STAFF PAPER

22-23 Oct 2012

IFRS Advisory Council Meeting

Project	Rate-regulated Activities		
Paper topic	Restarting the project		
CONTACT(S)	Jane Pike	jpike@ifrs.org	+44 (0)20 7426 6925
	Michael Stewart	mstewart@ifrs.org	+44 (0)20 7426 6922

Introduction

1. In response to the Agenda Consultation feedback, the IASB, in its May 2012 meeting, supported giving priority to developing a proposal for a standards-level project for Rate-regulated Activities. Advisory Council members expressed support for this at their June 2012 meeting.

2. At its September 2012 meeting, the IASB decided that the project should focus on developing a Discussion Paper (DP) to assess whether and how the IASB should develop an IFRS (or amend existing IFRSs) to reflect the impact of rate regulation. The staff assessment is that we should aim to publish the DP in the fourth quarter of 2013.

3. However, the Agenda Consultation process highlighted that constituents are aware that developing a comprehensive standards-level proposal will take time. Consequently, the IASB has also received requests for an interim IFRS to be published for use until a comprehensive solution is developed.

4. The staff presented several alternatives for an interim IFRS to the IASB at their September 2012 meeting but at that time the staff did not ask the IASB to make a decision on this point. We have presented an updated analysis of these alternatives in this paper. At this meeting, we are seeking input from the IFRS Advisory Council in order to help us to develop a staff recommendation for the IASB as to whether we should develop an interim IFRS, or focus only on the DP.

5. The remainder of this Agenda Paper 3 covers the following areas:

   (a) Background

      (i) financial reporting issues to be addressed;

      (ii) the previous Rate-regulated Activities project; and

      (iii) why we are restarting the project with a Discussion Paper.

   (b) Requests for an interim IFRS

      (i) reasons for the requests;

      (ii) alternatives for an interim IFRS.

   (c) Questions for the Advisory Council.

   (d) Next steps.

Background

Financial reporting issues to be addressed

6. In many jurisdictions, rate regulation is imposed when an entity has a monopoly or a dominant market position that gives it excessive market power, particularly over 'essential' goods or services, such as water, electricity and other utilities. In such situations, there is a lack of competition to constrain the prices that the entity can charge. To compensate, governments impose rate regulation through a 'regulatory authority' that aims to set 'just and reasonable rates'. Generally, the rate-regulated entity is not allowed to charge prices other than those approved by the regulator.

7. The regulator can increase the rate to allow the entity to recover particular 'allowable' costs, or lower the rate to eliminate excess profits. Such rate changes are usually applied prospectively and are often designed to 'smooth' the impact of rate changes over time. Consequently, there is usually a 'time lag' between cause and effect, eg an entity may incur higher than expected costs of raw materials in the current period but cannot increase prices to reflect this until later periods.

8. Most commentators acknowledge that rate regulation has an economic impact on the timing and amount of revenue of the rate-regulated entity and that the impact

can be either positive or negative. In some jurisdictions, this impact is recognised in the financial statements of rate-regulated entities as a regulatory asset (a right to charge higher prices in the future) or as a regulatory liability (an obligation to reduce prices in the future).

9. However, some argue that the right or obligation to charge higher or lower prices in the future is not a sufficiently differentiating feature of rate regulation and so regulatory assets and regulatory liabilities should not be recognised. Such differing views were not resolved in the previous Rate-regulated Activities project.

The previous Rate-regulated Activities project

10. The IASB has previously undertaken a project to identify whether, and if so, how, an entity should reflect, in its general purpose IFRS financial statements, the impact that rate regulation has on its activities. An Exposure Draft (ED) *Rate-regulated Activities* was published in July 2009 to try to resolve this issue. This ED proposed that, in cost-of-service regimes (see paragraph 13), there are circumstances in which regulatory assets or regulatory liabilities should be recognised.

