STAFF PAPER

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Project	**Rate-regulated Activities**		
Paper topic	Interim Standard: Sweep issues		
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Introduction

1. In January 2013, the IASB discussed the proposed interim Standard for Rate-regulated Activities and made decisions on the detailed proposals for its technical content.

2. We have started to draft the proposed interim Standard to reflect the IASB's decisions to date, but we have identified some issues that we think would benefit from added clarity, which might require consequential amendments to other Standards or might require application paragraphs to be included in the proposed interim Standard.

3. The purpose of this paper is to identify these application issues and to ask the IASB to decide whether to include authoritative application guidance in the proposed interim Standard or make consequential amendments to other Standards, as appropriate.

4. In particular, we recommend that:

   (a) when the earnings per share (EPS) ratio is provided (either voluntarily or because it is required by IAS 33 *Earnings Per Share*), that the earnings amount used should exclude regulatory items;

   (b) any amounts presented separately in the primary statements for discontinued operations or disposal groups, in accordance with

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, should exclude regulatory items;

(c) although the entity's previous local GAAP impairment policy should apply to the regulatory deferral account balances, the normal IAS 36 *Impairment of Assets* impairment test and loss allocation should apply to any cash-generating unit that contains regulatory items;

(d) the regulatory balances recognised should not be subject to the requirements of IAS 12 *Income Taxes* to recognise deferred tax; and

(e) the normal requirements of IFRS should apply to the regulatory deferral account balances, unless otherwise specified, and the [draft] interim Standard should include brief application guidance to clarify this.

Application of IAS 33 *Earnings per Share*

Background

5. In January 2013, the IASB decided that the regulatory deferral account balances recognised in accordance with the proposed interim Standard should be presented separately in the statement of financial position. Movements in those balances should be presented separately in the statement of profit or loss and other comprehensive income, immediately below an appropriate subtotal for 'profit (or loss) before taxation and regulatory amounts'.

6. This will isolate the impact of recognising these balances in such a way that users should be able to identify 'at a glance' the comparable amounts for all line items that are recognised, measured and presented in accordance with other Standards. This should improve comparability between those rate-regulated entities that currently do not recognise regulatory deferral account balances in financial statements and those that will be allowed to do so in accordance with the [draft] interim Standard.

7. We have considered the impact of this separate presentation in the profit or loss statement on the requirements of IAS 33 *Earning per Share*. Paragraph 9 of IAS 33 requires that an entity

> "shall calculate basic earnings per share amounts for profit or loss attributable to ordinary equity holders of the parent entity and, if presented, profit or loss from continuing operations attributable to those equity holders"[1].

8. The illustrative examples to IAS 1 *Presentation of Financial Statements* show that the profit or loss attributable to ordinary equity holders of the parent entity is the net profit after taxation, as presented in the profit or loss section of the statement of profit or loss and other comprehensive income or in the separate statement of profit or loss. The position of this subtotal means that the amount used for earnings in the IAS 33 earnings per share (EPS) ratio will include the net movement on the regulatory deferral account balances.

9. Consequently, the transparency and comparability achieved by the decision outlined in paragraph 6 above would be lost within the earning per share ratio required to be presented in accordance with IAS 33.

Staff recommendation

10. We recommend that entities that present regulatory deferral account balances in accordance with the [draft] interim Standard should be required to exclude the movement on those balances from the earning figure used to calculate earnings per share in accordance with paragraph 9 (and paragraph 30) of IAS 33.

11. If an entity wishes to disclose EPS including the regulatory line item, in addition to the basic and diluted earnings per share excluding the regulatory line item as recommended, they may do so in accordance with paragraph 73 of IAS 33[2].

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[1] Paragraph 30 of IAS 33 requires diluted earnings per share to be calculated using the same profit or loss amount, which is then adjusted for the effects of dilutive potential ordinary shares.

[2] Paragraph 73 of IAS 33 states: "If an entity discloses, in addition to basic and diluted earnings per share, amounts per share using a reported component of the statement of comprehensive income other than one required by this Standard, such amounts shall be calculated using the weighted average number of ordinary shares determined in accordance with this Standard. Basic and diluted amounts per share relating to such a component shall be disclosed with equal prominence and presented in the notes. An entity shall indicate the basis on which the numerator(s) is (are) determined, including whether amounts per share are before tax or after tax. . . . . "

Questions for the IASB

Question 1: Earnings per share
Do you agree with the staff's recommendation to require that the earnings amount used to present the basic and diluted earnings per share ratio in accordance with IAS 33 should exclude the regulatory deferral account movement line item?

