# STAFF PAPER

**January 2013**

## IASB Meeting

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| **Project** | **Rate-regulated Activities** | | |
| Paper topic | Interim Standard: Recognition and measurement requirements | | |
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## Introduction

1. This paper considers the recognition and measurement proposals to permit an entity that recognises regulatory deferral account balances to continue to do so. It sets out a recommendation that the [draft] interim Standard should not contain specific recognition or measurement criteria for such balances, but should instead require an entity within the scope of the [draft] interim Standard to determine its own recognition, initial measurement and subsequent measurement accounting policies. To achieve this, the [draft] interim Standard will need to contain a temporary exemption from paragraph 11[1] of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This would be consistent with the approach taken in IFRS 6 *Exploration for and Evaluation of Mineral Resources*.

2. However, to provide some restrictions and safeguards to limit the potential overstatement of any such amounts recognised, we also recommend (in accordance with the IASB's tentative decision in December 2012-see paragraph 3 of Agenda Paper 5) that these policies should conform to the entity's existing accounting policies, but only if those policies are generally accepted in accordance with the entity's jurisdictionally accepted accounting principles (local

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[1] IAS 8 paragraph 11 reads: "11 In making the judgement described in paragraph 10, management shall refer to, and consider the applicability of, the following sources in descending order:

(a) the requirements in IFRSs dealing with similar and related issues; and

(b) the definitions, recognition criteria measurement concepts for assets, liabilities, income and expenses in the Framework."

GAAP). Consequently, entities that currently do not recognise regulatory deferral account balances would not be permitted to start doing so on application of the [draft] interim Standard.

3. In addition, we propose that the [draft] interim Standard should require an entity to:

   (a) assess the recoverability of any regulatory deferral account balance and to recognise impairment of that balance for any amounts that may not be recoverable; and

   (b) derecognise the entire carrying amount of any regulatory deferral account balances when the related underlying activities cease to meet the scope criteria.

## Recognition

### *Background*

4. Paragraph 4.38 of the IFRS *Conceptual Framework* (the *Framework*) indicates that an asset or liability should be recognised if:

   (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

   (b) the item has a cost or value that can be measured reliably.

5. The 2009 ED did not set out any specific recognition requirements. Instead, it proposed that the scope criteria should be accepted as being sufficient. The Basis for Conclusions, paragraph BC41, explained that the

> "Board concluded that if rate-regulated activities satisfied the scope criteria in the proposed IFRS, the actions of a regulator provide reasonable assurance that the economic benefit will flow to or from the entity. In addition, because regulatory assets and regulatory liabilities relate to specifically identifiable amounts expended or collected by the entity, the Board concluded that reliable measurement was possible".

6. Many respondents to the 2009 ED expressed the view that the IASB should have included explicit recognition criteria within the project that would be consistent with paragraphs 4.37-46 of the current *Framework*, specifically paragraph 4.40, which deals with the notion of probability. These respondents believe that implementation of a Standard without any recognition threshold may be onerous and lead to the recognition of regulatory assets and regulatory liabilities for which there is a low probability of cash flows occurring.

### *Staff recommendation*

7. We recommend that the [draft] interim Standard should not contain specific recognition criteria for regulatory deferral account balances but should instead require the entity to determine a recognition accounting policy. This should be based on their existing accounting policy, which should be generally accepted in accordance with their jurisdictionally accepted accounting principles (local GAAP).

8. There is currently some uncertainty among commentators as to whether the regulatory deferral account balances that are currently recognised in the financial statements of some rate-regulated entities in various jurisdictions do satisfy the IFRS *Framework* definitions of assets and liabilities. One of the primary goals of the comprehensive Rate-regulated Activities project is to identify whether rate-regulated activities create recognisable assets or liabilities in accordance with both the existing and the developing *Framework*[2].

9. As a result of this uncertainty, we do not think that the [draft] interim Standard should be constrained by the recognition criteria for assets and liabilities in the *Framework*. Instead, the main purpose of the [draft] interim Standard is to permit grandfathering of existing recognition and measurement accounting policies on first-time adoption of the [draft] interim Standard. This will minimise disruption for those rate-regulated entities that currently do recognise regulatory deferral account balances in their financial statements.

[2] The IASB has restarted the *Conceptual Framework* project. As part of that project, the definitions of assets and liabilities and the criteria for recognising them in the financial statements will be reviewed. Consequently, work on the *Rate-regulated Activities* project will interact with developments in the *Framework* project.

10. To achieve the recommended approach (ie grandfathering of existing policies), the [draft] interim Standard will need to contain a temporary exemption from paragraph 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. This is because this paragraph requires that, in developing an accounting policy, the entity would need to consider the definitions of assets and liabilities in the *Framework*. As noted in paragraph 8 above, this is one of the main objectives of the comprehensive Rate-regulated Activities project. This temporary exemption would be consistent with the approach taken in IFRS 6 *Exploration for and Evaluation of Mineral Resources*.

