IFRS

STAFF PAPER

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IASB meeting

Project	**Rate-regulated Activities**		
Paper topic	Project update and responses to the Agenda Consultation		
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Purpose of this paper

1. This paper provides a summary of :
   (a) the Rate-regulated Activities project's current status and planned next steps; and
   (b) the feedback received from the Agenda Consultation on the project.
2. The Board is not asked to make decisions about the project at this meeting. It will be asked at a future meeting to provide views on the balance and content of its overall work plan, and the prioritisation of projects, including the rate-regulated Activities project, within the work plan.
3. This paper sets out:
   (a) the project scope and objectives (paragraphs 4-5),
   (b) the project background (paragraphs 6-14),
   (c) a summary of the project status and public discussions since the publication, in September 2014, of the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the DP) (paragraphs 15-23),
   (d) a summary of feedback received about the project in the 2015 Agenda Consultation (paragraphs 24-40), and
   (e) planned next steps (paragraphs 43-44).

Objective and scope of the Rate-regulated Activities project

4. The objective of the project is to consider whether (or how) IFRS Standards should be amended to change how entities report the effects of rate regulation.

5. The project will look to:

   (a) further clarify the financial effects of different types of rate regulation, using the descriptions in the DP;

   (b) summarise how those financial effects are currently being accounted for in IFRS financial statements and in financial statements prepared in accordance with other GAAP requirements;

   (c) develop for discussion a possible accounting model or models for reporting the financial effects of defined rate regulation, including a definition of the scope of any such model(s); and

   (d) provide the Board with sufficient evidence to decide whether it should confirm the existing predominant IFRS practice for reporting rate-regulated activities or change that practice by amending IFRS 14 *Regulatory Deferral Accounts* or other existing IFRS Standards.

Background to the Rate-regulated Activities project

6. Except for the temporary Standard IFRS 14 (see paragraph 14), there are no specific IFRS requirements dealing with rate-regulated activities. The existing predominant IFRS practice results in revenue being recognised for goods or services delivered to customers during the period using the 'regulated rate', ie the rate chargeable to customers as determined through the rate regulation. However, the regulated rate commonly includes amounts that reflect activities that:

   (a) occur in a different period; and/ or

   (b) do not meet the definition of a 'performance obligation' in IFRS 15 *Revenue from Contracts with Customers* (for example, construction of assets for the entity's own use).

7. Some stakeholders suggest that using the regulated rate in such circumstances does not faithfully represent the satisfaction of the entity's rights and obligations, ie its

performance during the period. Consequently, they suggest that the existing predominant IFRS practice creates timing or accounting mismatches. The stakeholders have repeatedly asked the Board to consider amending existing IFRS requirements to enable entities to change the way that the effects of rate regulation are currently reported. In some jurisdictions, local accounting requirements or generally accepted accounting practice (GAAP) permit or require adjustments to be made to the timing of recognition of revenue and/ or costs to eliminate or reduce the perceived mismatches.

The previous Rate-regulated Activities project: 2008-2010

8. A previous Rate regulated Activities project produced an Exposure Draft *Rate-regulated Activities* (the 2009 ED), published in July 2009. This 2009 ED proposed that items described as "regulatory assets" and "regulatory liabilities" would be recognised in the statement of financial position if an entity's activities are subject to a specific type of rate regulation, ie cost-of-service rate regulation. The 2009 ED proposed that such balances could be recognised either as separate line items or, in specific situations, as part of the cost of property, plant and equipment.

9. However, views on the proposals were mixed. Some respondents to the 2009 ED argued that the nature of rate regulation (which need not be restricted to cost-of-service) justifies the recognition of regulatory assets and regulatory liabilities in some jurisdictions, but may not in others. This, they stated, is because of the different rights and obligations created by different type of rate regulation. Some respondents did not accept that rate regulation, irrespective of its type, justifies the recognition of regulatory assets and regulatory liabilities.

10. The responses to the 2009 ED and the Board's subsequent discussions failed to identify a clear path to answering the fundamental issue: do items described as "regulatory assets" and "regulatory liabilities" meet the definitions of assets and liabilities within the IFRS *Conceptual Framework*? The project was suspended in September 2010 because of resource constraints and other priorities.

Starting a new Rate-regulated Activities project: 2012-2014

11. In the responses to the 2011 Agenda Consultation, there was strong support, shared by preparers and investors, for the Board to re-examine the rate-regulated activities issue. Two projects were started as a result.

Research project—Rate Regulation

12. In September 2012, the Board considered a plan to start a new project on Rate-regulated Activities. The Board decided to start a new research project with the aim of developing a Discussion Paper (DP) to provide the opportunity for a broader debate on the circumstances in which rate regulated activities may give rise to assets or liabilities. The DP *Reporting the Financial Effects of Rate Regulation* was published in September 2014. The DP and responses to it are discussed in paragraphs 19-23 as part of the current project status.

