IASB RRA Discussion Paper Outreach Meeting Notes
Washington, DC
December 8, 2014

Introduction

- The meeting was attended by over 20 participants and observers, plus IASB and FASB Board members (termed 'standard-setters' in this meeting summary) and IASB staff. Participants represented the following stakeholder groups:
    - Financial statements users ('analysts')
    - US Regulated entities and industry associations ('preparers')
    - Auditing firms ('auditors') and
    - Regulatory agencies ('rate regulators').
- IASB staff outlined the purpose of the meeting:
    - Discuss the rights and obligations resulting from rate regulation
    - What are the most important financial effects of rate regulation
    - What do financial statement users need

Topic 1 – Information desired by users of financial statements (FS)

- A standard-setter asked if the focus is the ability to recover costs and stability of earnings
- An analyst addressed the needs of FS users:
    - Concern of fixed income analysts is sustainability of earnings, asset value, and cash flows
    - Reliability of regulatory recovery
    - Noted that industry analysts have a high level of confidence in the amounts recorded under US GAAP
    - Prefer recording regulatory assets and liabilities in the FS as opposed to footnote disclosure or MD&A (unaudited)
        - Would result in preparer adjustments to GAAP FS to incorporate regulatory assets and liabilities through non-GAAP measures
        - If IFRS does not allow regulatory assets and liabilities to be recognized in the FS, this would increase the reliance on non-GAAP measures and there are concerns about reliability and consistency of non-GAAP information
- Another analyst commented that equity analysts consider regulatory assets to be recoverable
    - Courts support regulatory recovery of prudently incurred costs
    - Regulator's objectives include maintaining a low cost of capital for utilities
    - If there is no recognition of regulatory assets and liabilities under IFRS,
        - will result in an increased reliance on non-GAAP disclosures, thus increasing uncertainty, risk premiums and cost of capital
        - will require greater resources and costs for FS users to find information from other sources
- Question from standard-setter regarding different regulatory jurisdictions
- Question from standard-setter regarding reliability of recovery

- Response by an analyst:
    - Rate regulation creates a "new economic reality"
    - Noted that a major credit rating agency evaluates all 50 states from most supportive to least supportive regulatory environment, which impacts credit quality
    - Supports the approach of IFRS 14 along with disclosures to help understand what is happening, how regulatory assets and liabilities arise and validate rate recovery
    - Focus is on future cash flows and when expected to be recovered, so useful disclosures include:
        - analysis of how/why regulatory balances arise
        - a maturity schedule indicating when balances are expected to be recovered/reversed
    - Wants to see the information audited – non-GAAP disclosures are not consistent
- A rate regulator:
    - Regulatory Commissions need audited financial statements (do not have the resources to perform their own audits)
    - Regulatory accounts are legally binding once decided by public utility commissions
    - If IFRS does not allow for regulatory assets and liabilities, regulators will still render rate decisions that recognize regulatory assets and liabilities
- IASB staff asked what happens if there is a change in demand (i.e., the level of sales changes)
    - The rate regulator responded that a specified Public Utility Commission provides a true-up mechanism and other states PUCs have similar mechanisms
    - An auditor noted that there is decoupling in certain states to shift demand risk from the supplier to the customers
- A preparer noted that there is a prohibition against retroactive ratemaking so past decisions cannot be overturned by new government/rate regulatory bodies
    - A rate regulator noted that a transmission rate approved by the FERC cannot be denied by a state PUC
    - An analyst noted that the rate regulator's point about FERC approval has been upheld by the U.S. Supreme Court
- A standard-setter noted that SFAS No. 71 has been in place in the US for many years, but international is different
    - They are trying to determine how to distinguish economic effects that result from regulatory schemes
    - Asked how to put a boundary on the standard, for example, legally enforceable as a bright line
- An analyst stated that legally binding may not be the appropriate standard and that he supports probable. Some auditors expressed agreement with probable because judgment may be appropriate in some cases to recognize balances when there is evidence to suggest that recovery is highly probable but the formal regulatory approval process has not been completed (this point was also discussed under Topic 2).
- A standard-setter noted that international standard-setters are concerned about how to limit the application of probable because of concerns that amounts recognized will not be recovered

