September 2014

Discussion Paper

Snapshot: *Reporting the Financial Effects of Rate Regulation*

This Snapshot introduces the International Accounting Standards Board's (IASB) Discussion Paper *Reporting the Financial Effects of Rate Regulation*.

Project objectives:	To identify what information about the financial effects of rate regulation is most relevant to users of financial statements in making investment and lending decisions and to determine how best to reflect that information in International Financial Reporting Standards (IFRS) financial statements.
Project stage:	The IASB has published the Discussion Paper as part of its active research programme. The Discussion Paper considers the common features of rate regulation and explores which of them, if any, creates a combination of rights and obligations that is distinguishable from the rights and obligations arising from activities that are not rate-regulated. The Discussion Paper does not include specific accounting proposals. Instead, it explores several possible approaches that the IASB could consider when deciding how best to report the financial effects of a defined type of rate regulation.
Next steps:	Following consideration of the responses to the Discussion Paper, the IASB will assess whether to develop proposals for reporting specified financial effects of rate regulation.
Comment deadline:	15 January 2015.

IFRS

Overview

Interested parties can contribute to the discussion by responding to the questions in the Discussion Paper. The Discussion Paper asks questions such as:

- What information about an entity's rate-regulated activities do users of financial statements find most useful?
- Does the defined type of rate regulation that the Discussion Paper focuses on capture an appropriate population of rate-regulatory schemes?
- Which, if any, of the possible accounting approaches discussed in the Discussion Paper do you think would best portray, in IFRS financial statements, the financial effects of the defined type of rate regulation?

Please see the Discussion Paper for the full set of questions.

The IASB is seeking to identify what information about the financial effects of rate regulation is most relevant to users of financial statements in making investment and lending decisions.

In order to provide a common starting point for the discussion, the Discussion Paper focuses on a type of rate regulation (called *defined rate regulation* in the Discussion Paper). Defined rate regulation applies when customers have little or no choice but to purchase essential goods or services from the rate-regulated entity.

Defined rate regulation is designed to ensure that the rate-regulated entity recovers a determinable amount of consideration (the *revenue requirement*) in exchange for the rate-regulated activities that it performs. In addition, the rate regulation establishes, through the rate per unit chargeable to customers, the time at which the entity can bill customers for that consideration.

The Discussion Paper summarises the key features of defined rate regulation.
It discusses whether or not the features create a distinguishable combination of rights and obligations for which specific accounting requirements should be developed.

The IASB is seeking to confirm whether the description of defined rate regulation appropriately identifies the type of rate regulation that has the biggest effect on the amount, timing and certainty of revenue, profit and cash flows of rate-regulated entities.

Through the Discussion Paper, the IASB is seeking input about the advantages and disadvantages of possible accounting approaches before it decides whether or not to develop specific accounting proposals.

Background

Many governments regulate the supply and pricing of particular types of activity by entities. These activities usually involve providing goods or services that are considered in that jurisdiction to be essential to customers, including transport services, some types of insurance policies, and utilities such as gas, electricity and water.

Rate regulation is widespread and some types of rate regulation significantly affect the economic environment of rate-regulated entities. Generally accepted accounting principles (GAAP) in some jurisdictions provide specific guidance on this matter, but there is no equivalent guidance in IFRS.

Deciding whether and, if so, how IFRS should be amended to recognise the financial effects of rate regulation is therefore important.

Defined rate regulation balances the needs of the customers to purchase essential goods or services at a reasonable price with the needs of the entity to attract capital and remain financially viable. This balancing act results in the rate regulator establishing the rate that the entity charges its customers and when changes to the rate come into effect.

This can sometimes result in differences between the time at which particular costs or income are recognised for regulatory purposes and when those costs or income are recognised in the statement of profit or loss in IFRS financial statements. These differences are tracked in 'regulatory deferral accounts'.

Although most existing IFRS preparers do not recognise regulatory deferral account balances in their financial statements, they question whether the financial effects of rate regulation would be better reflected by recognising such balances in the statement of financial position.