Application of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*

Background

12. A similar issue to that noted for IAS 33 above arises when considering whether the relevant regulatory deferral account balances should be included in any discontinued operations or disposal group presented separately in accordance with IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*.

13. We think that there are two aspects of this question to consider:

    (a) should the regulatory deferral account balances be measured in accordance with IFRS 5; and

    (b) should the regulatory deferral account balances that have been recognised and that relate to the discontinued operations or disposal group remain in the separate line items for regulatory items, or should they be reclassified to be included in the amounts presented in accordance with IFRS 5?

14. Paragraph 5 of IFRS 5 contains a list of items for which the measurement provisions of IFRS 5 do not apply because they are dealt with in other Standards. We think that regulatory deferral account balances should also be excluded from the measurement provisions of IFRS 5 for the same reason. This is consistent with the decisions made to grandfather existing local GAAP accounting policies for recognition, measurement and impairment of the regulatory balances.

15. Although we can see some justification for reclassifying amounts for the regulatory line items to the discontinued operations/disposal group line items, we think that this goes against the IASB's decision to isolate the impact of recognising regulatory balances from all other items recognised in accordance with other Standards.

16. In addition, IFRS 5 already requires additional disclosure and analysis[3] of the amounts presented. We think that this, together with the disclosures proposed in the [draft] interim Standard, should provide the information that users need to understand the impact of the discontinued operations or disposal groups. At the same time, they will still have 'at-a-glance' access to amounts related to discontinued operations and disposal groups, which will be directly comparable with the amounts for entities that do not recognise regulatory deferral account balances.

Staff recommendation

17. We recommend that entities that present regulatory deferral account balances in accordance with the [draft] interim Standard should not apply the measurement provisions of IFRS 5 to those balances.

18. In addition, we recommend that the regulatory deferral account balances relating to any discontinued operations or disposal group should continue to be presented within the separate line item for regulatory items, without being reclassified to the discontinued operations or disposal group amounts presented in the primary statements.

19. However, we also recommend that the amount of the regulatory deferral account balances relating to any discontinued operations or disposal group should be disclosed as part of the analysis already required by IFRS 5.

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[3] IFRS 5, paragraph 33 requires the single line item amount relating to discontinued operations to be analysed into components, including revenues, expenses, pre-tax profit or loss, taxation, gain or loss on remeasurement to fair value less costs to sell. Disclosure is also required of the net cash flows attributable to discontinued operations.

IFRS 5, paragraph 38 requires the separate line item amounts for assets held for sale or for disposal groups to be analysed into components, based on major classes of assets and liabilities. Paragraph 41 requires disclosure of narrative information and the amount of any gain or loss recognised.

Questions for the IASB

Question 2: Discontinued operations and disposal groups
(a) Do you agree with the staff's recommendation that the measurement provisions of IFRS 5 should not apply to regulatory deferral account balances?
(b) Do you agree with the staff's recommendation that the regulatory deferral account balances relating to any discontinued operations or disposal group should continue to be presented within the separate line item for regulatory items, without reclassification?
(c) Do you agree with the staff's recommendation to require disclosure of such amounts as part of the analysis already required by IFRS 5?

Recoverability/Impairment

Background

20. In January 2013, the IASB decided that an entity can continue to apply its existing local GAAP accounting policy for the assessment and measurement of any impairment of its regulatory deferral account balances. This is consistent with the IASB's decision to allow an entity to grandfather its existing local GAAP accounting policies for recognition and measurement of such regulatory balances.

21. In reaching this decision, the IASB considered the unique nature of the regulatory balances, and the uncertainty as to whether they are assets (or liabilities), and if so, what is the nature of any asset (or liability). Consequently, some members of the IASB argued that it was inappropriate to set specific requirements for impairment of the regulatory balances, without also establishing the initial and subsequent measurement basis for them. Establishing the appropriate measurement basis is outside the scope of this phase of the Rate-regulated Activities project, and will be considered in the main research project. One of the aims of the main project is to identify the nature of any assets or liabilities that might be established through rate regulation.

22. We agree with the IASB's conclusion that IAS 36 should not apply directly to the regulatory deferral account balances that have been recognised. However, we have subsequently been asked for guidance on how to apply IAS 36 to a cash-generating unit (CGU) containing rate-regulated activities, when IAS 36 requires that CGU to be tested for impairment. This test may be required because the CGU also contains goodwill or because one or more of the impairment indicators described in IAS 36 have been identified.

