STAFF PAPER

24 October 2012

Prepared for Capital Markets Advisory Committee Meeting

Project	**Rate-regulated Activities**		
Paper topic	Restarting the project		
CONTACT(S)	Jane pike	jpike@ifrs.org	+44 (0)20 7246 6425

This paper has been prepared by staff of the IFRS Foundation. The views expressed in this paper reflect the individual views of the author[s] and not those of the IASB or the IFRS Foundation. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs.

Purpose

1. The IASB has recently restarted a project to undertake comprehensive research resulting in a Discussion Paper to establish how rate-regulated activities should be reflected in IFRS financial statements. The purpose of this paper is to solicit CMAC members' views on the current accounting for rate-regulated activities as part of the research phase of that project.

Background

2. 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.

3. 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.

4. The IASB, in July 2009, issued an Exposure Draft (ED) *Rate-regulated Activities*. This ED proposed that, in cost-of-service regimes, there are circumstances in which regulatory assets or regulatory liabilities should be recognised. 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.

Overview

5. 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.

6. 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 for existing rights or obligations.

7. We understand that no significant diversity exists in practice in jurisdictions applying IFRSs: we understand that entities generally do not separately recognise regulatory assets or regulatory liabilities. 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.

8. However, in some jurisdictions that have not yet adopted IFRSs, entities with rate-regulated activities are permitted or required to recognise regulatory assets and regulatory liabilities. In some cases, the amounts reported for other line items in the financial statements (eg property, plant and equipment, employee benefits and income taxes) are also adjusted to more closely reflect the amounts that are used by the rate regulator in setting future prices.

Questions for CMAC

Question 1: Current accounting in IFRS financial statements
We understand that entities generally do not separately recognise regulatory assets or regulatory liabilities in IFRS financial statements. Is this understanding consistent with your experience? If not, can you identify any trends in the recognition of such regulatory assets/liabilities; eg is recognition concentrated in a specific geographical area or industry sector?

Question 2: Comparing rate-regulated entities
Some jurisdictions explicitly permit or require rate-regulated entities to separately recognise regulatory assets/liabilities in their financial statements. What adjustments, if any, do users make when comparing rate-regulated entities in these jurisdictions with similar entities in jurisdictions that use IFRSs and that do not recognise regulatory assets/liabilities? What information is needed to make any such adjustments? Is the information provided in the financial statements? If not, where is it provided?

Question 3: Information provided about the rate regulation regime
Many types of rate-regulation exist, ranging from cost-based (cost-of-service) through to incentive-based (price cap), with many hybrid regimes that use a combination of these two types. What information is available to users to help them understand the economic impact of the specific rate regulation that an entity is subject to? How do users obtain this information? What changes would users like to see to the information that they are provided with, both in terms of content and how it is presented (eg amounts recognised in the financial statements vs disclosed in the notes to the financial statements vs disclosed in management commentary)?