11. We understand that in general, regulatory deferral account balances that are recognised in financial statements follow the recognition policies determined by the rate regulator. Although this does not guarantee full recovery of the deferred costs or full elimination of the deferred revenues, we believe that it does provide a suitable basis for recognition for the purpose of this [draft] interim Standard.

12. In addition, we propose an impairment or recoverability assessment requirement for any regulatory deferral account balances that are recognised (see paragraphs 29-36 below).

### *Changes to existing accounting policies*

13. As noted in paragraph 9, the main purpose of the [draft] interim Standard is to permit grandfathering of existing recognition and measurement accounting policies on first-time application of the [draft] interim Standard. Previous IASB discussions (in September and December 2012) considered whether an interim Standard should be available only to first-time adopters of IFRS (and so could be dealt with through IFRS 1 *First-time Adoption of International Financial Reporting Standards*).

14. We do not think that IFRS 1 is suitable for this purpose because:

    (a) IFRS 1 only applies in an entity's first IFRS financial statements[3] (and any related interim financial reports for the same period). Entities that

[3] IFRS 1 paragraph 2. Appendix A to IFRS 1 defines an entity's first IFRS financial statements as the first annual financial statements in which the entity adopts IFRS by an explicit and unreserved statement of compliance with IFRSs.

grandfather their previous-GAAP accounting policies when adopting IFRS for the first time will need specific guidance for subsequent periods (until the comprehensive Rate-regulated Activities project is completed); and

(b) any entity that might currently recognise regulatory deferral account balances in its IFRS financial statements[4] should be subject to the same requirements as first-time adopters of IFRS when the [draft] interim Standard is applied.

15. Some IASB members expressed concern during the previous discussions that an interim Standard instead of IFRS 1 might allow entities that currently do not recognise regulatory deferral account balances in accordance with IFRS to start to do so. We think that this risk is mitigated by our recommendation in paragraph 7 that an entity should determine a recognition policy based on their existing accounting policy, which should be generally accepted in accordance with their local GAAP. In addition, we recommend that changes to existing policies should be restricted.

### *Restricting changes to accounting policies*

16. Existing interim Standards IFRS 4 *Insurance Contracts*[5] and IFRS 6 *Exploration for and Evaluation of Mineral Resources*[6] both restrict the circumstances in which an entity can change an accounting policy for the relevant transaction or activity. In each case, an entity may only change its accounting policy if the change makes the financial statements more relevant to the economic decision-making needs of users and no less reliable, or more reliable and no less relevant to those needs, using the criteria in IAS 8.[7] Both Standards go on to explain that in order to justify a change in policy, the change must bring the financial statements closer to meeting the criteria in IAS 8.

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[4] Although we have not seen examples of regulatory deferral account balances being recognised in IFRS financial statements, we cannot dismiss the possibility that some entities might already do so.

[5] Paragraphs 21-23 of IFRS 4

[6] Paragraphs 13-14 of IFRS 6

[7] Paragraphs 7-12 of IAS 8

17. We think that the existing uncertainty as to whether or not regulatory deferral account balances satisfy the IFRS *Framework* definitions of assets and liabilities, means that changing an accounting policy to start to recognise such balances would not make the financial statements more reliable.

18. Consequently, entities that currently do not recognise regulatory deferral account balances would not be permitted to start doing so on application of the [draft] interim Standard.

19. However, we think that changing an accounting policy to no longer recognise such balances would result in the entity presenting more comparable information. The predominant practice in IFRS has, in general, been that rate-regulated entities do not recognise regulatory deferral account balances in IFRS financial statements. Consequently, we think that adopting this policy of not recognising regulatory deferral account balances would bring the financial statements closer to the criteria in IAS 8.

## Questions for the IASB

| **Question 1: recognition criteria** |
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| Do you agree with the staff's recommendation to grant a temporary and conditional exemption from paragraph 11 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, which would:<br><br>(a) permit an entity to recognise regulatory deferral account balances in accordance with their existing accounting policy, but only if that policy is generally accepted in accordance with their jurisdictionally local GAAP? and<br><br>(b) restrict the circumstances in which an entity can change an accounting policy to those described in IFRS 4 and IFRS 6?<br><br>If not, what alternative do you suggest? |

## Measurement

20. Paragraph 12 of the 2009 ED proposed that:

> 12 On initial recognition and at the end of each subsequent reporting period, an entity shall measure a regulatory asset or regulatory liability at its expected present value.

21. The 2009 ED defined regulatory deferral account balances as regulatory assets and regulatory liabilities on the basis of the rate-regulated entity's rights or obligations relating to future cash flows. Consequently, the measurement basis proposed tried to reflect expectations about future cash flows.

