countries but often regulators operate a cost-plus system under which a utility is allowed to make a fixed return on investment. Similarly, a regulator may allow a utility to recoup its investment by increasing the prices over a defined period.

Consequently, the future price that a utility is allowed to charge its customers may be influenced by past cost levels and investment levels. Under a number of national GAAPs accounting practices have developed whereby an entity accounts for the effects of regulation by recognising a 'regulatory' asset (or liability) that reflects the increase (or decrease) in future prices approved by the regulator. Such 'regulatory assets' may have been classified as intangible assets under those national GAAPs.

During 2008 the IFRIC considered for a time whether regulated entities could or should recognise an asset or a liability as a result of regulation by regulatory bodies or governments. The IFRIC again decided not to add the issue to its agenda, coming to the same conclusion as before that whilst rate regulation is widespread and significantly affects the economic environment of regulated entities, there did not seem to be significant divergence in practice for entities that were already applying IFRS. The current consensus among existing IFRS reporters was that no regulatory assets or liabilities are recognised, unless they meet the definition of a financial asset or a financial liability (these arise in few regulatory regimes).

However, the IASB decided to add a project on rate-regulated activities to its agenda. The Board acknowledged that this was a matter of significant interest in a number of countries that would be adopting IFRS in the near future and where recognition of regulatory assets and liabilities was either permitted or required. In July 2009, the IASB issued an exposure draft on rate-regulated activities, which is discussed at 5.1 below.

Chapter 24 *Provisions, contingent liabilities and contingent assets*, 5.4.12 Regulatory liabilities

Under certain national GAAPs, an entity can defer benefits that would otherwise be included in profit for the period (for example, revenues) as regulatory liabilities on the basis that the regulator requires it to reduce its tariffs so as to return the amounts concerned to customers. Under IFRS, should an entity recognise a liability (or a provision) when a regulator requires the entity to reduce its future prices/revenues so as to return to customers what the regulator regards as the excess amounts collected in the current period?

No reference is made within IAS 37, or any of its examples, to this type of situation. However, we believe that under IFRS no such liabilities can be recognised since there is no present obligation relating to a past transaction or event. A liability is defined in IAS 37 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'.

The return to customers of amounts mandated by a regulator depends on future events including:

- future rendering of services
- future volumes of output (generally consisting of utilities such as water or electricity) consumed by users; and
- the continuation of regulation.

Consequently, items described as 'regulatory liabilities' do not meet the definition of a liability cited above since there needs to be a present obligation at the end of the reporting period before a liability can be recognised. Entities, in general, would recognise a liability for those items only if an obligation to refund exists as a result of past events or transactions, and regardless of future events.

This conclusion is consistent with the position in the UK. In Appendix VII to FRS 12, which discusses the development of the standard, it is noted that by basing the recognition of a provision on the existence of a present obligation, the standard rules out the recognition of any provision made simply to allocate results over more than one period or otherwise to smooth the results reported. To illustrate this, it goes on to say 'For example, in a regulated industry the results achieved in the current period may cause the pricing structure in the next period to be adjusted, e.g. the higher the profits in this year the lower the prices permitted for next year. There is no justification under the FRS for a provision to be recognised in such circumstances. The purpose of such a provision would be to transfer some of the current year's profit to the following year, which would suffer from lower prices because of the current year's profits. However, there is no present obligation that requires the transfer of economic benefits to settle it and nothing to justify recognition of a provision.'

As discussed in more detail at 3.1 in Chapter 15, the IFRIC has been asked a number of times to consider whether such regulatory liabilities should be recognised and on each occasion, the most recent being in November 2008, decided not to add the issue to its agenda, noting in particular that whilst rate regulation is widespread and significantly affects the economic environment of regulated entities, divergence did not seem to be significant in practice for entities that were already applying IFRS. The current consensus among existing IFRS reporters is that no regulatory liabilities are recognised, unless in those rare cases where they meet the definition of a financial liability.

