Project **Rate-regulated Activities**

Topic **Analysis of RRA disclosure requirements**

Purpose of this agenda paper

1. This paper provides an analysis of disclosure requirements related to the *Rate-regulated Activities* (RRA) project.

Staff analysis

Background

2. For decades, US GAAP has had authoritative guidance (FAS 71) specifying that entities that meet certain criteria (ie cost-of-service regulatory requirements) are required to defer costs incurred or cash receipts received in excess of the amounts included in the budget for the corresponding rate period. Likewise, Canada has introduced very similar guidance in CGAAP as have a few other jurisdictions around that world that do or have in the past looked heavily to US GAAP for guidance.

3. As part of the guidance specific to entities with rate-regulated activities, there are generally specific disclosure requirements to assist users of the general purpose financial statements in better understanding the impact of rate-regulations on the reporting entity.

4. The Board's exposure draft *Rate-regulated Activities* (RRA ED) published in July 2009 also proposed specific disclosure requirements for entities with rate-

regulated activities. Comments were received on all aspects of the RRA ED including the proposed disclosure requirements.

Future plans for the RRA project

5. In the September 2010 Board Papers 12–12D, the staff opinion is that the effects of rate-regulations are most appropriately addressed by an analysis of intangible assets (IAS 38 *Intangible Assets*) and provisions (IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*). The staff notes that the Australian Accounting Standard Board (AASB) has previously performed a significant amount of research and analysis on intangible assets. The IASB (and FASB) had last discussed whether to add an active project to its agenda in December 2007. This work by the AASB has since been supplemented by discussions and input received from various National Standard Setter members with a discussion paper published by the AASB in October 2008.

6. The staff has recommended that the Board consider the impact of rate-regulations in the broader context of 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.

RRA specific disclosures

7. While the staff believes that the economic impacts of rate-regulation should be analysed in the context of intangible assets and provisions, the staff acknowledge that the influence by a third-party to determine an entity's prices is not common to most entities. Therefore, the staff questions whether or not required RRA specific disclosures would improve the overall decision usefulness of general purpose financial statements or whether the disclosure requirements that presently exist in IFRSs are sufficient.

View 1 – Yes, RRA specific disclosures

8. Regulations, in some shape or form, impact almost all aspects of an entity's operations. However, regulations that result in a third-party determining the rates (prices) that an entity may charge to customers is not common to most entities.

9. Specific disclosures were proposed in the RRA ED. Those proposed disclosures and comments received can be reviewed and considered by the Board when finalising the RRA project to ensure the appropriate level of detail is available for the general purpose financial statement users.

10. Some of national GAAPs already specify required disclosures related to rate-regulation. Canadian GAAP is an example where entities that are subject to rate-regulation are required to provide disclosures whether or not the entity satisfies the criteria to recognise regulatory assets and liabilities. Specifically, paragraph 3 of the CICA Handbook – Accounting AcG 19 *disclosures by entities subject to rate regulation* states:

> This Guideline does not address recognition and measurement issues associated with the accounting for rate-regulated operations, and applies regardless of the accounting policies selected by an entity for its rate-regulated operations.

11. Appendix A to this paper provides the entire CICA AcG 19 guidance.

12. The impact of regulations on RRA should therefore be disclosed and specific disclosure requirements should be provided to ensure comprehensive and adequate information is provided.

View 2 – No, IFRSs currently provide sufficient disclosure requirements

13. If the Board agrees with the staff opinions that regulatory assets (and liabilities) should be considered as part of a comprehensive project on intangible assets (and the Board's projects on provisions and the Conceptual Framework), the Board may determine that specific disclosure requirements addressing RRA should be considered as part of that comprehensive project.

14. Said another way, if the Board agrees with the staff that regulatory assets should be considered in the context of intangible assets, then the current requirements (for recognition, measurement and disclosure) in IAS 38 should apply. Any intangible assets that may be created as a result of the actions of a regulator are not significantly different when comparing rate-regulation with other forms of regulation. Other examples of actions by a regulator that may impact an entity are: changes in environment licenses (emissions, permissions on drilling/ extracting), approvals for food and drugs, use of telecommunication devices and related technology (airwaves, broadband spectrum), advertising permissions and restrictions, etc.

