

STAFF PAPER

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Project	Rate-regulated Activities: Research project		
Paper topic	Unit of account		
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Introduction

1. The features described in Agenda Paper 9A contribute to a series or package of rights and obligations, a combination of which, in our view, distinguishes rate-regulated activities from general commercial activities. This package of rights and obligations are usually embodied within a licence agreement, service concession arrangement or legislative/regulatory document (the rate-regulatory licence or other agreement).
2. Before analysing the combination of rights and obligations that result from the distinguishing features of rate regulation, we think that it is important to consider what level of aggregation is appropriate in order to provide users with relevant information. In other words, we need to consider the ‘unit of account’.

Purpose of this paper

3. The purpose of this Agenda Paper 9B is to set out the guidance about identifying the appropriate unit of account contained within the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*)¹ and also in any specific IFRSs.

¹ The contents of the existing *Conceptual Framework* may be subject to revision, as proposed in the Discussion Paper: *A Review of the Conceptual Framework for Financial Reporting*, published in July 2013 (the *Conceptual Framework DP*). Consequently, this Agenda Paper 9B will consider both the existing *Conceptual Framework* and the *Conceptual Framework DP*.

4. It also sets out the staff's initial analysis of what unit of account might be appropriate and asks the IASB if it agrees with that analysis.

Summary

5. We recommend that the unit of account for analysing whether rights and obligations associated with rate regulation give rise to assets and liabilities should be set at a level of aggregation that is lower than the whole package of rights and obligations embodied within the rate-regulatory licence or other agreement. If the outcome of this project should be to recognise assets and liabilities, we do not think that accounting for the licence or other agreement as a single resource would provide users with information that is relevant, faithfully represents what it purports to represent, and can be produced at a cost that does not exceed the benefits.²
6. We recommend that the unit of account should focus on the rights and obligations arising from the feature of the rate-setting mechanism that incorporates a 'true-up' adjustment for differences between estimated and actual amounts for previous periods and for any bonuses or penalties that relate to past performance.

Unit of account guidance in the Conceptual Framework

Existing Conceptual Framework

7. The existing Conceptual Framework does not include guidance on the 'unit of account'.³ Currently, any guidance on determining the unit of account is contained within individual Standards.⁴

² Paragraphs 9.38-9.39 of the *Conceptual Framework* DP.

³ Appendix A of IFRS 13 *Fair Value Measurement* defines the unit of account as: "The level at which an asset or a liability is aggregated or disaggregated in an IFRS for recognition purposes".

⁴ See paragraph BC47 of the Basis for Conclusions on IFRS 13.

Conceptual Framework DP

8. The IASB's preliminary view, set out in paragraph 9.38 of the *Conceptual Framework DP*, is that deciding which unit of account will provide the most useful information to users of financial statements will normally be a decision for Standards-level projects to develop.⁵ This preliminary view seems to be consistent with the IASB's existing approach. Consequently, it seems to represent a clarification of the IASB's existing practice that we would be able to continue using in this project.
9. Although the *Conceptual Framework DP* suggests that, in many cases, it is appropriate to aggregate rights (and/or obligations) and present them as a single asset, paragraph 3.10 of the *Conceptual Framework DP* also acknowledges that separate presentation may be appropriate in some cases. This would be the case if the separation "produces information that is relevant to users of financial statements and provides a faithful representation of the entity's resources, at a cost that does not exceed the benefit of doing so".

What unit of account is appropriate?

10. Entities that are subject to rate regulation commonly have an exclusive or near-exclusive right to operate in a predetermined service territory.⁶ The exclusive right may be defined by a rate-regulatory licence or other agreement.
11. This rate-regulatory licence or other agreement establishes the package of rights and obligations that have been identified in Agenda Paper 9A as the distinguishing features of rate regulation. Consequently, we need to consider what level of aggregation of these rights and obligations is appropriate to provide information to users that is relevant, faithfully represents what it purports to represent, and can be produced at a cost that does not exceed the benefits.

⁵ The 'unit of account' is considered in paragraphs 3.7-3.13 and 9.35-9.41 of the *Conceptual Framework DP*.

⁶ See paragraphs 5-9 of Agenda Paper 9A.