11. Respondents to the ED, as well as IASB members, expressed very divergent, and often strongly-held, views relating to the key issues above. The views expressed by preparers and users generally reflected their existing financial reporting. Little common ground was identified between the opposing views. Consequently, the project was subsequently suspended in September 2010 pending the outcome of the Agenda Consultation.

Why we are restarting the project with a DP

12. The research carried out during the previous project concluded that no significant diversity existed in practice in jurisdictions applying IFRSs: we understand that entities generally do not separately recognise regulatory assets or regulatory liabilities. However, advocates for the ability to recognise regulatory assets and regulatory liabilities continue to discuss the issue, particularly in those

jurisdictions that have (or previously had) specific local GAAP financial reporting requirements that support the recognition of regulatory assets and regulatory liabilities. Many in these jurisdictions believe that those accounting requirements are appropriate for their particular rate regulations.

13. We understand that there is a wide diversity of regulatory regimes in different jurisdictions. These range from cost-based (cost-of-service) regimes that focus on allowing the rate-regulated entity to recover particular 'allowable' costs, plus a reasonable return on those costs, through to incentive-based (price-cap) regimes that aim to encourage the rate-regulated entity to maximise efficiency to reduce costs and thereby reduce prices charged to end-users. In practice, many rate regulators use a combination of the two types of regimes.

14. Although the different regimes often lead to a similar impact on the rates that an entity can charge its customers, the differences in the regime can lead to different rights and obligations for the rate-regulated entity. Some of these rights and obligations may support the recognition of some types of assets and liabilities that are currently recognised in accordance with existing IFRSs. Changes to the rates chargeable under rate regulation may result in separate rights or obligations or may represent a change in value of existing rights or obligations.

15. However, the previous project did not include a broad debate about what types of rights and obligations in differing regulatory regimes might support the recognition of assets and liabilities. Consequently, the IASB has decided that the Rate-regulated Activities project should focus on developing a Discussion Paper as a matter of urgency.

16. A DP will enable the divergent views expressed during the previous project to be compared and analysed in a balanced way to build general acceptance of the basis for the IASB's eventual conclusions on this project. A DP would also be able to explore whether existing regulatory assets and regulatory liabilities can be analysed to identify, at a finer level, the features necessary in a regulatory regime to give rise to the rights and obligations that support the recognition of assets and liabilities.

17. In addition, the key technical issues for the *Rate-regulated Activities* project are closely interlinked with the definitions of assets and liabilities in the

Conceptual Framework. In particular, a DP for *Rate-regulated Activities* could test the definitions of assets and liabilities being developed in the *Conceptual Framework* project[1] and the staff involved with the two projects will work closely together to ensure that a consistent approach is adopted.

18. The DP would help us to:

    (a) confirm our preliminary understanding of users' information needs with respect to rate regulation;

    (b) determine the scope of a future IFRS (if it is decided that an IFRS is needed);

    (c) identify, across a range of common regulatory regimes, the differentiating features of rate regulation, ie the nature of the rights and obligations generated by rate regulations;

    (d) determine whether those rights and obligations give rise to regulatory assets and regulatory liabilities (ie do they meet the definitions of assets and liabilities in the *Conceptual Framework*?);

    (e) identify the broad accounting model (or models) that should be applied to the recognition and measurement of regulatory assets/liabilities (if they are determined to exist within the definitions in the *Conceptual Framework*); and

    (f) identify the main disclosure needs.

Requests for an interim IFRS

19. The staff think that the additional research required can be completed expeditiously and that an ambitious but realistic target for the publication of a comprehensive DP exploring the key issues is late Q3/early Q4 2013. This is subject to the interaction with the *Conceptual Framework* project and to an assumption that resources are not redirected towards developing an interim IFRS.

[1] At its meeting in September 2012, the IASB agreed that the staff should begin to develop material for a Discussion Paper that will cover the chapters that were not completed in the previous *Conceptual Framework* project, including 'Elements'. The IASB plans to begin discussing that material in early 2013 and to publish the Discussion Paper in the first half of 2013. The IASB should complete the project by September 2015.