In addition, many would-be first-time adopters of IFRS that recognise such balances in their financial statements, in accordance with their local GAAP, view this practice as a barrier to adoption of IFRS. In January 2014, the IASB issued IFRS 14 *Regulatory Deferral Accounts* as a temporary Standard to reduce that barrier.

IFRS 14 is available only to specified entities that adopt IFRS after IFRS 14 was issued. Using IFRS 14, the eligible first-time adopters are able to continue to apply their previous GAAP recognition and measurement policies for regulatory deferral account balances until the IASB concludes on the outcome of this Rate-regulated Activities project.

Providing useful information about rate regulation

The IASB has heard that users of financial statements particularly value information that distinguishes between variability in performance that is adjusted through the rate regulatory mechanism and variability for which the mechanism provides no adjustment.

This information is needed to understand the effect of the rate regulation on the revenue, profit and related cash flows of the entity, and to assess how reliable the rate regulation is in ensuring that the entity can earn its allowed returns through its billings to customers.

Some forms of rate regulation (called *market regulation* in the Discussion Paper) establish a cap on the rate per unit that the entity is permitted to charge to customers for its rate-regulated goods or services. However, the entity's management is then free to manage the business in order to maximise its profitability. The IASB has not had requests to develop any specific accounting or disclosure requirements for this type of rate regulation.

In contrast, defined rate regulation has a more significant effect. The rate regulator not only regulates the rate per unit to be charged to customers for the rate-regulated goods or services, but also regulates the activities that the entity must perform, which heavily influences the investment that the entity makes in the assets that are required to carry out those activities.

Defined rate regulation applies when there is no effective competition to the rate-regulated entity's supply of the rate-regulated goods or services and demand for those goods or services is predictable and relatively stable. The main risks to the rate-regulated entity's profitability and financial viability are, therefore, likely to be regulatory risks.

The IASB has not developed proposals regarding what information should be presented in IFRS financial statements as a result of this Rate-regulated Activities project. Through the Discussion Paper, the IASB is seeking feedback from users of financial statements to identify what information is most useful to them in making lending and investment decisions about rate-regulated entities. The Discussion Paper includes a discussion about the presentation and disclosure requirements in IFRS 14 in order to obtain more feedback about their usefulness.

Requirements of IFRS 14

The IASB is seeking feedback on the usefulness of the IFRS 14 presentation and disclosure requirements to users of financial statements. If the IASB decides to develop a long-term solution to replace IFRS 14, the requirements in IFRS 14 will inform the discussion, but those requirements may not be retained.

Entities that are eligible to apply IFRS 14 are able to continue to apply their previous GAAP recognition and measurement policies for regulatory deferral account balances. IFRS 14 provides presentation and disclosure requirements, which may differ from their previous GAAP.

