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IFRS Developments

IASB issues a discussion paper on reporting the financial effects of rate regulation

What you need to know

- The IASB hopes to identify the information about the financial effects of rate regulation that is most relevant to users of financial statements in making investment and lending decisions and to determine how best to reflect that information in IFRS financial statements.
- In the DP, the Board identifies certain common features in its definition of rate regulation, which establishes the starting point for discussions on the scope of the project.
- Based on a defined type of rate regulation, the DP considers four possible approaches to reporting the financial effects of rate regulation:
  - Recognising the package of rights and obligations as an intangible asset (i.e., a licence)
  - Adopting the regulatory accounting requirements as an exemption to the general requirements of IFRS
  - Developing specific IFRS requirements for rate regulation
  - Prohibiting the recognition of regulatory deferral account balances
- Using the feedback received, the IASB will assess whether to develop proposals for reporting specified financial effects of rate regulation.

Highlights

In response to requests to reconsider the financial reporting of the impact from rate-regulated activities, the International Accounting Standards Board (the IASB) launched a new comprehensive research project and published the Request for Information *Rate Regulation* (RFI) in March 2013. In the latest phase of the project, the IASB published a Discussion Paper (DP) on 17 September 2014.

Many governments regulate the supply and pricing of certain goods or services that are considered to be essential to customers in their respective jurisdictions. This rate regulation may affect various industries, such as transport services, certain types of insurance, and utilities. Rate regulation mechanisms vary across jurisidictions, but, generally, result in either an entity's right to increase future rates or an obligation to decrease future rates. Prior to IFRS 14 *Regulatory Deferral Accounts*, there were no specific requirements for the accounting for the effects of such rate regulation under IFRS.

In past discussions, it was determined that rate-regulated rights and obligations did not meet the definitions of assets or liabilities in the *Conceptual Framework* and were, therefore, not recognised in the statement of financial position. However, rate-setting mechanisms usually have a significant economic impact on rate-regulated entities and ignoring them in an entity's financial statements could be misleading.

As a common starting point for considering the recognition of regulatory deferral accounts in IFRS financial statements, the DP focuses on developing an overall definition of rate regulation ('defined rate regulation') and aims to obtain feedback on:

- The common features of rate regulation that create a combination of rights and obligations that are distinguishable from those arising from activities that are not rate-regulated and would support the recognition of an asset or liability in the statement of financial position.
- Whether the description of the defined rate regulation encompasses those features of regulation that have the most significant effect on the amount, timing and certainty of revenue, profit and cash flows of rate-regulated entities, for which specific accounting requirements should be developed.
- What information about the financial effects of rate regulation is most relevant to users of financial statements in making investment and lending decisions – the DP seeks feedback on the usefulness of the presentation and disclosure requirements within IFRS 14 to financial statement users.

The DP does not include specific accounting proposals. Instead, it explores several possible approaches that the IASB might consider when deciding how best to report the financial effects of a defined type of rate regulation. The IASB is seeking input on the advantages and disadvantages of the possible accounting approaches before it decides whether to further develop specific accounting proposals.

The IASB's definition of rate regulation balances the customer's need to purchase essential goods or services at reasonable prices with the entity's needs to attract capital and remain financially viable.

Defined rate regulation

Based on feedback from the respondents to the RFI, the DP includes a definition of rate regulation which incorporates a number of features that are thought to be common to a wide variety of rate-regulatory schemes:

- The rights and obligations are enforceable on the rate-regulated entity and the rate regulator, i.e., there is a regulatory agreement.
- Customers generally have little or no choice but to purchase essential goods or services from the rate-regulated entity because there is no effective competition to supply. Therefore, the main risks to the rate-regulated entity's profitability and financial viability are likely to be regulatory risks.
- Parameters are established to maintain the availability and quality of the supply of the rate-regulated goods or services and other rate-regulated activities of the entity, which may heavily influence the investment that an entity will have to make in assets that are required to carry out those activities.
- The rate-setting framework establishes:
    - Prices or tariffs that the entity charges to customers for delivering the rate-regulated goods or services during the regulatory period.
    - A revenue requirement in exchange for the activities that a rate-regulated entity performs. In addition, the time at which the entity can bill customers for that consideration is managed through varying the rate per unit chargeable to customers.
    - A regulatory adjustment mechanism to: (a) reverse specified differences between the amounts of the revenue requirement accrued to date and the amounts billed to customers; (b) adjust for the time value of money; and (c) adjust for other forms of revenue requirement mismatches. This mechanism seeks to ensure that the rate-regulated entity earns no more or no less than the amount of the revenue requirement and any related profit or return to which it is entitled.

