# STAFF PAPER

**16-17 July 2015**

**Accounting Standards Advisory Forum**

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| **Project** | **Rate-regulated Activities: Research project** | | |
| Paper topic | Project status and next steps | | |
| CONTACT(S) | Jane Pike | jpike@ifrs.org | +44 (0)20 7246 6925 |



## Purpose of the paper

1. The purpose of this paper is to set out the reasons for, and ask the IASB to accept, the staff's recommendation to keep this project within the Research Programme, instead of transferring to the Standards Programme agenda. This means that we will aim to publish a second Discussion Paper before developing proposals for exposure as a final Standard (ie before publishing an Exposure Draft).

2. This paper explains that, although we have a strong mandate to develop an accounting model for defined rate regulation that will lead to the recognition of at least some regulatory deferral account balances (regulatory balances) in IFRS financial statements, the operability and acceptability of any resulting model will need further research and consultation.

3. The paper also explains why the staff do not envisage that this will significantly slow down the final completion of the project. On the contrary, we are merely suggesting that we 'front-load' the project by doing more detailed consultation and field testing to develop the second Discussion Paper. This is intended to put us in a stronger positon to develop proposals in an Exposure Draft that we will be confident will be operable and provide a strong basis for the finalisation of a Standard without the need for extensive further consultation.

## Background

4. In September 2014, the IASB published the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the Discussion Paper).[1] The Discussion Paper did not set out any specific accounting proposals. The objective of the publication was to gather input from a wide range of stakeholders about:

    (a) what features, if any, distinguish the economic environment in which some rate-regulated entities operate; and

    (b) whether those features would best be reflected in general purpose financial statements by modifying the requirements of International Financial Reporting Standards (IFRS) in any way.[2]

5. The intention in publishing the Discussion Paper at an early stage in the project was to help overcome some of the problems that arose after the publication of an Exposure Draft in an earlier project. The proposals in the Exposure Draft generated strong but conflicting views about how the effects of rate regulation should be reported in IFRS financial statements. That project was suspended in 2010 without a clear way forward, largely because the financial effects of rate regulation were not clearly identified. The Discussion Paper's main purpose, therefore, was to help us to clearly define the problem that we are looking to solve by identifying the nature of rate regulation, what rights and obligations it creates for the entity and what financial effects arise from the resulting rights and obligations.

6. The Discussion Paper contains descriptions of several types of rate regulation and highlights the various types of rights and obligation typically created by rate regulation. The Discussion Paper discusses whether some types of rate regulation may create a distinctive combination of rights and obligations, for which the requirements of existing IFRS may not provide users of financial statements with

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[1] Appendix 1 reproduces the relevant extract from the Update for the February 2015 IASB meeting, at which the IASB discussed the staff's initial analysis of the feedback received through outreach activities and comment letter responses to the Discussion Paper. Appendix 2 sets out a brief reminder of the contents of the Discussion Paper and the high-level messages received in response to it.

[2] The objective is set out in the summary at the beginning of the Discussion paper, immediately under the heading 'Why is the Discussion paper being published?'.

the relevant information that they need to assess the financial effects of rate regulation.

7. The feedback received through comment letter responses and other outreach activities provided valuable input on the two issues noted in paragraph 4. This has provided a very strong base of evidence from which we can address the key issues. The project's key issues are:

   (a) the scope (description of rate regulation);

   (b) whether the resulting rights and obligations create recognisable assets and liabilities, as defined in the *Conceptual Framework*, in addition to those already recognised in accordance with existing IFRSs; and

   (c) how to report the financial effects in the income statement.

8. The following paragraphs outline the direction provided by the feedback from the Discussion Paper. Further detail is contained in Appendix 2.

### *What features, if any, distinguish the economic environment in which some rate-regulated entities operate?*

9. Most respondents agree that the description of the hybrid type of rate regulation, termed 'defined rate regulation' in paragraph 4.2 of the Discussion Paper, appropriately captures the common characteristics of a wide variety of rate-regulatory schemes found in practice. In addition, many agree that the rights and obligations identified in the Discussion Paper adequately capture the rights and obligations created by a wide variety of rate-regulatory schemes and no significant additional rights or obligations were noted.