Interim Standard project

13. In December 2012, the Board decided to develop an interim Standard to provide guidance on the accounting for rate-regulated activities until the research project and any subsequent Standards-level project is completed.

14. In January 2014, the Board issued IFRS 14 *Regulatory Deferral Accounts*. This interim Standard:

    (a) permits ‘grandfathering' of existing recognition and measurement policies for first-time adopters of IFRS Standards that recognise regulatory assets or regulatory liabilities in accordance with their previous GAAP; and

    (b) requires the presentation of regulatory amounts as separate line items in the statements of financial positon and performance.

Current project status

15. The project is currently classified as a ‘major project’ on the Board’s work plan. After reviewing the summary of feedback on the DP, the Board decided, in May 2015, to move the project from the Research programme to the Standards-level programme. However, the form of the Standard-setting activity is not yet clear. This is because the outcome of the project could conclude that:

(a) the existing predominant IFRS practice is appropriate because regulatory deferral account balances should not be recognised as assets or liabilities. Some Standards-level activity would then be needed to withdraw IFRS 14; or

(b) the recognition of some regulatory assets and regulatory liabilities is appropriate but a change to existing IFRS practice can be achieved by modifying existing IFRS Standards. Some Standards-level activity would then be needed to introduce the new requirements and withdraw IFRS 14; or

(c) the recognition of some regulatory assets and liabilities is appropriate but should be done through a specific Standard, rather than modifying the requirements of existing Standards. A change to the existing IFRS practice would then be achieved by substantially revising or replacing IFRS 14 to provide accounting requirements for qualifying rate-regulated activities conducted by all entities preparing IFRS financial statements.

16. Although the project is classified as a Standards-level project, the Board decided to develop a second Discussion Paper to help stakeholders consider a thorough analysis of the issues and possible solutions before the Board decides what changes to make to existing IFRS requirements, including IFRS 14.

Public discussions since September 2014

17. Since the publication of the DP, we have received input on issues and possible accounting solutions through the following meetings with the IASB and its advisory groups:

(a) Capital Markets Advisory Committee (CMAC) in October 2014;

(b) Stakeholder roundtable meetings in Washington DC, USA and Toronto, Canada and a panel discussion in Brussels, Belgium in December 2014;

(c) Board meetings in February 2015, May 2015 and July 2015;

(d) Accounting Standards Advisory Forum (ASAF) meetings in December 2014, July 2015, October 2015, and April 2016;

(e) The Board's Rate-regulated Activities Consultative Group in March 2015; and

(f) Global Preparers Forum (GPF) meeting in March 2016.

18. The meetings held in 2014 provided feedback on the DP. The meetings in 2015 and 2016 have considered the feedback on the DP and are contributing to the ongoing analysis of issues.

Summary of the DP

19. The DP:

(a) described the common features of different types of rate regulation, which range from pure cost-of-service to pure incentive-based;

(b) identified that most jurisdictions have moved away from pure cost-of-service rate regulation and many instead use a type described in the DP as ‘defined rate regulation’, which is a ‘hybrid’ type of rate regulation containing a combination of cost-recovery and incentive-based mechanisms;

(c) explored which of the common features of defined rate regulation could create a combination of rights and obligations that is distinguishable from the rights and obligations arising from activities that are not rate-regulated;

(d) sought to identify what information about the economic and financial effects of rate regulation are most relevant to users of financial statements and how that information might best be presented or disclosed; and

(e) explored several possible approaches that the Board could consider when deciding whether to amend existing IFRS requirements to change the existing predominant practice.

Feedback on the DP

20. The main messages received through outreach and comment letters on the DP were:

(a) Many respondents suggested that the combination of rights and obligations created by defined rate regulation may not always be faithfully represented by the existing predominant IFRS practice and that the project should lead to the recognition of at least some regulatory assets and regulatory liabilities in IFRS financial statements.

(b) Many respondents suggested that the scope of any future IFRS requirements should focus on the rights and obligations and how they relate to the ratesetting mechanism, with other features being considered more as supporting features.

(c) The strongest support for was for developing specific IFRS requirements using a revenue-focussed approach.

21. In its May 2015 meeting, the Board discussed implications of the tripartite relationships between:

(a) the rate-regulated entity and its customers;

(b) the rate-regulated entity and the rate regulator; and

(c) the rate regulator and the rate-regulated entity's customers.

22. The Board noted that the existing predominant practice in IFRS financial statements deals with the first of these relationships. Thus, when applying existing Standards, an entity would use the terms and conditions in the individual contracts between the entity and its customers, which includes the regulated rate. For example, existing Standards containing requirements for revenue recognition would result in an entity recognising revenue for the goods and service provided to customers in the period using the regulated rate.