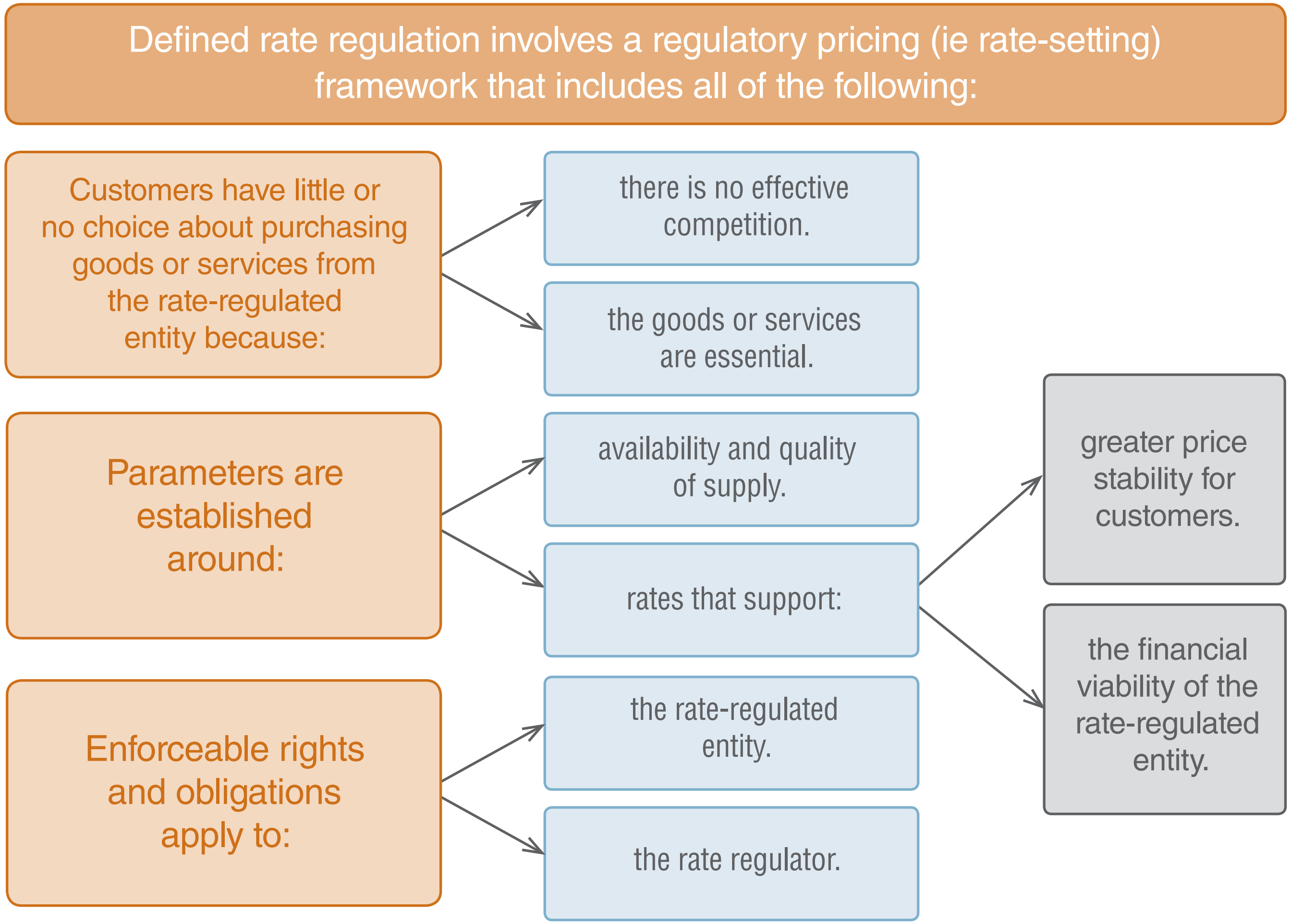
In particular, IFRS 14 requires that all regulatory deferral account balances, and the movements in them, are presented separately from the assets, liabilities, income and expenses that are presented in accordance with other Standards. This requirement for separate presentation was developed because the IASB did not, in developing IFRS 14, express any preliminary view about whether regulatory deferral account balances meet the definitions of an asset and a liability in the *Conceptual Framework for Financial Reporting*.

In addition, the separate presentation of regulatory deferral account amounts is required in order to address the potential reduction in comparability that was perceived to be created by making IFRS 14 available, on an elective basis, only to a limited population of entities.

However, if the IASB decides to develop specific accounting requirements as a result of the feedback from the Discussion Paper, those requirements would not be limited to first-time adopters of IFRS. Although the requirements of IFRS 14 may not be retained in any subsequent requirements that may be developed, they may be a useful starting point for discussions to determine how best to present the information that would help users of IFRS financial statements understand the financial effects of rate regulation.