10. Many respondents suggest that the combination of rights and obligations created by defined rate regulation creates unique or distinguishable economic conditions that are not faithfully represented by the current predominant practice in IFRS financial statements. A common theme among respondents is that, although the individual rights or obligations described in the Discussion Paper are unlikely to be unique individually and, therefore, do not require any specific accounting requirements on an individual basis, the combination of rights and obligations is considered to create a sufficiently distinct economic environment.

11. Many respondents suggested that, when trying to establish the scope of any possible accounting requirements, the IASB should refine the description of defined rate regulation to focus on the regulatory support for the entity's entitlement to receive a determinable amount of consideration in exchange for satisfying its rate-regulated obligations, ie the revenue requirement. The development of the scope for any resulting accounting guidance would, using this approach, need to focus on the existence of a regulatory pricing (ie rate-setting) framework that creates enforceable rights and obligations and includes an adjusting mechanism to reverse specified differences between the amount of the 'revenue requirement' accrued to date and the amounts billed to customers. The revenue requirement is the amount of consideration to which the entity is entitled in exchange for carrying out the required rate-regulated activities during the period.

### *Would the distinguishing features best be reflected in general purpose financial statements by modifying the requirements of International Financial Reporting Standards (IFRS) in any way?*

12. There is strong support for developing specific accounting requirements that will lead to the recognition of at least some regulatory deferral account balances in IFRS financial statements. However, views are mixed about whether this should be done through a separate Standard to replace IFRS 14 or through amendments to, or an Interpretation of, existing Standards.

13. Most of those who support recognition consider that, on the basis of the description of the combination of rights and obligations created by defined rate regulation, there are at least some regulatory deferral account balances that do meet the definitions of assets and liabilities in the *Conceptual Framework*. There are some who consider that the suggested changes to the definitions that have been tentatively agreed by the IASB in the *Conceptual Framework* project are necessary to support this view. Others consider that some regulatory deferral account balances already meet the existing asset and liability definitions.

### *Preferences for the possible accounting approaches*

14. The Discussion Paper does not set out detailed proposals for an accounting model for activities subject to defined rate regulation. Instead, paragraph 5.34 of the Discussion Paper summarises four possible accounting approaches:

    (a) recognising the package of rights and obligations created by defined rate regulation as a single asset, namely the 'regulatory licence';

    (b) adopting the accounting requirements established by the rate regulation, that is, overriding IFRS requirements with those of the rate regulation;

    (c) recognising the financial effects of rate regulation through specific IFRS requirements by changing the timing of recognition of specified costs, revenue, or a combination of costs and revenue; and

    (d) prohibiting the recognition of regulatory deferral account balances.

15. The Discussion Paper discusses some of the advantages and disadvantages of each approach and asked stakeholders for input on which model they preferred, and why.

16. The strongest support expressed by respondents to the Discussion Paper was for an approach that would result in the development of specific accounting requirements that would modify existing IFRS to recognise regulatory deferral account balances as assets and liabilities by changing the timing of recognition of a combination of costs and revenue. The strongest support from respondents is for an approach that is based on IFRS 15 *Revenue from Contracts with Customers*.

## Staff recommendation

17. The staff recommend that the Rate-regulated Activities project should remain in the Research Programme, instead of transferring to the Standards Agenda. This means that we will aim to publish a second Discussion Paper before developing proposals for exposure as a final Standard (ie before publishing an Exposure Draft).

18. The following paragraphs explain the staff's reasoning for the recommendation.

## Reasons for the staff recommendation

19. Although the Discussion Paper achieved its objective and we received some strong messages from stakeholders about the desired outcomes for the project, we think that there are a number benefits to be gained by publishing a second Discussion Paper before progressing to an Exposure Draft of a proposed Standard. This is because our further analysis of some of the issues raised in the responses to the Discussion Paper indicates that there are complexities in the interactions between this project and others, in particular the *Conceptual Framework* and IFRS 15. We think that these issues can be explained and explored more thoroughly, quickly and effectively through a Discussion Paper than through the publication of an Exposure Draft.