23. Currently, the staff's analysis is focussing on the interaction of the relationships outlined in paragraph 19 with the rights and obligations created by defined rate regulation and how those rights and obligations are reflected in the regulated rate. The staff subsequently will explore whether an accounting model could be developed to fairly present the entity's rights and obligations and performance using the concepts and principles contained in the Board's proposed revisions to the *Conceptual Framework* and in existing Standards, especially IFRS 15.

Feedback from the 2015 Agenda Consultation

24. The Agenda Consultation Request for Views (the RFV) contained a list of major Standards-level and other projects, which included Leases, Insurance Contracts, *Conceptual Framework*, Disclosure Initiative, Dynamic Risk Management and Rate-regulated Activities. The RFV did not contain a description of the Rate-regulated Activities project, nor did it ask a specific question about the project. Instead, it asked a generic question about the major projects:

Major projects

4 Do you have any comments on the IASB's current work plan for major projects?

Comment letters

25. There was widespread support for the Board to prioritise its major projects. Many responses specifically mentioned the importance of the Leases, Insurance Contracts, *Conceptual Framework*, and Disclosure Initiative projects. About a fifth of respondents to the 2015 Agenda Consultation referred specifically to the Rate-regulated Activities project.[1] The majority of respondents that commented on the project were Standard-setters, accountancy bodies and firms.

26. Views expressed were mixed, with roughly equal numbers of respondents ranking the project as either high or low priority. Some respondents expressed support for continuing the project but the level of priority attached to the support was either unclear or mixed. The views are mixed across geographical areas.

27. It is important to note that respondents did not express views about whether (or how) IFRS Standards should be amended to change how entities report the effects of rate regulation. Instead, the focus was on the need to reach some form of conclusion because the current position is uncertain, particularly about whether the rights and obligations created by rate regulation do create assets and liabilities that should be recognised in IFRS financial statements.

28. One Standard-setter suggested that the project should be removed from the Board's work plan. Another suggested that, considering the incremental benefits and associated costs in trying to address a complex situation, along with the difficulty of finding a solution that would provide useful information for different jurisdictions and regulatory environments, a disclosure-only solution may be more appropriate. This disclosure-only solution was also suggested by an investor representative group that was concerned with the level of resources needed to try to resolve the accounting issues. This and two other investor representative groups ranked the project as low

[1] 119 comment letters have been received on the 2015 Agenda Consultation.

priority, although one of them noted that the interest and importance may be high to investors in particular industries.

29. A couple of securities regulators asked the Board to prioritise the completion of the project in the near future. One noted that the lack of IFRS guidance leads to potential comparability and enforcement issues in some jurisdictions. Another noted that the lack of clear guidance is delaying the adoption of IFRS Standards in its jurisdiction.

30. Respondents who ranked the project as important and/or urgent provided the following reasons for their views:

    (a) absence of guidance in IFRS Standards; and

    (b) diversity resulting primarily from the existing carve-out in IFRS 14 and in some other local GAAPs.

31. Respondents who ranked the project as of low importance and/or urgency provided the following reasons for their views:

    (a) in some jurisdictions and industries, rate regulation is not a major issue and the Board should focus on more pervasive issues that affect a greater number of entities; and

    (b) the difficulty of finding a solution that could deal with complex and changing rate-regulatory environments.

Other factors to consider

32. In March 2016, the Board considered a summary of the feedback received in response to the Agenda Consultation presented in Agenda Paper 24A Request for Views—2015 Agenda Consultation: *Comment letter and outreach summary* (AP24A March 2016). Paragraph 43 of that paper listed a variety of factors that respondents suggested the Board should consider in classifying and prioritising projects on its work plan. Although the respondents making these suggestions did not specifically link them to the Rate-regulated Activities project, some of them are particularly relevant to the project. The following paragraphs highlight the more relevant factors.

33. **Eliminating inconsistencies between Standards or between Standards and the *Conceptual Framework*** (paragraph 43(a) AP24A March 2016): As noted in paragraph 10 of this paper, the fundamental issue underlying this project is whether

items described as ‘regulatory assets’ and ‘regulatory liabilities’ represent rights and obligations that meet the definitions of assets and liabilities within the IFRS *Conceptual Framework*. Many of those who support the recognition of regulatory balances suggest that the existing predominant IFRS practice is inconsistent with the *Conceptual Framework*. It may also be inconsistent with the principles underlying IFRS 15.

34. **Addressing gaps in IFRS requirements** (paragraph 43(b) AP24A March 2016): Except for the temporary Standard IFRS 14, which applies to a limited population of entities, there are no specific IFRS requirements dealing with rate-regulated activities.