However, in response to a request made to the November 2008 meeting of the Standards Advisory Council and discussions at its December 2008 meeting, the IASB decided to add a project on rate-regulated activities to its agenda. The Board acknowledged that while divergence in practice did not currently exist, this was a matter of significant interest in a number of

countries that would be adopting IFRS in the near future and where recognition of regulatory liabilities (and assets) was either permitted or required. The approaching conversion of these jurisdictions to IFRS would increase pressure for a definitive conclusion on the question. In July 2009, the IASB issued an exposure draft on rate-regulated activities (see 8.4 below).

A3. KPMG's *Insights into IFRSs* 2009/2010 states, in part [emphasis added]:

> ***3.3.180** Regulatory assets*
>
> **3.3.180.10** In many countries utility companies (or other entities operating in regulated industries) have contractual arrangements with the local regulator to charge a price based on a cost-plus model. Some arrangements will allow the entity to recover excess costs incurred through future price increases. Typically under such arrangements the regulator should approve the costs to be recovered based on conditions set out in the contractual arrangement. In our view, any excess cost that is incurred that may be recovered through future price increases does not qualify for recognition as an asset as it does not meet the definition of an intangible asset and there is no contractual right to receive cash or other financial assets. The legal right to increase prices in the future is not sufficient to satisfy the definition of an intangible asset because the entity does not control the customers. The customers might decide not to buy or buy less and thereby leave the entity with uncovered cost. For a discussion of regulatory liabilities, see 3.12.720.
>
> ***3.12.720** Regulatory liabilities*
>
> **3.12.720.10** In many countries utility companies, and other entities operating in regulated industries, have contractual arrangements with the local regulator to charge a price based on a cost-plus model. When costs incurred are lower than budget, some arrangements may require the regulated entity to return any "excess margin" to customers through future price decreases.
>
> **3.12.720.20** Under such arrangements the regulator specifies the reduction in future prices, generally based on conditions set out in the agreement. For example, in 2009 an electricity generator U was subject to rate regulation that limits the return on capital to six percent. Actual sales and costs resulted in U earning eight percent and U knows that under the terms of its licence it must reduce 2010 prices to achieve a target return of four percent. This expected future rate reduction is equal to 750,000 of "excess" 2009 revenue.
>
> **3.12.720.30** The question is whether a liability for the expected future rate reduction of 750,000 should be recognised in the 2009 financial statements and if yes, then what type of obligation is being recognised and measured. In our view, when the claw-back of the excess margin is contingent on future activity and sales, U has no contractual obligation to deliver cash to a third party; therefore it does not have a financial liability within the scope of IAS 32 and IAS 39. However, if U was required to pay the 750,000 to the local regulator if it stops operating, or to another entity if that entity took over U's licence, then the 750,000 would be considered a financial liability. Further, since the mechanism for "returning" current year excess revenue is a reduction in prices on future sales, U does not have a present obligation within the scope of IAS 37 and a provision would be recognised

only if U had an onerous contract, i.e., if it was obligated to provide future services at a loss.

3.12.720.40 In our view, in the circumstances described in 3.12.720.20 - .30 U also would have to consider, in preparing its 2009 financial statements, if it has satisfied the revenue recognition requirements of IAS 18 in respect of the 750,000 of excess revenue. Revenue recognition requires that the risks and rewards of ownership of goods have been transferred and that services have been rendered, and measured by the reference to the stage of completion. If an entity is required to deliver additional goods or services for monies already collected via an adjustment of the sales price, then in our view recognition of revenue related to these additional goods or services would not be appropriate. Instead the excess of 750,000 would be recognised as deferred revenue. Deferred revenue is recognised in profit or loss as the future discounted goods or services are provided. This approach is similar to the approach for multiple deliverables such as customer loyalty programmes (see 4.2.50 and .340).

3.12.720.50 For a discussion of regulatory assets, see 3.3.180.

A4. PricewaterhouseCoopers *Financial reporting in the utilities industry: International Financial Reporting Standards* (April 2008) states, in part [emphasis added]:

1.2.3 Regulatory assets & liabilities

Complete liberalisation of utilities is not practical because of the physical infrastructure required for the transmission and distribution of the commodity. Privatisation and the introduction of competition is often balanced by price regulation. Some utilities continue as monopoly suppliers with prices limited to a version of cost plus margin overseen by the regulator.