20. However, we think that the diversity in existing views will require more time to reconcile. Even if the comments received on the DP turn out to identify a reasonable level of agreement on a way forward, further guidance, in whatever form it may take (eg a *Rate-regulated Activities* IFRS, amendments to other IFRSs or a conclusion that no specific requirements need to be developed), will need to be the subject of our normal due process.

21. Consequently, we would not expect to issue a final Standard until 2016, because of the cross-cutting nature of the issues. We are therefore considering requests to act more urgently to develop an interim IFRS.

22. As noted in paragraph 12, we understand that generally, regulatory assets and regulatory liabilities are not separately recognised in jurisdictions that currently use IFRSs. Historically, first-time adopters that previously recognised such assets and liabilities decided, albeit reluctantly, to write off the balances of regulatory assets and regulatory liabilities on transition to IFRSs. This seems to have been the general approach adopted most recently in Brazil, where listed companies were required to report using IFRSs from 2010.

23. However, we are told that the issue of the July 2009 ED (which indicated that regulatory assets and regulatory liabilities could be recognised within the IFRS Conceptual Framework) and the IASB's subsequent delay in resolving the issue (the previous project was suspended in September 2010), has contributed to the uncertainty that exists as a result of the lack of explicit guidance in IFRSs.

24. This uncertainty is seen by some to be a barrier to adoption of IFRSs in jurisdictions where rate-regulated entities are reluctant to eliminate existing balances of regulatory assets/liabilities. For example, a guidance note based on the July 2009 ED has recently been issued to clarify the accounting permitted for rate-regulated activities in accordance with Indian GAAP. In addition, we understand that only a small number of rate-regulated entities in the Canadian utilities sector are making the transition to IFRSs because securities regulators currently permit financial statements to be filed using alternative GAAPs, eg some

entities are applying the permitted deferral of transition to IFRSs[2] and retaining pre-changeover Canadian GAAP while others are choosing to apply US GAAP[3].

25. This lack of guidance and diversity in practice prompted some respondents to the Agenda Consultation and the related outreach activities to request that some guidance should be provided more quickly in the form of an interim IFRS. Consequently, the staff set out some options for such an interim IFRS and some benefits and disadvantages of each one (see paragraphs 27-46).

26. We are not seeking a decision from the Advisory Council at this meeting but are seeking views and advice on what factors the IASB should prioritise in making their decision whether to issue an interim IFRS and, if so, what type of interim IFRS. This will help develop a staff recommendation to present to the IASB later this year. Some questions for the Advisory Council to consider are set out in paragraph 47.

Alternatives for an interim IFRS

27. The options identified are:

(a) set disclosure-only requirements;

(b) allow IFRS 6-style 'grandfathering' of existing accounting policies;

(c) allow 'grandfathering' of existing accounting policies but with restrictions, either

(i) require the use of existing national GAAP; or

(ii) isolate the impact of regulatory amounts;

---

2 In early September 2012, the Canadian Accounting Standards Board (AcSB) decided to extend the existing deferral of the mandatory IFRS changeover date for entities with qualifying rate-regulated activities by a further year to 1 January 2014. The AcSB said it would monitor future developments and consider the need for a further deferral should an interim solution not occur within a year, but remain a possibility. This is the case, given recent statements the IASB has made publicly about the priority it intends to give rate-regulated activities when setting its future agenda. The AcSB believe that those discussions suggest an increased possibility that the IASB may:

- address rate-regulated activities as part of its future agenda; and
- develop interim guidance in the meantime that, in effect, would allow the continuation of accounting practices in accordance with pre-changeover standards in Part V of the Handbook.

The AcSB decided it was better to end stakeholder uncertainty about a further extension now, than to wait until closer to the end of 2012 to do so.

3 Entities that are SEC-registered are permitted to file US GAAP financial statements with the Canadian Securities Administrators (CSA). Other entities have been granted, on a case-by-case basis, permission from the CSA to defer transition to IFRSs until 2015 and instead file US GAAP financial statements.

