

SUMMARY REPORT ON USER EVENT

RATE-REGULATED ACTIVITIES: IS THERE ANYTHING MISSING FROM THE BALANCE SHEET?

BRUSSELS

18 DECEMBER 2014

This summary report has been prepared for the convenience of European constituents by the EFRAG secretariat and has not been subject to review or discussion by the EFRAG Technical Expert Group and the EFRAG Board. It has been reviewed by the EFFAS and ABAF Secretariats and by IASB staff and has been jointly approved for publication by representatives of EFRAG, EFFAS, ABAF and the IASB who attended the joint outreach event.

Introduction

Rate regulation can apply to industries where a regulator is appointed to set prices that a company can charge to customers. Companies affected by rate regulation usually provide essential services such as utilities where the level of competition is low. It is argued by many that the special circumstances around rate-regulated activities should be the subject of a specific financial reporting standard.

On 17 September 2014, the IASB published a Discussion Paper *Reporting the Financial Effects of Rate Regulation* ('DP') and requested comments by 15 January 2015. The main objectives of the DP are 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 how best to reflect that information in the IFRS financial statements. The DP sought feedback, in particular from users of financial statements, about how these objectives could be achieved.

To seek the views of users on the IASB DP, the European Financial Reporting Advisory Group (EFRAG), the European Federation of Financial Analysts Societies (EFFAS) and the Association Belge des Analystes Financiers (ABAF), in cooperation with the International Accounting Standards Board (IASB), organised a joint outreach event ('the event') that took place on 18 December 2014 in Brussels.

In addition to users, the event attracted a range of other stakeholders including preparers, auditors, Standard Setters and other European organisations. The views expressed in this summary report reflect the individual views expressed by participants at the event. The feedback they provided contributed to EFRAG's comment letter in response to the DP.

The speakers panel was composed of Jesùs Lopez Zaballos, Chairman of EFFAS; Philippe Danjou, IASB Board Member; Françoise Flores, Chairman of EFRAG TEG; Patricia McBride, EFRAG Technical Director, and a panel of analysts: Bart Jooris, Equity analyst at Bank Degroof; Myriam Cohen, Equity analyst at Alpha Value; Stefanie Voelz, Vice President - Senior Analyst at Moody's Investors Service Ltd.

Objective and scope of this Summary Report

Participants focussed their discussions on the following issues:

- What information about an entity's rate-regulated activities and the rate-regulatory environment do users need?;
- Where do users currently obtain information about rate regulation?; and
- Whether users prefer the impact of rate regulation to be included in the primary financial statements or/and as disclosures.

Summary of observations

The main observations made by participants can be summarised as follows:

- Users want to understand the driving forces of rate regulation, how transparent and predictable it is, the financial effects it creates, and how it impacts the business model and the risk profile of an entity that operates with activities subject to rate regulation. Furthermore, users need to understand the reasons why reported results differ from budgeted figures and how reported differences could be translated into adjustments to future tariffs and therefore cash flows for the entity.
- Users need detailed information to assess the return on capital employed, an entity's ability to repay debts and to assess future cash flows.
- Currently, users generally obtain information from sources other than the IFRS financial statements.
- A major difficulty for users is the lack of comparability and consistency in the way financial information is currently presented where different regulations exist in different countries.
- Where enforceable rights and obligations exist, users preferred having this information recognised in the primary financial statements where a certain level of reliability is ensured; but they would be concerned about recognition if the definition of elements (e.g. assets and liabilities) in the Conceptual Framework were not met.
- Where recognition of regulatory items in the primary statements were considered, sufficient, supplementary qualitative and quantitative disclosures should be mandatory to let users understand how management has exercised judgement and what risks are attached to the regulatory items.

Detailed comments

Jesùs Lopez Zaballos introduced the discussion and explained that users generally need to understand the driving forces of rate regulation, the financial effects it creates and how it impacts the business model of an entity that operates with activities subject to rate regulation. In order to understand financial effects, it was necessary to have a description of the regulatory regime and rate-setting framework. Users need to be able to understand how transparent regulations are in order to form a view about their predictability.