15. In addition to the existing disclosure requirements in IAS 38, IAS 1 *Presentation of Financial Statements* already provides the following guidance that states, in part:

> 14 Many entities also present, outside the financial statements, reports and statements such as environmental reports and value added statements, particularly in industries in which environmental factors are significant and when employees are regarded as an important user group. Reports and statements presented outside financial statements are outside the scope of IFRSs.
>
> **112 The notes shall:**
>
> **(a) …**
>
> **(c) provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.**
>
> 116 An entity may present notes providing information about the basis of preparation of the financial statements and specific accounting policies as a separate section of the financial statements.

16. Therefore, if an entity may provide information it deems useful to the users of its financial statements even if not explicitly required by IFRSs. Additionally, IFRSs require that information that is relevant to an understanding of an entities financial statements must be presented somewhere within the IFRS financial statements. Because of these general permissions and requirements in IFRSs, additional required disclosures specific to the impact of rate-regulations are not considered necessary.

Staff recommendations

17. The staff believes that the Board should consider whether improvements in general purpose financial statement reporting related to the impact of rate-regulations can be achieved in the short-term.

18. The staff recommends that the Board:

    (a) finalise the current *Rate-regulated Activities* project through the issue of a final standard that requires specific disclosures on the impact of regulations on entities with activities subject to rate-regulation, and

(b) incorporate the issue of whether regulatory assets (and liabilities) exist and whether they should be recognised into a comprehensive project to review the accounting for intangible assets.

19. In the staff's opinion, the finalisation of the required disclosures could be accomplished by an amendment to add application guidance in IAS 38.

20. In the staff's opinion, the comprehensive project on intangible assets should be reconsidered in H2 2011 for addition to the Board's Work Plan.

Appendix A – Excerpts from Canadian GAAP

A1. Excerpt from the CICA Handbook – Accounting AcG 19 *disclosures by entities subject to rate regulation* that states, in part:

accounting guideline
AcG-19
disclosures by entities subject to rate regulation

This Guideline is to be read in conjunction with the Introduction to Accounting Guidelines contained in the CICA Handbook – Accounting.

May 2005 [i]*

TABLE OF CONTENTS	**Paragraph**
Purpose and scope	1
Disclosure	4
Principles	4
General information on rate regulation and its economic effects	6
Additional information on the financial statement effects of rate regulation	7
Presentation	10
Transitional provisions	11
Illustrative example	

PURPOSE AND SCOPE

1 This Guideline presents the views of the Accounting Standards Board on certain aspects of the disclosure and presentation of information in the financial statements of entities providing services or products for which customer rates are established, or subject to approval, by a regulator or a governing body empowered by statute or contract to set rates. The objective is to ensure that financial statement users are better informed about the existence, nature and effects of all forms of rate regulation.

2 The requirements in this Guideline supplement those found elsewhere in the CICA Handbook – Accounting, as they pertain to rate-regulated operations.

3 This Guideline does not address recognition and measurement issues associated with the accounting for rate-regulated operations, and applies regardless of the accounting policies selected by an entity for its rate-regulated operations.

DISCLOSURE

Principles

4 Rate regulation can affect both the revenue-generating ability of an entity and the period in which its revenues are earned, and may, in certain circumstances, result in the creation of material economic benefits and obligations. It is, therefore, an important consideration in evaluating the financial performance of entities with rate-regulated operations.

5 To meet the needs of financial statement users, entities subject to rate regulation should disclose general information facilitating an understanding of the nature and economic effects of rate regulation, as well as additional information on how rate regulation has affected the entity's financial statements. The information should be presented in such a manner as to enable a clear understanding of these effects.