23. Paragraphs 74-79 of IAS 36 contain guidance about the required method for identifying the recoverable amount and the carrying amount of a CGU. This guidance is designed to ensure that the recoverable amount and the carrying amount that are being compared are determined on a comparable basis (ie the same items are included in or excluded from both amounts in order to avoid double-counting or omission). In particular, paragraphs 76-77 note:

> 76 The carrying amount of a cash-generating unit:
>
> (a) includes the carrying amount of only those assets that can be attributed directly, or allocated on a reasonable and consistent basis, to the cash-generating unit and will generate the future cash inflows used in determining the cash-generating unit's value in use; and
>
> (b) does not include the carrying amount of any recognised liability, unless the recoverable amount of the cash-generating unit cannot be determined without consideration of this liability.
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> This is because fair value less costs of disposal and value in use of a cash-generating unit are determined excluding cash flows that relate to assets that are not part of the cash-generating unit and liabilities that have been recognised (see paragraphs 28 and 43).
>
> 77 When assets are grouped for recoverability assessments, it is important to include in the cash-

> generating unit all assets that generate or are used to generate the relevant stream of cash inflows. Otherwise, the cash-generating unit may appear to be fully recoverable when in fact an impairment loss has occurred. In some cases, although some assets contribute to the estimated future cash flows of a cash-generating unit, they cannot be allocated to the cash-generating unit on a reasonable and consistent basis. This might be the case for goodwill or corporate assets such as head office assets. Paragraphs 80–103 explain how to deal with these assets in testing a cash-generating unit for impairment.

24. We think that the determination of which cash flows are used to calculate the recoverable amount of a CGU is a matter of judgement, based on the specific facts and circumstances under review. Consequently, we think that an entity should determine, on the basis of their specific facts and circumstances, whether the regulatory balances recognised should be included in the calculation of the recoverable amount of the CGU. This will determine whether the regulatory balances should be included in the carrying amount of that CGU. Once this has been decided upon, we think that the entity should apply the existing guidance in IAS 36 for the purposes of testing that CGU for impairment.

25. We have considered whether any impairment loss identified by the IAS 36 test should be allocated first to the regulatory balance. However, because we have not identified the nature of these balances, and have not identified a specified measurements basis for them, we see no compelling reason to disturb the existing IAS 36 allocation requirements[4].

Staff recommendation

26. We recommend that the existing IAS 36 impairment test requirements should apply to a CGU that contains regulatory deferral account balances. If an impairment loss is identified, the existing allocation requirements should apply.

[4] See IAS 36, paragraphs 104-108.

Consequently, for this purpose, the relevant regulatory deferral account balances should be treated in the same way as asset balances contained in the CGU.

27. We also recommend that, for the avoidance of doubt, that the [draft] interim Standard should provide brief application guidance to clarify this point.

Questions for the IASB

Question 3: Impairment/recoverability
(a) Do you agree with the staff's recommendation that the normal requirements of IAS 36 should apply to the CGU containing regulatory balances?
(b) Do you agree with the staff's recommendation to provide brief application guidance in the [draft] interim Standard to clarify this point?

Application of IAS 12 *Income Taxes*

Background

28. In January 2013, the IASB discussed whether the tax effects of an entity's recognised regulatory deferral account balances could be separately identified and presented. The regulatory balances are considered in the assessment of future prices and the rate regulator may specify the period over which recovery is intended. However, when recognising the future revenue, judgement needs to be applied to identify whether that revenue is recovering current costs or past costs (or in some cases, future costs). In practice, the deferral account balances are often amortised over a designated period (which would vary in length). We therefore think that the allocation of deferral balance amounts to the related tax cash flows could be complex and might not provide useful or reliable information.

29. Consequently, we do not think that it is practicable to separately present the tax impact of the regulatory balances. This is consistent with the reasoning applied to the following decisions that were made by the IASB in January 2013:

(a) regulatory debit and credit balances should not be offset; and

(b) regulatory deferral account balances should not be separated into current and non-current components.

30. However, we think that there are two aspects of the tax effect that are worth highlighting:

(a) Regulatory accounting requirements may affect the amount and timing of a regulated entity’s income tax payments. In some rate-regulatory regimes, an entity may be able to recover some income tax costs through the rate-setting mechanism in the same way as for other allowable costs. Consequently, a regulatory deferral account balance may arise when a current or deferred tax asset or liability is recognised.

(b) The recognition of this tax-related regulatory balance, as well as other regulatory balances, might then create a further temporary difference for which, in accordance with IAS 12 *Income Taxes*, a further deferred tax amount would be recognised. This in turn might increase the regulatory balance, which again might create a further temporary difference. This process is then repeated through an iterative process until the additional amounts generated cease to be material.