22. The vast majority of respondents to the 2009 ED disagreed with this proposal, including those that supported the recognition regulatory deferral account balances. Many of the comments demonstrated the current uncertainty over whether a regulatory deferral account balance is an asset (or liability) in accordance with the *Framework* and if so, what type of asset (or liability) it is.

23. It is worth noting here that determining the appropriate measurement basis is dependent on identifying the nature of any assets and liabilities created by the effects of rate regulation. This is outside the scope of this project but will be addressed in the main research project.

24. The majority of respondents who suggested an alternative measurement model indicated a preference for measurement criteria consistent with Topic 980 *Regulated Operations*[8]in the *FASB Accounting Standards Codification*®. This approach can broadly be seen as a cost accumulation model (and therefore with no remeasurement to reflect the time value of money in subsequent periods). This seems to be consistent with the regulatory accounting requirements in many rate-setting methodologies.

### *Return on investment or interest rate*

25. In practice, rate regulators will decide whether or not to allow the rate-regulated entity to earn a return (ie interest) on the deferred costs (or pay a return on

[8] Topic 980 brings together the requirements formerly contained in SFAS 71 *Accounting for the Effects of Certain Types of Regulation* and subsequent related guidance and amendments.

deferred revenues) to reflect the time value of money until the costs are recovered (or over-recoveries are eliminated). Where a return is permitted or required to be included in the regulatory deferral account balance, the rate regulator, in some cases, determines a general interest rate to be applied. In other cases, the rate regulator permits or requires the entity to apply an entity-specific rate, which may be calculated according to a specified formula.

26. Many respondents to the 2009 ED asked whether this regulator-determined interest rate could be used for IFRS financial reporting purposes as well as for regulatory accounting purposes. In general, this use of a regulator-determined rate is the approach taken in local GAAP when measuring recognised regulatory deferral account balances.

### *Staff recommendation*

27. We recommend that the [draft] interim Standard should not contain specific measurement criteria but should instead require the entity to determine an initial and subsequent measurement accounting policy. This should be based on their existing accounting policy, which should be generally accepted in accordance with their local GAAP. This is consistent with our recommendation and related reasoning for recognition, and avoids prejudging the outcome of the main Rate-regulated Activities project.

28. We acknowledge the concern expressed by some IASB members in the December 2012 meeting that this may lead to a potential overstatement of regulatory deferral account balances that may not be recoverable through future sales of regulated goods and services. We address this concern under the heading “Recoverability /Impairment” below.

## Questions for the IASB

| **Question 2: measurement criteria** |
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| Do you agree with the staff's recommendation that an entity should be permitted to measure, both on initial recognition and subsequently, regulatory deferral account balances in accordance with their existing accounting policy, but only if that policy is generally accepted in accordance with their jurisdictionally accepted accounting principles (local GAAP)? If not, what alternative do you suggest? |

## Recoverability /Impairment

### *Background*

29. Paragraph 17 of the 2009 ED acknowledged that although a particular regulator may permit a variety of specific costs to be recovered through future rates, the entity may conclude that rates set at those levels would affect demand. In addition, paragraph B14 of the 2009 ED concluded that the anticipated reduction in demand is an indication of impairment.

30. Paragraph B14 then went on to require that the entity should test the entire cash generating unit (CGU) containing the regulatory deferral account balance for impairment in accordance with IAS 36 *Impairment of Assets*. Paragraphs B15-B18 contained more detailed application requirements for the measurement and allocation of any resultant impairment loss.

31. Most respondents agreed with the proposals in paragraph 17 of the 2009 ED that some deferred amounts may not be recoverable through future sales even though they are permitted to be classified as allowable costs and can be included in a regulatory deferral account by the regulator.

32. However, many respondents then expressed confusion as to the interaction between the proposal to measure any regulatory deferral account balance at the net present value of expected future cash flows and the impairment requirements outlined in paragraphs B14-B18. There was also confusion as to whether the

regulatory item should be assessed for impairment separately or only as part of the related GCU that produces the rate-regulated revenues.

### *Staff recommendation*

33. We recommend that the [draft] interim Standard should provide an exemption from applying IAS 36 to regulatory deferral account balances. This is consistent with our recommendations and related reasoning for recognition and measurement and reflects the uncertainty as to whether these balances are assets and, if so, what type of asset.

34. We recommend instead that the [draft] interim Standard should include similar proposals to those in paragraphs 17 of the 2009 ED. This would require an entity to consider the net effect on its future rates of all the regulatory deferral accounts arising from actions of a regulator and to assess the recoverability of any regulatory deferral account balance that is recognised.