The regulatory regime is often unique to each country. The two most common types of regulation are incentive-based regulation and rate-based regulation. The regulator governing an incentive-based regulatory regime usually sets the 'allowable revenues' for a period with the intention of encouraging cost efficiency from the utility. A utility entity operating under rate-based regulation is usually permitted the recovery of an agreed level of operating costs, together with a return on assets employed.

An entity's accounting policies should take account of the regulatory regime and the requirements of IFRS. Any regulatory type asset or liability recognised under IFRS needs to be a financial asset, an intangible asset or a financial liability in its own right, as there are no special recognition requirements for regulatory assets or liabilities under IFRS.

Future price increases

A common feature of price-regulated markets is the agreement of the regulator to allow future price increases in compensation for certain identified past costs. These price increases are above those that otherwise might have been permitted by the regulator in normal cost plus calculations.

The costs associated with these price increases can be considered in two broad categories: those that are operating in nature and those that are capital. Examples of operating costs might include previously unbudgeted employee costs (for example, pension cost increases) and increased fuel costs in volatile market conditions. These costs are expensed as incurred under IFRS and included in cost of sales in the period in which the employee service is rendered or the fuel is consumed. These costs have been incurred directly in generating the power sold in that period.

Examples of capital costs include damage to fixed assets from extreme weather, such as hurricanes and ice storms, or from other unexpected and uninsured events. An impairment charge is recognised under IFRS for any damaged assets. The cost of replacement assets are capitalised as appropriate as PPE.

The regulator may grant the utility permission to add an additional charge per unit to future billings to customers. This gives rise to a financial receivable only as the power, water or gas is delivered to the customer, not when the rate agreement is reached. The rate agreement does not give rise to the recognition of an intangible asset as it does not change the nature of the existing licence. Any 'compensation' receivable through an increased future price is not recognised until that amount becomes receivable, which is when the future electricity, water, or gas is delivered. A regulatory adjustment, billable to identifiable existing customers with no further obligation to deliver services, might meet the recognition criteria as a financial asset. Few regulatory regimes allow this kind of retroactive pricing adjustment.

Future price decreases

Price regulation can also lead to the requirement from a regulator for a utility entity to reduce its prices in a future period. A decrease in prices seldom leads to the recognition of a liability, as it does not constitute a refund of past amounts collected. The benefit of reduced prices is only received by customers if they continue to purchase the commodity. This is not sufficient to cause the recognition of a liability. It might be appropriate to recognise a liability if the entity was obliged to repay cash to the customers (or perhaps to the government) or if the reduction in prices was so significant that it represented an onerous contract. An obligation to pay cash to customers or the government would be recognised as a financial liability. An onerous contract would be recognised as a provision. It is extremely rare that the recognition of a liability under IAS 39 or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* is met in the context of price regulation because the customer must purchase future services or commodity to receive the benefits.

The IFRIC has considered the topic of regulatory assets and liabilities twice; once when dealing with service concessions and a second time in response to a question about whether FAS 71 could be applied under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The IFRIC concluded on both occasions that the recognition criteria in FAS 71 were not fully consistent with IFRS and that any assets or liabilities recognised in relation to rate-regulated utilities needed to meet the normal recognition criteria in the IFRS standards.

Regulatory assets and business combinations

The acquisition of a utility in a business combination requires the recognition of all of the utility's identifiable assets and liabilities at their fair values. A utility's rights to charge a higher tariff in the future or to reduce future prices provides additional information about the value of the licence. The tariff value will usually be reflected in the fair value of the licence recognised on acquisition rather than the recognition of a separate regulatory asset.

Stranded costs

Stranded costs are a particular type of regulatory asset that are not associated with a utility's normal day-to-day operations. They arise as a result of a regulator requiring a utility to dispose of capital assets at a loss in order to achieve greater liberalisation of the utility. The loss incurred is known as a stranded cost, and typically the regulator allows the utility entity to charge a higher tariff to customers in the future in order to compensate it for the loss incurred on disposal of the capital assets. There may be unusual circumstances in which recognising such stranded costs as an asset could be justified; for example, if the entity had a substantial change to the terms of its operating licence such that it had exchanged its existing licence (an intangible asset under IAS 38) for a new operating licence.