Philippe Danjou presented the IASB discussion paper *Reporting the Financial Effects of Rate Regulation* and noted the importance for the IASB of obtaining an in-depth understanding of users' needs when rate regulation exists.

What information about an entity's rate-regulated activities and the rate-regulatory environment do users need?

Users want to understand the driving forces of rate regulation, how transparent and predictable it is, the financial effects it creates and how it impacts the business model and the risk profile of an entity that operates with activities subject to rate regulation. Furthermore, users need to understand the reasons why reported results differ from budgeted figures and how reported differences could be translated into adjustments to future tariffs and therefore cash flows for the entity.

Philippe Danjou explained that the IASB discussion paper acknowledges that financial reporting aims to provide financial information that is useful to investors and analysts (users) when making decisions about providing funding or other resources to a particular entity. Therefore, a key objective of the IASB's project on rate-regulated activities is to understand what information users need about the effects that rate regulation has on the amount, timing and certainty of future cash flows of a rate-regulated entity and how this may influence the returns expected by users.

The panellists stated that there was a need to understand economic trends in entities operating rate-regulated activities in order to assess their potential cash flow generation. To do so, the following information is normally needed:

- A description of the business model of these entities and how the business risk profile and financial risk profile is affected by rate regulation;

- The nature of regulation and its driving forces; its inherent mechanics; how it is organised (i.e. existence of an external regulator); the countries where it is in force; the reasons why it was set up; and its maturity;
- The likelihood that rate regulation might change; and how changes could affect the underlying economic trends of entities;
- How this information is reflected in the financial statements and how it affects the current and future cash flow pattern and timing of those cash flows compared to peer entities and other non-rate-regulated entities (e.g. volatility in reported performance);
- How regulations result in incentives and how they affect the investment plans of an entity (such as investments in green energy);
- Why reported results differ from budgeted figures and how reported differences could be translated into adjustments to future tariffs and therefore to future cash flows;
- How political influence affects rate regulation, as this could reduce the level of predictability of the effects of rate regulation;
- How entities might influence the decisions of the regulator, for example, when there is a significant investment plan in place; and
- The building blocks of the revenue requirement together with how revenue is calculated where a regulatory asset base exists.

The panellists agreed that the information above was needed by country and by different regulations. They also highlighted that there should be segment reporting provided by an entity which has both rate-regulated and non-rate-regulated activities.

One panellist stated that where regulations encompassed adjustments to future tariffs, they needed to understand how straightforward the regulatory review process would be. For instance, where changes are subject to the discretionary approval of an external regulator, it could be argued that regulations do not themselves create enforceable rights and obligations.

Jesùs Lopez Zaballos concurred that assessing political influence and risk exposure is essential as, usually, political actions produce financial effects in the short-term. However, the business model of this type of entity is built on longer-term forecasts and users need to prepare their model based on consistent perspectives. Unexpected changes impair users' analyses.

Philippe Danjou noted that changes in regulations normally raise more fundamental issues over the expected recovery of the capital employed as these entities are usually capital intensive. He stated that some parts of the tariff adjustment relate to short-term timing differences that are recovered/reversed in the short-term and therefore, could be assessed over a consistent short-term period.

Users need detailed information to assess the return on capital employed, an entity's ability to repay debts and to assess future cash flows.

Jesùs Lopez Zaballos stated that EFFAS is working with some partners on non-financial measures and he stated that for investors in entities operating rate-regulated activities, non-financial information is key because smaller investors need easy measures to perform their analyses.

The panellists stated that the information about rate regulation is used mainly to assess:

- the return on capital employed;
- an entity's ability to repay debts;
- impact on certainty of cash flows;
- forecast future cash flows;
- the components of the weighted average cost of capital; and

- comparability with peer companies.