35. We also recommend that the regulatory deferral account balance should be reduced for any amounts that the entity concludes may not be recoverable, either because the rate permitted by the rate regulator may reduce demand or because the regulator is expected to exclude all or part of the regulatory deferral account balance from a future rate review. We think that this approach will achieve a similar result to that achieved by the recoverability requirements contained in the scope criteria of Topic 980 *Regulated Operations* in the *FASB Accounting Standards Codification*® (see the Appendix to Agenda Paper 5A).

36. The impairment of a regulatory deferral account debit balance may indicate that the related assets within the CGU that produces the rate-regulated revenues are impaired. We recommend that in such a case, the entity should then be required to assess that CGU in accordance with IAS 36.

## Questions for the IASB

| Question 3: impairment / recoverability |
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| Do you agree with the staff's recommendation to:<br>(a) require an entity to assess the recoverability of any regulatory deferral account balance that is recognised;<br>(b) reduce any impaired account balance for any amounts that the entity concludes may not be recoverable; and<br>(c) explicitly state that the impairment of a regulatory deferral account debit balance is an indicator of impairment of the related CGU?<br>If not, what alternative do you suggest? |

## Derecognition

### *Background*

37. Paragraph 21 of the 2009 ED proposed that an entity shall derecognise the entire carrying amount of regulatory assets and regulatory liabilities when the related underlying activities cease to meet the scope criteria.

38. Few respondents commented on this because there was no separate question on this proposal within the 2009 ED. Those that did comment asked primarily for greater clarity as to whether derecognition is appropriate in the following two situations:

(a) The rate regulator's actions reduce the recoverability of a deferral account balance without the activities falling outside the scope of the proposals. This could be done, for example, by changing the rate-setting methodology or changing what types of costs are allowable for rate-setting purposes.

(b) The rate regulator could change the rate-setting methodology so that the activities cease to be within the scope of the proposals but the deferred costs could still be recoverable through future rates in accordance with the revised rate-setting methodology.

### *Staff recommendation*

39. We recommend that an entity should derecognise the entire carrying amount of regulatory assets and regulatory liabilities when the related underlying activities cease to meet the scope criteria and cease to be classed as rate-regulated activities. Consequently, we think that they should be accounted for in the same way in which non-rate-regulated entities account for the same sort of activities. The two issues outlined in paragraph 38 above can then be clarified in application guidance. This is consistent with the original proposal in paragraph 21 of the 2009 ED.

40. With regard to paragraph 38(a) above, when a rate regulator's actions reduce the recoverability of a deferral account balance, but the entity's activities continue to be within the scope of the proposals, we think that this is an indicator of impairment and should be highlighted as such in the [draft] interim Standard. This would not lead to derecognition of the entire net regulatory deferral account balance but would result in a reduction of its carrying amount or the write-off of particular balances that are no longer classed as allowable costs, as discussed in paragraphs 34-35 above.

41. With regard to the concern expressed in paragraph 38(b) above, the scope of the 2009 ED was restricted to those rate-regulated activities for which the price (ie rate) was established by cost-of-service regulation. As noted in paragraph 5 of Agenda Paper 5A (AP5A), many respondents to the 2009 ED considered this scope to be too narrow.

42. The concern expressed in paragraph 38(b) was therefore significant, because many entities could have been required to derecognise their regulatory deferral account balances because of a change in the rate-setting mechanism while still being subject to rate regulation that had been designed to achieve a very similar outcome. One of the main reasons for changing the rate-setting mechanism is to reduce the administrative cost of operating the rate regulation, rather than fundamentally changing the rate-setting objectives.

43. However, if the IASB agree to the scope recommended in AP5A, then the number of entities that would fall out of scope will be significantly reduced, with a consequential reduction in the number of situations requiring derecognition of the

total regulatory deferral account balance. Derecognition (as opposed to impairment, which is discussed in paragraphs 29-36 above) would then be relevant mainly because of:

(a) deregulation; and

(b) a change in the rate regulator's approach to setting rates to the effect that regulatory actions, or the rate-setting process, is no longer designed to recover the entity's allowable costs of providing the regulated goods and services or to restrict the return that the entity can earn.

44. In these circumstances, the rate regulation is either removed or diminished to such an extent that the entity becomes subject to the same sort of economic environment as that in which an unregulated entity would operate. In such circumstances, we think that it is appropriate that the entity should account for its activities in the same way as a non-rate-regulated entity would, and eliminate any regulatory deferral account balances.

45. Agenda Papers 5C-5D address the presentation and disclosure proposals for rate-regulated entities, including those dealing with derecognition of any regulatory deferral account balances.

## Questions for the IASB

| **Question 4: derecognition** |
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| Do you agree with the staff's recommendation to require an entity to derecognise the entire carrying amount of regulatory assets and regulatory liabilities when the related underlying activities cease to meet the scope criteria? |