The broad objective of the defined rate regulation is to balance the need of customers to purchase essential goods or services at a reasonable price with the need of the entity to attract capital and remain financially viable. However, the IASB would need to potentially consider whether self-regulated bodies e.g., co-operatives, could be considered to be subject to defined rate regulation.

Respondents to the RFI suggested that the combination of rights and obligations in rate regulation creates economic conditions that are distinguishable from those found in environments that are not rate-regulated and that these conditions give rise to the specific assets and liabilities for which accounting requirements should be further developed.

Possible accounting approaches

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 any such changes would impact the recognition of rate-regulated assets and liabilities. Despite this uncertainty, the DP considers the following four alternative approaches to identify how best to reflect the financial effects of the defined rate regulation in IFRS financial statements:

The DP explores four alternatives to reporting the financial effects of rate regulation.

Recognising the package of rights and obligations established by the regulatory agreement as an intangible asset (i.e., a licence)

This approach considers recognising the rights and obligations created by the defined rate regulation as a single asset (i.e., a regulatory licence) which would be classified as an intangible asset. The Board would consider amending IAS 38 *Intangible Assets* to recognise changes to the carrying amount of the regulatory licence under the revaluation model.

The DP indicates that proponents of this approach believe the regulatory licence is similar to exclusive operating licences seen in other commercial environments and, hence, should be accounted for in the same way as an intangible asset.

Adopting the regulatory accounting requirements

This approach would allow an entity to prepare its IFRS financial statements using the accounting requirements established by the respective rate regulation. Because of the inconsistencies that would exist between existing IFRS and rate regulation requirements, the Board would need to create an exemption to the general requirements of IFRS as part of this approach.

Developing specific IFRS requirements to defer or accelerate the recognition of costs and/or revenue

The third alternative considered in the DP is to develop specific accounting requirements to defer or accelerate the recognition of costs, revenue or a combination of costs and revenue. This approach would align the timing of the recognition of specified costs more closely with income for regulatory purposes and IFRS financial reporting purposes.

The DP acknowledges that there would be added complexity under this approach that would arise from the interaction of regulatory requirements and general IFRS requirements.

Prohibiting the recognition of regulatory deferral account balances in IFRS financial statements

This approach acknowledges the possibility that, after considering the feedback from the DP and the *Conceptual Framework* project, the IASB may conclude that regulatory deferral account balances should not be recognised in IFRS financial statements. In this approach, the Board explores whether specific disclosure requirements should be further developed to explain the financial effects of rate regulation to users of IFRS financial statements. The IASB may consider using the requirements in IFRS 14 as a starting point for any future discussion on disclosure requirements.

Interaction with other standards

The DP identifies some issues that will need further evaluation by the IASB if the approach to develop specific accounting requirements is selected.

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, consideration of the interaction of IFRIC 12 with any specific accounting requirements that may be developed for rate-regulated activities will be required.

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 *Accounting for Government Grants and Disclosure of Government Assistance*

In cases in which the government or the rate regulator provides funding to the rate-regulated entity in exchange for some of its activities, the IASB may need to consider how to allocate the total revenue requirement between the amounts that will be recovered through billings 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 such balances. 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.

How we see it

We encourage both rate-regulated entities and users of their financial statements to respond to the DP. The feedback on defined rate regulation will be important as it will form the starting point for scope discussions on the project. When providing feedback, entities may wish to refer to the discussions in the DP in respect of their current regulatory environment.

Next steps

The DP is open for comment until 15 January 2015. 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 outlined above and whether there are any other approaches it should consider.

We expect the IASB to consider the comments received on the DP when it determines the next steps for the rate-regulated activities project, that is, whether or not to develop an exposure draft on reporting specified financial effects of rate regulation in IFRS financial statements.

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