31. In January 2013, the IASB addressed the issue in paragraph 28(a) above by deciding that an entity should disclose the impact of rate regulation on the amounts of current and deferred tax recognised. In addition, they should separately identify the amount of any regulatory deferral account debit or credit balance that relates to taxation.

32. We have considered whether an entity should apply IAS 12 to recognise an additional deferred tax amount relating to the regulatory deferral account balance that has been recognised because the regulator allows income tax to be recovered through future rates (the issue in paragraph 28(b) above). As noted previously, we have not identified the nature of these regulatory balances within the context of IFRS definitions of assets and liabilities. Consequently, there may be some situations in which application of other Standards to the regulatory balances may not be appropriate. We think that this is such a situation. We do not think that applying IAS 12 to the regulatory deferral account balances adds value to the information provided to users of the financial statements.

33. Similarly, we do not think that this is a situation in which continuation of the entity's existing local GAAP treatment is appropriate. In general, the amount of deferred tax that the entity recognises in its IFRS financial statements should be recognised and measured in accordance with IAS 12. We think it is inappropriate to modify this amount for any amounts calculated in accordance with existing local GAAP relating to the regulatory deferral account balances. We think that such a 'mixed model' approach would be confusing and would not provide relevant or reliable information for users.

Staff recommendation

34. We recommend that the recognised carrying amount of the regulatory deferral account balances should be explicitly excluded from the temporary differences to which IAS 12 is applied. Previous local GAAP accounting policies for deferred tax should not be grandfathered either. This will prevent the grossing up of both the deferred tax balance and the regulatory deferral account balance that could otherwise result from recognising the regulatory balances for financial reporting purposes.

Questions for the IASB

Question 4: Income taxes
Do you agree with the staff's recommendation to prohibit the recognition of deferred tax for the temporary differences that have been created solely by the recognition of the regulatory deferral account balances for financial reporting purposes?

Application of other Standards

Background

35. So far, we have identified the items above where we think that specific guidance is needed as to whether or how other Standards should be applied to any regulatory deferral account balances recognised. We can identify others where

requests for application guidance might arise because it might be unclear whether the local GAAP recognition and measurement policies that have been grandfathered on initial application of the [draft] interim Standard take precedence over other Standards. For example, an entity may have regulatory deferral balances recorded in the accounting system in a foreign currency. These balances will need to be translated in order to be reported in the entity's financial statements. Questions may arise as to whether the regulatory balances should be translated in accordance with a grandfathered local GAAP policy or in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. If IAS 21 is to be applied, other application questions might arise, such as whether the regulatory balances should be classified as monetary or non-monetary items.

36. Another example might be whether IAS 10 *Events after the Reporting Period* should apply to the estimates and assumptions used in determining the regulatory deferral account balances or, instead, should the old local GAAP requirements still apply. For example, if the rate regulator issues a formal rate decision after the reporting period, a grandfathered local GAAP policy might not require this to be taken into account at the reporting date.

37. We think that, in general, other IFRS Standards should apply to the regulatory deferral account balances where relevant, except where there is explicit guidance that they do not. We think that relying on old local GAAP for all issues relating to the regulatory balances would be too pervasive and would be contrary to the intention of minimising and isolating the impact of grandfathering old policies. It would also, in our view, be inconsistent with the assertion that the financial statements are, in general, prepared in accordance with IFRS.

38. Consequently, in the example above, we think that the formal rate decision information is relevant, and so it should be taken into account in the estimates and assumptions used in the calculation of the regulatory deferral account balances that are recognised in the financial statements at the reporting date. Consequently, we think that IAS 10 should apply. Similarly, we think that IAS 21 should be used to translate the regulatory balances, with judgement being used to determine whether the regulatory account balances are monetary or non-monetary in nature, depending on the specific circumstances.

Staff recommendation

39. We recommend that the [draft] interim Standard should clarify that the policies for recognition, measurement and impairment that are grandfathered on initial adoption of the [draft] interim Standard, relate to the determination of the balances recorded in the financial reporting record-keeping system that form the basis for recognition in the financial statements. These balances should then be subject to other general Standards, such as IAS 21, unless otherwise specified (for example, the exceptions for IAS 12, IAS 33 and IFRS 5 discussed above).

40. We also recommend that the [draft] interim Standard should provide some brief application guidance to demonstrate this.

Questions for the IASB

Question 5: Applicability of other Standards
(a) Do you agree with the staff's recommendation that the normal requirements of IFRS should apply to the regulatory deferral account balances, unless otherwise specified?
(b) Do you agree with the staff's recommendation to provide brief application guidance in the [draft] interim Standard to clarify this point?