(d) allow 'grandfathering' of existing accounting policies for first-time adopters and, for existing IFRS preparers, the reinstatement of previously-used policies that were eliminated on transition to IFRSs; or

(e) establish specified accounting requirements.

28. The development of any interim IFRS will divert both staff and IASB resources away from the Discussion Paper and so may delay the publication of that due process document. The extent of any delay will depend on the type of interim IFRS to be developed (if the IASB decides to develop such an interim IFRS). Alternatives (a)-(c)(i) in paragraph 27 could be developed reasonably quickly but are unlikely to reduce the current diversity seen, for example, in Canada. In addition, it might raise new uncertainties about whether existing IFRS preparers could or could not recognise 'regulatory assets' or 'regulatory liabilities'.

29. Alternatives (c)(ii)-(e) are more complex and would take longer to develop. Although this could reduce some diversity on transition to IFRSs, alternatives (c)(ii)-(d) may result in introducing diversity in practice among entities currently using IFRSs. In addition, these alternatives could result in some entities having to implement a major change to their current accounting for rate-regulated activities, potentially followed by another change when the IASB completes the main Rate-regulated Activities project.

30. A further issue to consider is whether any interim IFRS (other than a disclosure-only IFRS) should be targeted at first-time adopters only. An IFRS 6-style 'grandfathering' option (alternatives (b)-(c) in paragraph 27) would focus on entities that currently recognise regulatory assets/liabilities, allowing them to continue to do so. This could create diversity with those entities currently applying IFRSs in practice. Consequently, alternatives (d)-(e) could be designed to allow entities that do not currently recognise regulatory assets/liabilities to (re)commence recognising them. However, this pre-empts the outcome of the current project and so may again result in some entities implementing a major change to their current accounting for rate-regulated activities, followed by another change when the IASB completes the main Rate-regulated Activities project.

31. The following paragraphs set out some further advantages/disadvantages of the various alternatives identified, which can be summarised as follows:

Alternative in paragraph 27	**Advantages**	**Disadvantages**
a) Disclosure only	• Quick to develop • Improves consistency of disclosure	• Doesn't address the fundamental issue
b) IFRS 6 grandfathering of existing policies	• Quick to develop • May reduce barrier to adoption of IFRS	• Introduces diversity into IFRS practice • May unfairly disadvantage entities that eliminated regulatory assets/liabilities when making the transition to IFRSs
c) (i) grandfathering of national GAAP	• As b) above	• As b) above
c) (ii) grandfathering with isolation of impact	• Reduces the diversity introduced into IFRS by isolating the impact into a single line item	• Time and resources to develop may delay the main project • Introduces major change to accounting by first-time adopters • May unfairly disadvantage entities that eliminated regulatory assets/liabilities when making the transition to IFRSs
d) grandfathering of existing and previous policies	• Reduces unfair disadvantage for entities that eliminated	• Time and resources to develop could significantly delay the main project • Introduces diversity into IFRS practice

	regulatory assets/liabilities when making the transition to IFRSs	• Creates confusion with reversal of previous policy change, which may be followed by another change when main project is completed
e) specified requirements	• Reduces the diversity introduced into IFRS practice	• Time and resources to develop could significantly delay the main project • May introduce major change to accounting for some first-time adopters and existing IFRS preparers, which may be followed by another change when main project is completed

A disclosure-only IFRS (alternative (a) in paragraph 27)

32. A disclosure-only IFRS would provide users with more consistent, transparent and relevant information to enable them to better understand the potential impact of rate regulation on the activities of an entity. The scope of any such IFRS could be wide and capture a range of different rate regulations.

33. We understand that regulatory assets or regulatory liabilities are generally not currently recognised in jurisdictions that have already adopted IFRS and there are currently no specific disclosure requirements within IFRS for the impact of rate-regulated activities. Consequently, an interim, disclosure-only IFRS could potentially have a broad impact on existing IFRS preparers, aiding consistency in disclosures.