Single intangible asset—the licence or other agreement

12. Licences or similar agreements that grant an entity an exclusive right to supply specified goods or services are common and are often seen in other commercial environments. Such licences usually embody a package of rights and obligations but are often accounted for as a single resource,⁷ with the licence being identified as the “unit of account” for accounting purposes. This single resource is then usually accounted for as an intangible asset,⁸ in accordance with IAS 38 *Intangible Assets*.
13. In summary, IAS 38 would require the licence or other agreement to be recognised and measured, initially, at cost⁹. We think that, if the entity has paid directly for the licence, there is little argument that this would meet the definition of, and recognition criteria for, a separately acquired intangible asset, in accordance with IAS 38.¹⁰
14. However, the responses to the Request for Information: *Rate Regulation* (the RfI), issued in March 2013, indicated that the direct cost to acquire or renew the licence or other agreement to supply the rate-regulated goods or services is typically insignificant and may be nil.¹¹ If the cost is nil, then the entity would not, in effect, recognise the intangible asset.
15. In addition, the revaluation model in IAS 38 would not be available to revalue the licence or other agreement because the use of that model requires an active market for the intangible asset.¹² Such a market would not exist for rate-regulatory licences or other agreements establishing the rights and obligations associated with rate-regulated activities.

⁷ Accounting for this package as a single resource is consistent with the observation in paragraph 3.12 of the *Conceptual Framework* DP, which notes: “Generally, when a package of rights and obligations arises from the same source, an entity will account for them at the highest level of aggregation that enables it to depict the rights and obligations, and the changes in those rights and obligations, in the most relevant, faithful and understandable manner”.

⁸ An intangible asset is defined in IAS 38 *Intangible Assets* as “an identifiable non-monetary asset without physical substance.”

⁹ Paragraph 24 of IAS 38.

¹⁰ Paragraphs 8-17 of IAS 38.

¹¹ See paragraph 29 of the Agenda Paper 9 *Request for Information response summary*, July 2013.

¹² Paragraph 75 of IAS 38.

16. Consequently, in assessing whether the rate-regulatory licence or other agreement is the appropriate unit of account, we need to consider:
- (a) whether the existing treatment for the rate-regulatory licence or other agreement, as established in IAS 38, can provide users with relevant information about the effects of rate regulation; or
 - (b) if not, whether the requirements of IAS 38 can (or should) be amended and, if so, how.

Relevant information

17. When identifying an appropriate unit of account, we need to consider whether the resulting information is relevant, faithfully represents what it purports to represent, and can be produced at a cost that does not exceed the benefits.
18. As part of the research work being done for this project, we have started to investigate what information users need in order to understand the rate-regulatory framework and how it affects the reporting entity.¹³ We have heard that users particularly value information that enables them to:
- (a) predict the amounts, timing and certainty of future cash flows;
 - (b) distinguish between variability in performance that is compensated for through the rate-regulatory mechanism from variability for which there is no compensatory mechanism; and
 - (c) reconcile the earnings reported in the financial statements both to cash flows and to the ‘stabilised’ earnings achieved through the rate regulation.
19. As identified in Agenda Paper 9A, many of the individual rights and obligations embodied within the rate-regulatory licence or other agreement are not unique to rate-regulated activities. Most of them can be found in other business environments. We do not, therefore, envisage that any specific or new accounting guidance would be needed for them when viewed individually.
20. However, we have identified that some rate-setting mechanisms do contain a unique feature that distinguishes them from the rights and obligations contained in

¹³ See IASB Agenda Paper 9A *Rate Regulation: User needs*, September 2013.

many licences or other agreements. This unique feature is the element of the rate-setting mechanism that requires a ‘true-up’ adjustment for differences between estimated and actual amounts for previous periods and for any bonuses or penalties that relate to past performance.¹⁴ In the vast majority of cases, the cash flows resulting from this adjustment are collected/delivered by adjusting the price of the goods or services to be sold in the future. Consequently, we think that information about the effects of this adjustment on both future cash flows and on earnings is relevant to users.