The panellists stated that assessing the trends on return on capital employed is helpful in predicting effects on future tariffs and therefore cash flows because when entities realise a high return on capital employed, the rate-setting mechanism is generally revised in order to balance the financial viability of entities with the customers' needs in having affordable prices.

Where do users currently obtain information about rate regulation?

Currently, users generally obtain information from sources other than the IFRS financial statements.

Generally, users obtain information about rate regulation and its effects on an entity from various sources such as the rate regulator, investor presentations or direct conversations with management. The usefulness of the regulatory information varies from jurisdiction to jurisdiction (some regulatory information is more transparent and detailed than others), and users sometimes need to supplement the regulatory information with information provided by the entity to enable a more complete picture of the current and future impacts.

The panellists acknowledged that where regulations are less transparent, they need to invest a significant amount of time to do their research and rely on information obtained directly from management. However, they also noted that not all investors had the time and/or resources to obtain this information.

Whether users prefer the impact of rate regulation to be included in the primary financial statements or disclosure-only requirements

One panellist stated that by allowing recognition of regulatory assets and liabilities where enforceable rights and obligations exist, the artificial volatility in performance would be removed over the short-term and users could assess how these items would affect the rate-setting process over the following regulatory periods.

If the information on the impact of rate regulation was reliable, it could be recognised in the financial statements if it resulted in improving transparency and comparability of financial information. However, the panellists would also want to see in the financial statements the actual cash flow generated by the entity to understand its liquidity position and highlight whether the entity could recover/pay back from/to the customers.

Furthermore, it was argued that the transparency of regulations differed between different types of regulations and across countries. Therefore, it would be helpful to have additional information in the financial statements to enhance comparability and ensure that relevant information is obtained.

The panellists noted that it was not always helpful to have all the information on rate regulation directly in the primary financial statements.

It was generally agreed that the description of the rate-regulatory regime could be placed outside of the financial statements (e.g. in the management commentary). The panellists agreed that disclosures should not be excessive, otherwise they would reduce the relevance of financial information.

A major difficulty for users is the lack of comparability and consistency in the way financial information is currently presented where different regulations exist in different countries.

The panellists also stated that a major hurdle was to overcome the lack of comparability and consistency in the way financial information is currently presented given the diverse regulations in different countries. This difficulty is increased when entities in a group operate in different countries. However, some panellists would not favour recognising the financial effects of rate regulation in the financial statements where regulations are constantly subject to change and are not transparent.

One panellist indicated that currently users need information about the timing effects of rate regulation. In particular, they need information about why the regulatory differences have arisen, whether they are expected to be recurring or non-recurring and when they are expected to be recovered/reversed. The panellists agreed that recognising the impact of rate regulation in the financial statements, with a reconciliation of opening and closing balances and supporting information, would permit users to have information on a continuous basis and thereby assist in assessing future cash flows.

Philippe Danjou indicated that under certain conditions (e.g. where enforceable rights and obligations exist), if regulatory amounts were recognised, presentation of interim results would address this type of issue.

One panellist believed that where enforceable rights and obligations exist, information should be presented in the primary financial statements. Jesús Lopez Zaballos concurred and remarked that financial analysts generally prefer information in the primary financial statements rather than provided as disclosure-only. Furthermore, he added that the comparability issue is core for users that need to compare entities in different countries.

However, one panellist was concerned that recognising regulatory amounts in the statement of financial position does not necessarily imply that they are assets and liabilities. Therefore, he cautioned that recognition should be allowed only when assets and liabilities exist.

Françoise Flores asked whether the current pattern of cash generation could be found in the cash flow statement. The panellists commented that the cash flow statement does not help to predict future cash flows because it only provides information about past cash flow movements. However, they stated that users also need to analyse the statement of financial position to assess, for instance, the debt position and the quality of assets that are presented in it.

Philippe Danjou noted that the cash flow statement does not explain the reasons why an entity has collected the reported cash flows that may differ from budgeted numbers. It also does not explain whether part of the cash flows were generated by transactions and events that took place in previous years and whether they are expected to re-occur in future years.