General information on rate regulation and its economic effects

6 An entity subject to rate regulation should disclose general information useful to an understanding of the nature and economic effects of rate regulation, including, at a minimum, the following:

(a) the fact that the entity is subject to rate regulation, and a description of the nature and extent of the rate-regulated operations; and

(b) for each set of operations subject to a different rate-setting authority or type of regulation:

   (i) the identity of the rate-setting authority and, if it meets the definition of a related party (see RELATED PARTY TRANSACTIONS, Section 3840), a statement to this effect, together with an explanation of why this is the case; and

   (ii) the process by which the entity's rates are approved, as well as a description of the type of regulation in effect, and information providing a basic understanding of how it has been applied. For example, in the case of cost-of-service regulation, this information would include the allowed rate of return, and for performance-based regulation it would include the approved formula for rate increases and how often the formula is reviewed.

Additional information on the financial statement effects of rate regulation

(paragraph 7 deleted)

8 When rate regulation has caused an entity to account for a transaction or event differently than it would have in the absence of rate regulation, the entity should state this fact and disclose additional information about the effect on its financial statements. This information should include, at a minimum, the following:

(a) the specific financial statement items affected;

(b) for each item, how it has been reflected in the financial statements, as well as:

   (i) the rationale for this treatment, including information about either the supporting regulatory action, for example, issuance of a final rate order or approval to accumulate amounts pending final disposition at a later date (the date being disclosed, when known), or the expectations of the entity regarding future regulatory actions; and

(ii) how it would have been reflected in the absence of rate regulation;

(c) when a separate asset or liability has been recognized solely as a result of the effects of rate regulation:

(i) the carrying amount of the asset or liability, as at the most recent balance sheet date, and the balance sheet line item that includes it when it is not otherwise evident;

(ii) the income statement effect of such recognition for the current period;

(iii) the remaining period over which the carrying amount of the asset is expected to be recovered or the liability is expected to be settled;

(iv) a description of the regulatory risks and uncertainties affecting the eventual recovery of the asset or settlement of the liability and its timing, consistent with MEASUREMENT UNCERTAINTY, Section 1508; and

(v) when the regulator does not include a return on investment in the rate base for the asset during its recovery period, a statement to that effect; and

(d) when accounting for the effects of rate regulation has been discontinued since the last financial statements issued, a statement to that effect, together with the reasons for the discontinuance and identification of the rate-regulated operations affected.

9 The financial statement note providing the information required by paragraph 8(a) should make reference to any other note containing the information required by paragraphs 8(b) and 8(c).

PRESENTATION

10 Assets and liabilities, including those recognized as a result of the effects of rate regulation, should be offset only when specifically permitted or required by another Section or Guideline.

TRANSITIONAL PROVISIONS

11 This Guideline is effective for fiscal years ending on or after December 31, 2005.

12 The information to be disclosed under paragraph 8(c)(ii) is not required for comparative information for periods prior to the effective date of this Guideline.

ILLUSTRATIVE EXAMPLE

This material is illustrative only.

This example illustrates how certain of the disclosure requirements specified in this Guideline might be applied in a particular situation. Matters of principle relating to particular situations should be decided in the context of this Guideline. The example relates only to the requirements of paragraph 8 of the Guideline. It does not show the disclosures required by the remainder of the Guideline, or other disclosures required by generally accepted accounting principles. The financial statement items included in the example are particularly relevant to utilities in the gas or electricity industries. However, since the primary purpose of the example is to illustrate the extent of the disclosures required by the Guideline, and to indicate how a tabular format may be used, it has relevance for all entities subject to rate regulation.

RRO Inc.
Notes to the Consolidated Financial Statements (extract)

Note 2: Financial statement effects of rate regulation

The following describes each of the circumstances in which rate regulation affects the accounting for a transaction or event. Regulatory assets represent future revenues associated with certain costs, incurred in the current period or in prior periods, that are expected to be recovered from customers in future periods through the rate-setting process. Regulatory liabilities represent future reductions or limitations of increases in revenues associated with amounts that are expected to be refunded to customers as a result of the rate-setting process.