- Another standard-setter noted that in the international arena there is concern with smoothing
  - Important to note that regulatory liabilities are equally included in US accounting for rate regulation
  - Must overcome the concern about merely avoiding recognition of an expense in the current period
  - Noted also that many demand differences are not reversed – elasticity of demand is minimal and is compensated for in the regulatory process
  - Also, should not apply to all rate regulated entities such as hospitals and insurance companies
  - Need to focus on the nature of the rate setting process with limited application

Topic 2 – Rate Regulation as Defined in the Discussion Paper (DP)

- Confirmation that "defined rate regulation" as described in the DP is a hybrid form of rate regulation, which can incorporate some incentive mechanisms as well as cost recovery elements
- IASB staff asked if companies book regulatory assets and liabilities based on past history of rate regulatory decisions, before a formal regulatory approval
  - A preparer responded that there is a hierarchy for deciding to record regulatory assets and liabilities: rate order, tariff, prior experience/decisions of the PUC, decisions in other jurisdictions
- A standard-setter asked how much uncertainty exists about recovering some costs versus other costs; another standard setter asked how fast does the regulator work, e.g., how long does it take before formal regulatory approval of adjustments is given
  - A preparer responded that it depends on the jurisdiction; some jurisdictions have riders (adjustments related to these are fairly mechanical with little discretion or judgment because the regulation is clear about what costs are captured by the rider adjustment) and others do not, which requires analysis regarding the probability of rate recovery
- IASB staff asked how specific does the regulation need to be since it can vary from specific recovery to settlements in different jurisdictions
  - A rate regulator described the process for requesting rate recovery when costs are incurred which can include an accounting order with later rate recovery
  - Another rate regulator noted that the issuance of an accounting order gives consideration to the likelihood of rate recovery being allowed
  - A preparer noted that the US concept is that the regulator will take action to create binding jurisdictional rights and obligations; therefore, when looking at the definition, it is important to look at all characteristics taken as a whole to see if they create an economic result that warrants recognition
- A standard-setter noted that the IASB is redefining its concept statements and that it would be good to consider how defined rate regulation fits the proposed concepts of economic resource and economic benefit
- Another standard-setter noted that scoping is critical regarding SFAS No. 71 versus the DP

- Another standard-setter noted that the regulatory compact is designed to allow recovery of costs/expenditures resulting in future cash inflow (an asset) – an economic environment, a regulatory compact, and enforceable rights and obligations

Topic 3 – Potential Accounting Approaches

- IASB staff noted that some international commentators are not convinced that the incurrence of a cost that is eligible for recovery is the "past event" that is needed to meet the definition of an asset in the IASB's *Conceptual Framework*
    - concern about future sales to collect costs being a future contingent event since you cannot obligate the customer to consume Kwh of electricity or Mcf of gas
    - An auditor noted that, based on specific facts and circumstances, the SEC provided pre-clearance approval of IFRS financial statements, including recognition of regulatory assets and liabilities in a particular case, suggesting the definitions were met in that case
- A standard-setter suggested discussing period cost versus product cost; product cost is recovered over time; only difference is regulatory asset is for a period cost which is recovered over time
    - The incurrence of cost provides evidence that performance has occurred
    - Recovery of the asset is probable since there are future sales of an essential good
    - If not an asset, then why are deferred tax assets recognized as assets
    - Cost is incurred in period 1 and revenue collected in period 2 resulting in an asset in period 1
- Several participants supported footnote disclosures of separate regulatory assets and liabilities related to cash flows
    - Unique rights and obligations
    - Not a net single asset or liability
    - Typically, not a legal right to offset without prior PUC approval
    - Information about timing of recovery/reversal of different types of regulatory assets and liabilities is important, especially for predictability of cash flows
- Revenue adjustment versus cost deferral
    - Some auditors and one of the standard-setters discussed the principles of IFRS 15 *Revenue from Contracts with Customers* as being a <u>possible</u> path to recognition of regulatory assets and liabilities and therefore deserving further study
    - An auditor noted that, based on specific facts and circumstances, it was his understanding that the SEC did not agree with revenue adjustment in a particular case referred to it, in which regulatory assets and liabilities were recognized in IFRS financial statements
    - A preparer – prefer cost deferral but could accept revenue adjustment
    - A standard-setter – SFAS No. 71 is a combination of cost deferral and revenue adjustment (e.g., for alternative revenue programs)