34. An Exposure Draft of such an interim IFRS could be developed quickly, with limited resources. We understand that Canadian disclosure requirements work well in practice. These requirements are similar to those proposed in the July 2009 ED and so could be used as a starting-point for developing a new ED.

35. However, a disclosure-only IFRS would not address the underlying issue as to whether regulatory assets/liabilities can or should be recognised in IFRS financial statements.

IFRS 6-style 'grandfathering' of existing accounting policies (alternative (b) in paragraph 27)

36. Paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* specify a hierarchy of criteria that an entity should use in developing an accounting policy if no IFRS applies specifically to an item. IFRS 6 provides an exemption from part of that hierarchy.

37. The purpose of this exemption was to allow an entity adopting IFRSs to continue to apply its existing accounting policy for the exploration for, and evaluation of, mineral resources, subject to some limited improvements. This avoided disruption to users (eg lack of continuity of trend data) and preparers (eg systems changes).

38. Developing an IFRS 6-style interim IFRS for rate-regulated activities would assist rate-regulated entities to adopt and state compliance with IFRSs in jurisdictions that have not yet adopted IFRSs. However, this 'grandfathering' of existing practices would not address the diversity of practices currently used in those countries. Instead, it would create new diversity in the application of IFRSs by incorporating policies from different previous GAAPs.

'Grandfathering' of existing accounting policies with restrictions (alternative (c) in paragraph 27)

39. The IASB could introduce some limitations on the choices available to entities making the transition to IFRSs and using an interim IFRS for rate-regulated activities. Such limitations could help to reduce some of the diversity of practices currently used in those countries and would reduce the impact of the new diversity in the application of IFRSs that will be introduced by permitting 'grandfathering' of alternative policies.

40. We have identified two alternative types of restriction that might help:

    (i) require the use of existing national GAAP; or

    (ii) isolate the impact of regulatory amounts.

A national-GAAP 'grandfathering' option (alternative (c)(i) in paragraph 27)

41. An interim IFRS could allow rate-regulated entities to apply existing national accounting requirements (national GAAP) where the national GAAP has been accepted by the local standard-setter, securities regulator or similar body and allows the recognition of regulatory assets/liabilities. However, the IASB has previously considered and rejected this approach because defining 'national GAAP' is problematic and some entities do not apply the national GAAP of their own country.

A 'grandfathering' option that isolates the impact of regulatory assets/liabilities (alternative (c)(ii) in paragraph 27)

42. We understand that national GAAP for rate-regulated activities in some jurisdictions is based on US GAAP. This generally allows entities in a cost-of-service regulatory regime to not only recognise separate regulatory assets/liabilities but to also capitalise regulatory costs into property, plant and equipment (PPE) that would not be permitted to be capitalised in accordance with IAS 16 *Property, Plant and Equipment*, and to modify the accounting for other items such as income tax and employee benefits to reflect amounts that the rate regulator takes into account in setting rates. An interim IFRS could give the IASB an opportunity to require limited modifications to accounting policies used in accordance with local GAAP. Such modifications could require all line items in the financial statements (including PPE, income tax and employee benefits) to be recognised and measured in accordance with existing IFRSs, with the impact of rate regulation being isolated into a separate regulatory asset or regulatory liability.

43. This solution would allow users of the financial statements to better compare those entities that currently do not recognise regulatory assets/liabilities with those entities that might make the transition to IFRS using such an interim IFRS. However, this approach would require many entities making the transition to IFRSs to implement a major change to their current accounting for rate-regulated activities, which may be followed by another change when the IASB completes the current Rate-regulated Activities project.

'Grandfathering' of existing accounting policies and reinstatement of previously-used policies that were eliminated on transition to IFRSs; (alternative (d) in paragraph 27)

44. If an interim standard only allows grandfathering of existing practices, some entities that have already transitioned to IFRSs might feel unfairly disadvantaged, if they have already given up their previous GAAP practices when they made the transition to IFRSs. Consequently, the alternatives in paragraph 27(c) could be modified to allow entities that do not currently recognise such assets/liabilities to (re)commence recognising them using their previous local GAAP or the accounting policies that they used immediately before eliminating their regulatory assets/liabilities on transition to IFRS.