35. **Developing further the principles in the *Conceptual Framework*** (paragraph 43(c) AP24A March 2016): a planned future step in the project is to present an analysis to the Board about how the developing definitions of assets and liabilities in the *Conceptual Framework* project relate to the rights and obligations created by defined rate regulation. This will be essential in helping to answer the fundamental issue underlying this project and could be useful in helping to test the developing *Conceptual Framework*.

36. **Improving global comparability through increased convergence and by addressing local carve-outs and barriers to adoption** (paragraph 43(h) AP24A March 2016): US GAAP contains specific requirements that deal with accounting for rate-regulated activities. Entities within the scope of these requirements apply the general requirements of US GAAP and then overlay the specific accounting requirements relevant to the rate-regulated activities. Some jurisdictions have either ‘carved-in’ the US GAAP requirements or have developed similar local GAAP requirements. This has resulted in a widespread acceptance of the recognition of regulatory assets and regulatory liabilities. When issuing IFRS 14, the Board recognised that discontinuing the recognition of those regulatory balances could be a significant barrier to the adoption of IFRS. However, IFRS 14 is seen to create a ‘carve-in’ to IFRS requirements of the US and similar requirements.[2] Some stakeholders have commented that IFRS 14 should not be considered as a long-term solution because it applies only for a limited population of entities.

[2] IFRS 14 permits the grandfathering of existing recognition and measurement accounting policies for first-time adopters of IFRS Standards that recognised regulatory assets and/ or regulatory liabilities in accordance with their previous GAAP.

37. **Addressing issues for which existing accounting practice may not fairly present the entity's economic activities** (paragraph 43(i) AP24A March 2016): as noted in paragraph 20(a) of this paper, many respondents to the DP suggested that the existing predominant IFRS practice may not always faithfully represent the rights and obligations created by defined rate regulation.

Online survey

38. To provide input for the development of the Board's future agenda, the staff also conducted an online survey to understand the views of the investor community about the areas of financial reporting that are in the most urgent need of improvement.

39. Again, the survey did not ask a specific question about the Rate-regulated Activities project but merely included it in a list of major projects currently in progress. The list was followed by a generic question, which asked:

> 12. In addition to the above items, what are the areas of financial reporting however big or small that you would most like the IASB to improve? Please provide up to three topics, and give as much detail as you can about the reasons for your choices.

40. Five respondents: one investment consultant, three think-tank respondents and an individual, noted Rate-regulated Activities as their third high-priority topic. The reasons for the top-three priority were not stated, except in one case in which the reason given was the lack of clarity of the effects in utilities.

Other information

41. The project has also been discussed at a couple of IFRS Foundation Conferences and World Standard-setters meetings, and at a few other outreach events. Participants provided input on issues they encounter in practice and their views on accounting for rate-regulated activities. Commonly at these events, participants have raised concerns and questions about the accounting for rate-regulated activities that are within the scope of IFRIC 12 *Service Concession Arrangements*.

42. One respondent to the Agenda Consultation asked the Board to consider carrying out some post-implementation review type activities to look at the consistency of cross-cutting issues between IFRIC 12, IFRS 15 and the *Conceptual Framework*.[3] Staff consider that any such activity would necessarily need to consider the work being done in the Rate-regulated Activities project. Indeed, project staff have previously raised IFRIC 12 as an issue that will need to be considered within the scope of the project if the Board decide to change the way that rate-regulated activities are currently accounted for using the predominant IFRS practice.

Next steps

43. The staff plan to continue to analyse the rights and obligations created by defined rate regulation. In the coming months, the staff plan to present to the Board a series of papers that will discuss:

   (a) the meaning and use of 'the customer base', in particular within the context of the three-way relationship between a rate-regulated entity, the rate regulator and the entity's customers;

   (b) whether or how the rights and obligations created by defined rate regulation change the economics of the transactions between the entity and its customers;

   (c) whether the principles of IFRS 15, in particular relating to the identification of performance obligations, could be adapted to develop an accounting model for rate-regulated activities;

   (d) the interaction of this project with the *Conceptual Framework* project, particularly its definitions of assets and liabilities;

   (e) the consistency of the approach taken in this project compared with approaches used in other Standards and ongoing projects in accounting for the net effect of the rights and obligations;

[3] The respondent also included IFRS 10 *Consolidated Financial Statements* and IFRS11 *Joint Arrangements* in the scope of the requested review.

(f) the interaction of this project with the accounting models contained in IFRIC 12; and

(g) how to define the scope for any proposed accounting model, including an analysis of the rights and obligations that the rate regulation would need to create in order to qualify as 'defined rate regulation'.

44. The findings in the project, and the feedback we receive on the findings, will help the Board to decide whether to confirm the existing predominant practice and withdraw IFRS 14 or to change how entities currently report the effects of rate regulation.