Appendix B – Excerpts from IFRIC 12

B1. The Basis for Conclusions to IFRIC 12 states, in part:

An intangible asset (operator's cash flows are conditional on usage)

BC46 IAS 38 *Intangible Assets* defines an intangible asset as 'an identifiable non-monetary asset without physical substance'. It mentions licences as examples of intangible assets. It describes an asset as being identifiable when it arises from contractual rights.

BC47 The IFRIC concluded that the right of an operator to charge users of the public service meets the definition of an intangible asset, and therefore should be accounted for in accordance with IAS 38. In these circumstances the operator's revenue is conditional on usage and it bears the risk (demand risk) that the cash flows generated by users of the public service will not be sufficient to recover its investment.

BC48 In the absence of contractual arrangements designed to ensure that the operator receives a minimum amount (see paragraphs BC53 and BC54), the operator has no contractual right to receive cash even if receipt of the cash is highly probable. Rather, the operator has an opportunity to charge those who use the public service in the future. The operator bears the demand risk and hence its commercial return is contingent on users using the public service. The operator's asset is a licence, which would be classified as an intangible asset within the scope of IAS 38. And, as clarified in paragraph AG10 of the application guidance in IAS 32:

> Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset.

BC49 The IFRIC considered whether a right to charge users unsupported by any shortfall guarantee from the grantor could be regarded as an indirect right to receive cash arising from the contract with the grantor. It concluded that although the operator's asset might have characteristics that are similar to those of a financial asset, it would not meet the definition of a financial asset in IAS 32: the operator would not at the balance sheet date have a contractual right to receive cash from another entity. That other entity (ie the user) would still have the ability to avoid any obligation. The grantor would be passing to the operator an opportunity to charge users in future, not a present right to receive cash.

Contractual arrangements that eliminate substantially all variability in the operator's return

BC50 The IFRIC considered whether agreements incorporating contractual arrangements designed to eliminate substantially all variability in the operator's return would meet the definition of a financial asset, for example:

(a) the price charged by the operator would be varied by regulation designed to ensure that the operator received a substantially fixed return; or

(b) the operator would be permitted to collect revenues from users or the grantor until it achieved a specified return on its investment, at which point the arrangement would come to an end.

BC51 The IFRIC noted that, as a result of such contractual arrangements, the operator's return would be low risk. Only if usage were extremely low would the contractual mechanisms fail to give the operator the specified return. The likelihood of usage being that low could be remote. Commercially, the operator's return would be regarded as fixed, giving its asset many of the characteristics of a financial asset.

BC52 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. The operator's asset is a variable term licence, which would be classified as an intangible asset within the scope of IAS 38.

Appendix C – Excerpts from the AASB Discussion Paper *Initial Accounting for Internally Generated Intangible Assets*

C1. The Executive Summary of the AASB's Discussion Paper *Initial Accounting for Internally Generated Intangible Assets* states [emphasis added]:

EXECUTIVE SUMMARY

INITIAL ACCOUNTING FOR INTERNALLY GENERATED INTANGIBLE ASSETS	
Identification (Chapter 2) The manner by which an intangible item comes into existence is not relevant to the determination of whether the item can be identified as an asset. Therefore, intangible items of the same nature, irrespective of whether they are acquired in a business combination or internally generated (planned or unplanned), could be analysed in the same way for the purpose of determining whether they are assets. In particular, the principles and guidance for identifying the existence of and describing an intangible asset acquired in a business combination specified in IFRS 3 *Business Combinations* (and IAS 38 *Intangible Assets*) could be adopted for assessing whether internally generated intangible assets exist. Accordingly, a technique based on a hypothetical business combination is a possible technique for identifying internally generated intangible assets. (paragraph 66)	
Recognition (Chapter 3)	
If a cost-based model were adopted	***If a valuation-based model were adopted***
Internally generated intangible assets that satisfy the definition of an intangible asset in IAS 38/IFRS 3 should be subject to the *Framework's* recognition criteria. Accordingly, only planned internally generated intangible assets should be contemplated for recognition, on the basis that the plan identifies the unit of account and it is only those types of internally generated intangible assets that could satisfy the reliable measurement (of cost) recognition criterion. They do not warrant more specific recognition criteria, although guidance on the meaning of a 'discrete plan that is being or has been implemented to create an internally generated intangible asset' would be helpful. (paragraph 87)	Internally generated intangible assets that satisfy the definition of an intangible asset in IAS 38/IFRS 3 should be subject to the same recognition requirements for intangible assets acquired in a business combination, using a technique based on a hypothetical business combination. Accordingly, all internally generated intangible assets that would be recognised if acquired in a business combination under IFRS 3 should be recognised. While less onerous identification techniques or recognition criteria could be adopted, they have significant conceptual shortcomings. (paragraph 113)
Measurement (Chapter 4)	
If a cost-based model were adopted	***If a valuation-based model were adopted***
It is reasonable to presume that historical cost can be reliably measured for planned internally generated intangible assets from the commencement of implementing the plan up until completion or abandonment of the plan, based on the principles in IASB standards for allocating costs to other types of assets. Therefore, the attributable costs of planned internally generated intangible assets should be required to be recognised (capitalised) as an asset. A transitional period may be warranted to allow entities time to develop adequate accounting systems. Cost is not a suitable basis for measuring unplanned internally generated intangible assets because there is no basis for reliably attributing costs. (paragraph 134)	Internally generated intangible assets are capable of being reliably measured at fair value to the same degree that the IFRS 3 presumption (that the fair value of the same types of intangible assets acquired in a business combination is capable of reliable measurement) is valid. Subject to the outcome of the IASB/FASB Fair Value Measurement project, SFAS 157 *Fair Value Measurements* provides a possible basis for specifying the determination of fair value of internally generated intangible assets. Until then, IFRS 3 provides an adequate basis. (paragraph 171)
From a technical conceptual perspective, internally generated intangible assets should be required to be initially measured at fair value to enhance the decision-usefulness of financial reports. An option to adopt cost as an alternative to fair value should not be allowed. On balance, we also think that this view can be justified on practical grounds. However, we acknowledge the views of some against our conclusion. Accordingly, before our conclusion is considered for implementation, we think that further investigation of the perceived practical impediments is warranted. (paragraph 190)	

<table>
<tr><th colspan="2">Presentation/Disclosure (Chapter 5)</th></tr>
<tr><td colspan="2">The current reporting requirements in IAS 1 Presentation of Financial Statements can be applied to internally generated intangible assets, and are sufficient to facilitate the:

(a) separate presentation of internally generated intangible assets that are recognised; and
(b) disclosure of information in relation to the accounting policies adopted and judgements made by management in relation to internally generated intangible assets equivalent to the information that is required to be disclosed about other types of assets. (paragraph 203)</td></tr>
<tr><td>If a cost-based model were adopted</td><td>If a valuation-based model were adopted</td></tr>
<tr><td>The amount of costs incurred in a reporting period and recognised in the carrying amounts of internally generated intangible assets presented in the financial statements should be disclosed together with the accounting policies adopted. In response to users' comments, management's rationale for capitalisation should also be disclosed. (paragraph 214)</td><td>The methods and significant assumptions applied in determining an asset's fair value, including the extent to which the asset's fair value was determined directly by reference to observable prices or was estimated using other measurement techniques, should be disclosed. In addition, if changing one or more of the assumptions used to determine the fair value to reasonably possible alternative assumptions would change the fair value significantly, the entity should state this fact and disclose the effect of those changes. (paragraph 225)
In response to users' comments, the costs reliably attributable to an internally generated intangible asset should also be disclosed, either on an aggregate or a project-by-project basis. (paragraph 232)</td></tr>
<tr><td colspan="2">If an internally generated intangible asset does not meet the relevant recognition criteria, in the interests of providing useful information to users, entities should be required to disclose a description of the asset and the reason why the asset fails to meet the relevant recognition criteria. (paragraph 240)

Consistent with the recognition and disclosure principles in the Framework and IASB standards, disclosure is not an adequate substitute for recognition and internally generated intangible items that meet the relevant asset definition and recognition criteria should be recognised in the financial statements. While a disclosure-only approach may have some merit as a pragmatic interim step towards the adoption of a recognition-based accounting approach for internally generated intangible assets, in the interests of maximising the information content of financial statements on a timely basis, a recognition-based approach is preferred. (paragraph 258)</td></tr>
</table>