45. However, this approach risks generating greater diversity. Alternatives could include restricting entities that would be permitted to recognise regulatory assets/liabilities to those that are either making the transition to IFRSs or that have done so in the recent past (eg since the publication of the IASB's July 2009 *Rate-regulated Activities* ED). However, this may create additional confusion if entities that have recently eliminated regulatory asset/liability balances on transition were to reinstate them, only for potentially another major change to their accounting for rate-regulated activities to be required when the IASB completes the main Rate-regulated Activities project.

An interim IFRS with specified accounting requirements (alternative (e) in paragraph 27)

46. Some participants in the Agenda Consultation round-table discussions held earlier in 2012 suggested developing an interim IFRS based on the requirements of a particular existing national GAAP relating to rate-regulated activities. Several countries currently have requirements to recognise regulatory assets and regulatory liabilities, such as the USA, Canada and India. Developing an interim IFRS based on a particular country's existing requirements would have the advantage of better comparability across entities using that interim IFRS. However, this has some disadvantages, including:

    (a) the scope of the interim IFRS would need to be carefully defined, which would require consideration not only of the different types of rate regulation that it would apply to, but also whether it would apply only to those rate-regulated entities that currently recognise regulatory assets or regulatory liabilities in accordance with their current GAAP or whether it should also apply to existing IFRS preparers;

(b) substantial time would be required from IASB members and staff to analyse and evaluate the existing requirements in different jurisdictions, to identify whether a particular one is considered more appropriate than another when compared to the current IFRS *Conceptual Framework* or IAS 8 hierarchy for selecting an accounting policy. This work would be used as part of the development of the DP but may be seen as pre-empting the outcome of the more comprehensive Rate-regulated Activities project and would significantly delay the completion of that project; and

(c) for those entities that are not currently using the methodology selected, a change in accounting policies would be required that might be followed by another change, once the IASB's standards-level project on rate-regulated activities is completed.

Questions for the Advisory Council

47. The IASB has decided to prioritise work to address rate-regulated activities. It has committed to developing a DP in the short-term. The project is intended to address concerns that the current absence of specific IFRS guidance for accounting for such activities may be a barrier to adoption of IFRSs or may lead to diversity of accounting in practice. The IASB has been asked to issue an interim IFRS in the shorter term and this paper highlights several alternatives for such an interim IFRS. We are seeking the views of the Advisory Council on what factors the IASB should prioritise in making their decision whether to develop an interim IFRS and, if so, what type of interim IFRS?

Questions for the IFRS Advisory Council

What comments or advice do you have on the alternatives for developing an interim IFRS to permit the recognition of regulatory assets and regulatory liabilities until such time as the IASB completes its main project on Rate-regulated Activities? For example:

(a) What do you see as the consequences (positive or negative) of not issuing an interim IFRS?

(b) Some of the alternatives identified for an interim IFRS may introduce diversity in practice within IFRS reporting. What mitigating factors should the IASB consider against the potential diversity in practice?

(c) Issuing an interim IFRS that mandates a specific basis for accounting for rate-regulated activities may reduce the risk of diversity in practice but will take longer to develop and introduces the risk that some entities will face two changes in accounting policies (both on adoption of the interim IFRS and potentially again when the comprehensive project is completed). How should the IASB prioritise between consistency of application and timeliness of issuing comprehensive guidance?

(d) If you think that the IASB should issue an interim IFRS, which features of the alternatives presented in paragraph 27 do you think the IASB should prioritise?

(e) Are there any other issues that the IASB should consider in making their decision as to whether to develop an interim IFRS and, if so, what type of IFRS?

Next steps

48. IASB staff will incorporate your advice into their recommendations and initial plan for this project. This will be presented to the IASB at a future meeting in 2012.