The panellists generally agreed that if there was a high probability to recover/settle amounts due to the impact of rate regulation and if the right/obligation of an entity to recover/settle was enforceable, then that impact should be recognised in the financial statements. This would imply that only rights and obligations that meet the definition of elements (e.g. assets and liabilities) in the Conceptual Framework should be recognised in the primary financial statements and other elements should be disclosed.

Philippe Danjou indicated that there are two features in the description of defined rate regulation as set out in the discussion paper to address the probability to recover/settle amounts due to the impact of rate regulation:

- enforceability of the rights and obligations of rate-regulated entities; and
- relatively inelastic demand.

Where enforceable rights and obligations exist, users preferred having this information recognised in the primary financial statements where a certain level of reliability is ensured; but they would be concerned about recognition if the definition of elements in the Conceptual Framework were not met.

Transparency and stability of regulations however represented required conditions as they avoided the subjectivity of assessing probability where different regulations were in force in different countries. The panellists were concerned that the high level of judgement involved in these circumstances may lead to divergence and therefore would not address the current lack of comparability. Where reliability is ensured, recognition of the impact of rate regulation in the primary financial statements would reduce divergence in practice.

The panellists observed that the exercise of judgement is inherent in preparing financial statements (e.g. recognition of research and development intangible assets) and therefore, recognition of regulatory items should be permitted where a certain level of reliability is preserved; and it should be supplemented by sufficient disclosures.

Where recognition of regulatory items in the primary statements were considered, sufficient supplementary qualitative and quantitative disclosures should be mandatory to let users understand how management has exercised judgement and what risks are attached to the regulatory items.

Disclosures should be used to describe the risks to recover/settle the amount recognised irrespective of the type of regulation and the country where it is in force. Disclosures should also serve to address users' concerns about the complexity of rate regulation and how complex rate regulation would be reflected in a useful manner. Information about regulations could be presented elsewhere in the annual report or a link to other corporate sources in order to avoid disclosure overload.

Philippe Danjou noted that disaggregated disclosures by country and regimes might help to obtain sufficient information to understand how management has exercised judgement in recognising rate-regulatory items. Furthermore, he stated that in IFRS 15 *Revenue from Contracts with Customers*, revenue for a variable consideration could be recognised if it was highly probable it would be received. There should be sufficient certainty to recognise revenue where enforceable rights and obligations are present and a high probability of receiving the consideration exists.

While concurring, one panellist expressed concern that under IFRS 15 where the consideration is too variable, an entity might end up not recognising revenue at all. Philippe Danjou noted that the degree of prudence in IFRS 15 could guide entities to apply judgement in recognising revenue depending on facts and circumstances.

Françoise Flores asked why reliability would be considered an issue for recognition but not for disclosures. The panellists considered that recognition implied a high degree of subjectivity as it would be up to the rate-regulated entities or auditors to assess whether they believed that assets and liabilities were likely to be realised. However, where only disclosures were provided, users could make their own assessment on whether to rely on the entities' assessment or not and which adjustment should be made to numbers presented. Furthermore, having these numbers in the primary financial statements not supplemented by sufficient disclosures could reduce users' level of scrutiny regarding the risks attached to them.

Regarding the benefits for users where information on the effects of rate regulation were presented in the financial statements, the panellists stated that they would only have to contact the company to gain some clarifications when the financial statements are published. Some panellists stated that users generally perform adjustments to estimate future cash flows. One panellist noted that one source of adjustments is the qualified audit opinion on the financial statements. This panellist indicated that currently there are instances where entities recognise regulatory items into their financial statements but the recognition of these items results in qualifying the audit opinion. It was generally agreed at the event that if the IASB were to decide on whether rate regulation creates items that meet the definitions of assets and liabilities, similar situations were likely to become rare.

Moreover, one panellist stated that where facts and circumstances allowed recognition of the effects of rate regulation in the primary financial statements supplemented by sufficient detailed disclosures, the usefulness of financial information would increase and it could ease the decision-making process of users.