Features of ‘defined rate regulation’

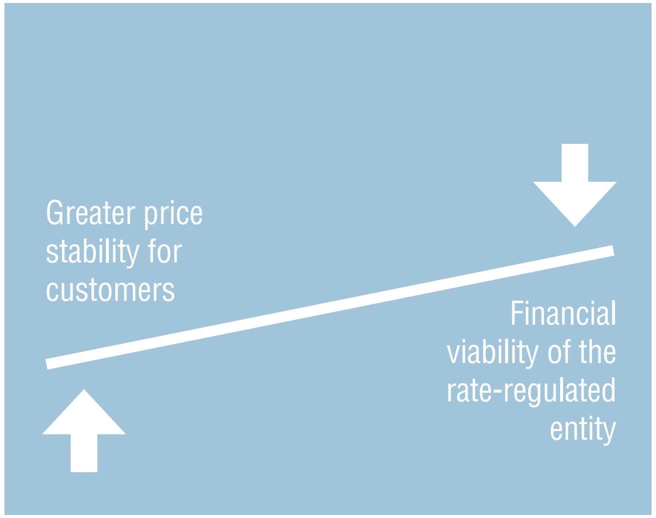
Defined rate regulation balances the needs of the customers *to purchase essential goods or services at a reasonable price* with the needs of the entity *to attract capital and remain financially viable*. The Discussion Paper explores whether this type of rate regulation creates a distinguishable combination of rights and obligations for which specific accounting requirements should be developed.



Defined rate regulation is designed to ensure that the rate-regulated entity recovers a determinable amount of consideration (called the *revenue requirement* in the Discussion Paper) in exchange for the rate-regulated activities that it performs. In addition, the rate regulation establishes, through the rate per unit chargeable to customers, the time at which the entity can bill customers for that consideration.

This can result in differences between the time at which the entity carries out its rate-regulated activities and when it can bill customers for the activities performed. Further differences can arise because the revenue requirement is initially estimated but is then revised to reflect actual events and transactions.

As a result, the rate-setting mechanism includes a regulatory adjustment mechanism to reverse specified differences between the amount of the revenue requirement accrued to date and the amounts billed to customers. This mechanism seeks to ensure that the rate-regulated entity earns no more and no less than the amount of the revenue requirement and any related profit or return to which it is entitled.



In defined rate regulation, the restriction of customer choice makes demand relatively inelastic and contributes to a high level of predictability of the timing and probability of future sales. It is, therefore, usually assumed that the rate regulator is able to use the adjustment to the price charged for future sales as a practical, low-cost and reliable mechanism for the entity to recover the amount of any under-billing or reverse the amount of any over-billing.

The Discussion Paper explores whether the regulatory adjustment mechanism, together with the other features of defined rate regulation, creates a combination of rights and obligations for which specific accounting requirements should be developed.

In addition, the Discussion Paper considers whether the combination of rights and obligations supports the recognition of the entity’s right to recover, or obligation to reverse, the specified differences as an asset, or a liability, in the statement of financial position.

Possible financial reporting approaches

The Discussion Paper presents some possible financial reporting approaches that explore how the financial effects of defined rate regulation could best be reported in IFRS financial statements.

The IASB has undertaken this project because it has received feedback that particular aspects of rate regulation create a special combination of rights and obligations that support the recognition of 'regulatory assets' and 'regulatory liabilities' in addition to the assets and liabilities already recognised in accordance with IFRS for non-rate-regulated activities.

The asset and liability debate

In an earlier Rate-regulated Activities project, the main focus of the discussions was about whether the entity's right to increase the future rate, or obligation to decrease the future rate, met the definitions of an asset and a liability in the *Conceptual Framework*. Strongly held but diverse views were formed during that project and, at that time, the IASB was unable to develop a clear direction to help it resolve the issues that were raised.

The IASB is currently revising the *Conceptual Framework*. Tentative decisions made to date suggest that the definitions of assets and liabilities are likely to change. However, it is not clear how significant the impact of these changes may be.

Consequently, the IASB is considering alternative approaches to identify how best to reflect the financial effects of defined rate regulation in IFRS financial statements. The possible approaches described in the Discussion Paper are summarised in the following paragraphs.

Recognising the package of rights and obligations as an intangible asset (ie a licence)

The IASB could consider whether to amend IAS 38 *Intangible Assets* to recognise particular aspects of the rate-setting process in changes to the carrying amount of the regulatory licence or components of the licence.