Regulatory assets and liability

Year ended December 31 ($ millions)	20X2	20X1	Remaining recovery / settlement period (years)
Regulatory assets			
Recoverable losses on debt retired prior to maturity	$ 11	$ 8	14-20
Recoverable storm costs (a)	5	—	5
Purchased power cost variance	—	37	N/A
Total regulatory assets	$ 16	$ 45	
	===	===	
Regulatory liability			
Purchased power cost variance	$ 26	—	1
Total regulatory liability	$ 26	—	
	===	===	

(a) The rate base does not include an allowance for a return on investment for this item.

As prescribed by a regulatory rate order, gains and losses on debt retired prior to the date of maturity are included in allowed rates on a gradual basis, over the period from the retirement date to the original maturity date of the debt. Since it is expected that the long-term application of this regulatory policy will result in these gains and losses being refunded or recovered through customer rates in their entirety, they are recognized as a regulatory liability or asset in the year the debt is retired, with a corresponding charge or credit to income. The regulatory liability or asset is amortized and included in operating results on an annuity basis over the same period as that approved for rate-setting purposes. In the absence of rate regulation, generally accepted accounting principles would require the inclusion of such gains and losses in operating results of the year in which the debt is retired. In 20X2, $3 million (20X1 — $4 million) in losses on debt retired prior to the date of maturity was recognized as a regulatory asset, and the amortization of previously capitalized amounts totalled $1 million (20X1 — $1 million). Consequently, operating results are $2 million (20X1 — $3 million) higher than would have been the case in the absence of rate regulation. The regulatory asset is presented net of accumulated amortization as at December 31, and is included in recoverable debt costs.

In 20X2, RRO Inc. incurred storm costs amounting to $5 million. The regulator has issued an order requiring the exclusion of these costs from the determination of customer rates until their final rate treatment is decided in the next rate hearing (scheduled for 20X3). The Company intends to seek, and expects to receive, approval for recovery of the costs through future rates over a five-year period commencing in 20X3. Accordingly, the costs have been recognized as a regulatory asset to be amortized over the same period. In the absence of rate regulation, generally accepted accounting principles would require that RRO Inc. include such costs in operating results of the year in which they are incurred. The regulatory asset is included in other recoverable costs.

Purchased power costs are included in allowed rates on a forecast basis. For rate-setting purposes, differences between forecast and actual purchased power costs in the rate year are held until the following year, when their final disposition is decided. RRO Inc. recognizes purchased power cost variances as a regulatory asset or liability, based on the expectation that amounts held from one year to the next for rate-setting purposes will be approved for collection from, or refund to, future customers. The regulatory liability (20X1 — asset) represents the excess of forecast over actual (20X1 — actual over forecast) purchased power costs. In the absence of rate regulation, generally accepted accounting principles would require that actual purchased power costs be recognized as an expense when incurred. In this case, operating results for 20X2 would have been $26 million higher (20X1 — $37 million lower). The regulatory liability (20X1 — asset) is included in refundable purchased power charges (20X1 — recoverable purchased power costs).

For certain of the regulatory items identified above, the expected recovery or settlement period, or likelihood of recovery or settlement, is affected by risks and uncertainties relating to the ultimate authority of the regulator in determining the item's treatment for rate-setting purposes. For example, RRO Inc.'s treatment of purchased power costs is dependent on the continued use of an automatic adjustment mechanism for regulatory purposes, and would require reconsideration if the regulator decided to discontinue the use of this mechanism or require the Company to absorb cost variances in a particular year. Similarly, there is a risk that the regulator may disallow a portion of the storm costs incurred in 20X2 for recovery through future rates, or disagree with the proposed recovery period.

Other items affected by rate regulation

The regulator permits an allowance for funds used during construction (AFUDC), based on RRO Inc.'s weighted average cost of capital, to be included in the rate base. AFUDC is also included in the cost of property, plant and equipment for financial reporting purposes, and is depreciated over future periods as part of the total cost of the related asset, based on the expectation that depreciation expense, including the AFUDC component, will be approved for inclusion in future customer rates. Since AFUDC includes not only an interest component, but also a cost-of-equity component, it exceeds the amount allowed to be capitalized in similar circumstances in the absence of rate regulation.

---

[i] * Guideline revised December 2007.