One participant (regulator) questioned how the probability of recovering/settling amounts would be assessed, who would assess it and the meaning of highly probable as that may differ from jurisdiction to jurisdiction.

One panellist suggested that if current regulation stipulates that the entity can recover the amounts impacted by rate regulation, then it could be seen as highly probable. The recognition of the rate-regulatory items in the balance sheet was then analogised with the accounting for deferred tax. Furthermore, it was stated that rate regulation is normally stable within the regulatory periods and it is the users' job to forecast expected changes in future regulatory periods.

Concluding remarks

The panellists provided their concluding remarks summarising their views as follow:

- The IASB should consider the information users need to make their own assessment, irrespective of whether entities will recognise the impact of rate regulation in the primary financial statements.
- Users preferred having this information recognised in the primary financial statements where a certain level of reliability is ensured, otherwise they would want it to be included in the disclosure notes. Irrespective of the location, users need to understand the information provided and the information management had in exercising judgment about what was either presented or disclosed. Whatever recommendations were to be made to the IASB, comparability and consistent application should be sought as the main characteristic of financial information.
- Equity analysts have little time and therefore where the reliability criterion was met, users preferred the impact of rate regulation to be presented in the primary financial statements supplemented by sufficient detailed disclosures.

Jesùs Lopez Zaballos, Philippe Danjou, and Françoise Flores thanked the panellists and participants.

RATE-REGULATED ACTIVITIES: IS THERE ANYTHING MISSING FROM THE BALANCE SHEET?

JOINT OUTREACH EVENT

THURSDAY 18 DECEMBER - EFRAG OFFICES BRUSSELS

SPEAKERS



Bart JOORIS

Bart Jooris CFA has been working as a senior equity analyst for Bank Degroof since July 2013, covering among others the regulated utility companies Elia and Fluxys. Before joining Degroof, he spent 13 years as a sell side and buy side analyst with Fortis. During this time, he worked on the IPO of Elia for Fortis, which was one of the leading banks. Bart has a master degree in Business Economics, Commercial Engineer.



Myriam COHEN

Myriam Cohen worked for 22 years in international banks and corporate groups: Crédit Lyonnais, Banque Indosuez (equity analysis, M&A), Lyonnaise des Eaux (utilities privatisation, growth operations, restructuring, board duties in France and abroad).

She subsequently worked for 10 years as an independent financial advisor for M&A and IPO operations and, in 2008, she joined AlphaValue, a new venture in independent equity research, where she has a special focus on the European utility and concessions sector (airports, energy, toll roads, water and waste, satellite services).

Myriam has 13 years of experience in teaching and educational engineering, including the International MBA and Masters Programmes at Conservatoire National des Arts et Métiers (Feasibility Study and Business plan, Corporate Finance).

Myriam graduated in Chemical Engineering (1971) and she holds a Master's degree in Business Administration (Columbia University, USA, 1973) and a graduate qualification in Accounting and Finance (2000).

She is a member of the French Financial Analysts' Association and its Financial Analysis and Accounting Commission which participates in the debates that precede the introduction of new IFRS standards.



Stefanie VOELZ

Stefanie is a Vice-President – Senior Analyst in Moody's Utilities and Infrastructure team in London. She is covering a portfolio of primarily regulated utilities in the UK, Germany, the Netherlands and the Czech Republic, as well as air traffic control providers in Europe. She has in-depth knowledge of highly-covenanted financing structures in the regulated utility space, as well as project financing techniques.

Stefanie has also been the lead author of Moody's Rating Methodology for Regulated Water Utilities, published in December 2009; Moody's Special Comment on the Incentive-Based Network Regulation in Germany, published in October 2010; and Moody's Special Comment on UK Operational Offshore Transmission Owners, published in May 2013.