A component of the rate-regulatory licence or other agreement

21. There may be an argument to suggest that the distinct feature of the rate-setting mechanism that gives rise to the true-up adjustment related to previous periods could be accounted for as a component of the overall licence. Each separate adjustment could then be amortised over the relevant adjustment period, which is usually shorter than the period of the rate-regulatory licence. This would be analogous to accounting for the separate components of a tangible asset that have a different useful life.
22. However, we do not think that this approach is feasible. A component approach suggests that the cost or value of the overall asset can be allocated to separate components and each component can then be recognised, measured and depreciated/amortised as though it was a separate asset. An amortisation model assumes that the asset is being consumed throughout its life, and amortisation reflects only a decrease in the carrying value.
23. However, the true-up adjustments resulting from the rate-setting mechanism can be both positive (an increase in prices) and negative (a decrease in prices). An asset component approach using a cost and amortisation model, such as used for tangible assets in IAS 16 *Property, Plant and Equipment*, is not, in our view, suited to reflecting the originating differences that can be negative as well as positive.
24. Consequently, we do not think that accounting for the whole package of rights and obligations that are contained in the rate-regulatory licence as a single unit of

¹⁴ See paragraph 24-39 of Agenda Paper 9A *Features of rate regulation*, October 2013.

account, or treating the true-up adjustment mechanism as a component of the overall licence is sufficient to reflect the impact of this distinct rate-setting mechanism. Accounting for the whole package as a single rate-regulatory licence in accordance with IAS 38 would not, in our view, provide relevant information about the impact on future cash flows, resulting from the application of the rate-setting mechanism.

25. We also do not think that modifying IAS 38 to permit revaluation of the licence would be appropriate either, because we do not consider that this would provide users with the most relevant information for their needs (see paragraph 18 above). Although revaluing the rate-regulatory licence may enable an entity to reflect negative as well as positive movements in the value of the licence, we do not think that it provides relevant information about the amount and timing of cash flows that relate to the separate components of the rate-setting mechanism. We also think that the value of the licence or other agreement would incorporate too wide a package of rights and obligations that affects many aspects of the entity's business. We think that this will make it difficult to distinguish elements of the licence or other agreement from internally generated intangible assets, including goodwill.

Disaggregating the licence or other agreement

26. In Agenda Paper 9A, we analyse the common features of rate regulation in order to identify whether those features create rights and obligations that distinguish rate-regulated activities from general commercial activities.
27. We have identified that the most important and unique feature of rate regulation is the component of the rate-setting mechanism that requires a 'true-up' adjustment that reflects:
- (a) differences between estimated and actual amounts for previous periods; and/or
 - (b) to award a bonus or to impose a penalty for meeting or failing to meet a performance target (paragraphs 24-39 of Agenda Paper 9A).
28. In some rare cases, the amount of the adjustment is recovered/reversed through a cash receipt from/payment to the regulator or other authorised body or through

retrospective billing adjustments to individual customers.¹⁵ However, in the vast majority of cases, the cash flows resulting from this adjustment are collected/delivered by adjusting the price of the goods or services to be sold in the future.

29. We think that it can be argued that focusing on this feature of the rate-setting mechanism, which requires a ‘true-up’ adjustment related to past performance, provides the clearest basis on which to provide users of financial statements with information about the direct and identifiable impacts of the rate regulation on the amount, timing and certainty of the entity’s rate-regulated cash flows.
30. In addition, we think that most of the information required to identify those amounts is already available to an entity that is subject to this form of rate-regulatory mechanism. This is because the rate regulator usually establishes detailed record-keeping requirements in order to ensure that the adjustments identified are appropriate and comply with the rate regulation.
31. Consequently, our initial assessment suggests that viewing, as the unit of account, the separate rights and obligations arising from the true-up adjustment feature of rate-setting mechanism has the potential to provide users with information that:
 - (a) is more relevant to their needs;
 - (b) more faithfully represents what it purports to represent; and
 - (c) can be provided at a cost that does not exceed the benefits.

Staff recommendation

32. We do not think that treating the rate-regulatory licence or other agreement as a single unit of account, and accounting for it as single resource, is appropriate to proceed with in this project.
33. Instead, we recommend that the unit of account should focus on the rights and obligations arising from the feature of the rate-setting mechanism that incorporates a ‘true-up’ adjustment for differences between estimated and actual

¹⁵ See Agenda Paper 9B(iii) *Rate Regulation: The rate-setting mechanism*, September 2013.

amounts for previous periods and for any bonuses or penalties that relate to past performance.

Question for the IASB: Unit of account

Do you agree with the staff recommendation to focus on the feature of the rate-setting mechanism that incorporates a 'true-up' adjustment for differences between estimated and actual amounts for previous periods and for any bonuses or penalties that relate to past performance as the unit of account for rate-regulated activities, instead of setting the underlying licence or other agreement as the single unit of account?