Adopting the regulatory accounting requirements

The IASB could consider whether to provide an exemption to the general requirements of IFRS to enable rate-regulated entities to apply regulatory accounting requirements that would otherwise conflict with existing Standards.

Developing specific IFRS requirements

The IASB could consider whether to develop accounting requirements to defer or accelerate the recognition of costs, revenue or a combination of costs and revenue. This approach could more closely align the timing of recognition of specified costs and income for regulatory purposes and IFRS financial reporting purposes.

Prohibiting the recognition of regulatory deferral account balances

The IASB may conclude, after considering the feedback from the Discussion Paper and from the *Conceptual Framework* project, that regulatory deferral account balances should not be recognised in IFRS financial statements.

In such a situation, the IASB could consider whether to develop specific disclosure-only requirements to explain the financial effects of rate regulation to users of IFRS financial statements.

Next steps

At this time, the IASB has not made any tentative decisions about which approach, if any, it prefers. Instead, the IASB is seeking feedback from stakeholders about the advantages and disadvantages of the approaches and whether there are any other approaches it should consider.

This feedback will then be considered, together with the feedback received on the other issues considered in the Discussion Paper, in order to determine the next steps for this Rate-regulated Activities project.

Other issues

The Discussion Paper discusses some issues that the IASB may need to consider if it decides to develop specific accounting requirements for rate-regulated activities.

Interactions with other Standards

IFRIC 12 *Service Concession Arrangements*

The issues faced by operators in some service concession arrangements are similar to those faced by entities that are subject to defined rate regulation. Consequently, the IASB may need to consider the interaction of many aspects of IFRIC 12 with any specific accounting requirements that may be developed for rate-regulated activities.

IFRS 15 *Revenue from Contracts with Customers*

If the IASB decides to develop specific accounting requirements that involve the deferral or acceleration of revenue, it may need to consider whether (and, if so, how) the principles of IFRS 15 could be adapted to form the basis of a tailored revenue recognition model for rate-regulated activities.

IAS 12 *Income Taxes* **and IAS 20** *Government Grants*

In cases in which the government or the rate regulator provides funding to the rate-regulated entity in exchange for some of its rate-regulated activities, the IASB may need to consider how to allocate the total revenue requirement between the amounts that will be recovered through amounts billed to customers and those to be recovered through other forms of settlement with the government or rate regulator.

IFRS 3 *Business Combinations*

If the IASB decides to develop specific accounting requirements that result in rate-regulated entities recognising regulatory deferral account balances in the statement of financial position, it may need to consider how to recognise and measure such balances acquired or assumed in a business combination.

IFRS 9 *Financial Instruments*

If the IASB decides that regulatory deferral account balances should be recognised in the statement of financial position, it may need to consider the nature of any such balances to be recognised. If the balances are determined to be similar in nature to financial assets and financial liabilities, the IASB may need to consider whether the balances should be measured in the same way as financial instruments.

Further information

The IASB invites comments on the topics presented in the Discussion Paper. Respondents are invited to respond to any or all of the questions in the Discussion Paper and to comment on any other matter that the IASB should consider. To view the Discussion Paper and submit your comments, please visit http://go.ifrs.org/comment.

The deadline for comments on the Discussion Paper is **15 January 2015**.

Stay informed

The IASB will consider the comments received on the Discussion Paper to decide whether or not to develop an Exposure Draft on reporting the financial effects of rate regulation. The IASB's discussions will take place in public meetings. To access information about those public meetings, stay up to date with the latest developments and to sign up for email alerts about the project, please visit the project homepage on http://go.ifrs.org/Rate-regulation.

International Accounting Standards Board® (IASB®)
The IASB is the independent standard-setting body of the IFRS Foundation®

30 Cannon Street | London EC4M 6XH | United Kingdom

Telephone: +44 (0)20 7246 6410 | Fax: +44 (0)20 7246 6411
Email: info@ifrs.org | Web: www.ifrs.org

Publications Department
Telephone: +44 (0)20 7332 2730 | Fax: +44 (0)20 7332 2749

Email: publications@ifrs.org

100%

Printed on 100 per cent recycled paper