Prior to joining Moody's in October 2004, Stefanie worked in the credit department of Bankgesellschaft Berlin AG (now Landesbank Berlin AG) in London and Berlin, where she held portfolio responsibility for project finance transactions in the energy and infrastructure sectors.

Stefanie holds a degree in business administration (Diplomkauffrau) from the University of Applied Sciences in Berlin.



Philippe DANJOU

Until his appointment with the IASB, Mr Danjou was the director of the accounting division of the Autorité des Marchés Financiers (AMF), the French securities regulator. He graduated from HEC, then qualified as a Chartered Accountant and Registered Statutory Auditor, and joined Arthur Andersen & Co. (Paris) in 1970. At Arthur Andersen, Mr Danjou ultimately became an audit partner. He was also Executive Director of the French Ordre des Experts Comptables (OEC) from 1982 until 1986.

Mr Danjou was a member of the International Auditing Practices Committee and a technical adviser to the French delegate to the former International Accounting Standards Committee, the predecessor to the IASB.

While at the AMF he served on the IASB's Standards Advisory Council, as an observer at the Committee on Auditing of the European Commission, as a member of IOSCO's Standing Committee 1 on Multinational Accounting and Disclosure, and the Financial Reporting Committee of the Committee of European Securities Regulators (CESRFin).

In 2006, he was appointed chairman of the European Enforcers Coordination Sessions created by CESRFin to help foster consistent enforcement by regulators of IFRS-based financial statements.

	<p>Françoise FLORES</p> <p>Françoise Flores has been EFRAG TEG Chairman and CEO since April 2010. She chaired the organisation from 2010 until the reform in October 2014.</p> <p>Prior to joining EFRAG, she was a partner of Mazars in France and one of the IFRS experts of the firm. In that capacity, she has been acting for several years as IFRS Technical Advisor to large European businesses (through Acteo, ERT and BUSINESSEUROPE). She has been a member of EFRAG TEG since April 2004.</p> <p>Her IFRS expertise is backed up by over 20 years in controlling and financial reporting, of which 10 years as CFO, in the context of large and medium-sized international listed corporations.</p>
	<p>Jesús LÓPEZ ZABALLOS</p> <p>Mr Zaballos is currently the Chairman of EFFAS and Deputy Chairman of the ACIIA (Association of Certified International Investment Analysts).</p> <p>He holds a PhD in Management & Business Administration from San Pablo CEU University, Madrid (1999), summa cum laude, and a Degree in Economics & Business Administration at Complutense University, Madrid (1985). He also has a Diploma in General Management (PDG) from IESE (1997). Since 1990, he has been a usual Lecturer and Visiting Professor in Seminars and specialised courses in several Universities and Business Schools.</p> <p>He began his professional activity as broker in the Spanish Money Market in 1983. He subsequently held various positions as manager and executive in the Financial and Capital Markets departments as ARGENTARIA (actual BBVA from late 1991 to 2000).</p> <p>In 2000, he founded Formación y Finanzas, S.L, a consultancy company of Financial and Training Advisory. He is currently the Chairman.</p> <p>Since 2002, he has been the General Manager of the Training & Qualification School of the Spanish Institute of Financial Analysts (IEAF) and since 2007, the Director of its International area.</p> <p>Since 2013, he has been founding partner of Aureo Wealth Advice EAFI, S.L, a wealth manager company registered in the Spanish regulator. In 2014, he has been appointed member of the Advisory Board of Docout, a specialised company in the outsourcing services, in business processes, records management and consulting, with high technological tools.</p>



Patricia McBride

Patricia McBride joined EFRAG on 29 April 2014 as Technical Director.

Although she is a UK citizen, she has spent most of her career working in Asia-Oceania. She is well known in the international IFRS arena for her technical roles supporting the standard setters in Australia, New Zealand and Hong Kong. Part of her career was spent in academia and in her earlier days she was Chief Accountant of a subsidiary of a large German corporate for eight years. She has written for textbooks, academic journals and newspapers and has extensive experience explaining technical accounting issues to non-accountants.