20. We have begun our further analysis by focusing on the interactions with IFRS 15. Our preliminary findings are outlined in Agenda Paper 9B *Developing a revenue approach*. That paper highlights that there are complex interactions between the rights and obligations created by the regulatory agreement between the entity and the rate regulator and the rights and obligations that arise through the entity's individual contracts with customers. As a result of this preliminary analysis, the staff recommend that the project should aim to develop a model for rate-regulated activities that is separate from the requirements of IFRS 15.

21. As noted in paragraph 13, respondents to the Discussion Paper have mixed views about whether the rights and obligations created by defined rate meet the definitions of assets and liabilities in the existing *Conceptual Framework* or in the working definitions being developed in the current project to revise the *Conceptual Framework*. The proposals to revise the *Conceptual Framework* are due to be published in an Exposure Draft in the forthcoming weeks. The definitions of assets and liabilities may require further revision as a result of the consultation on the Exposure Draft.

22. If the IASB were to move directly to an Exposure Draft of proposals for a final Standard on rate-regulated activities, it might want to wait until the *Conceptual Framework* project was complete, or at least close to completion, before publishing the rate-regulated activities proposals. In contrast, aiming to publish a second Discussion Paper would allow greater flexibility in exploring

how the proposed revisions to the *Conceptual Framework* might interact with any subsequent rate-regulated activities proposals.

23. We also anticipate other benefits of publishing a second Discussion Paper that we think will facilitate a more effective consultation that will lead to proposals that are operational and acceptable to a wide range of stakeholders. These benefits include:

    (a) clearer understanding of the proposed accounting model and how it reflects the financial effects of rate regulation—the responses to the Discussion Paper showed that some of the views previously expressed on the proposals in the earlier project were based on different fact patterns and different assumptions about the financial effects of rate regulation. Publishing a second Discussion Paper will enable us to describe a proposed accounting model in a more flexible way than is possible in an Exposure Draft of proposals for a Standard. This flexibility will enable us to provide clear links through the operation of a proposed model and how the outcome of the model could lead to a more representationally faithful presentation of the financial effects of rate regulation. The flexibility will also facilitate a clear explanation of the interaction of a proposed model with the *Conceptual Framework*.

    (b) better opportunities for field testing in the development stage—during the development of any proposed model, the staff will seek assistance from stakeholders through consultation and field testing of ideas. A second Discussion Paper will provide an opportunity to explain what alternatives have been considered and why various components of the model proposed have been selected over other alternatives. This will provide a much clearer and more complete picture for stakeholders, to aid their assessment of the model.

    (c) reduced risks of significant changes to the model proposed in the subsequent Exposure Draft—providing stakeholders with proposals based around a more complete and robust model in a subsequent Exposure Draft should minimise the need for substantive changes to the model after the Exposure Draft stage. This is because both the principles underpinning the proposed model and the operability of the model will have been more thoroughly tested through the second Discussion Paper phase.

## Conclusion

24. The Discussion Paper issued in September 2014 achieved its objectives and provided us with valuable input to help more clearly define the financial effects of rate regulation. The feedback from stakeholders has also helped us to identify the key pressure points that will need to be addressed in our further analysis of the issues. It has also provided us with strong signals about how best to report the financial effects of rate regulation.

25. Our initial analysis of the feedback has indicated significant complexities in following the favoured approach to developing a model, that is, to modify the existing requirements in IFRS 15. Consequently, we think that further consultation in the form of a second Discussion Paper will provide greater opportunities to test the operability and acceptability of any resulting accounting model.

26. As previously noted, we do not envisage that this will significantly slow down the final completion of the project. On the contrary, we are merely suggesting that we ‘front-load’ the project to put us in a stronger positon to develop proposals in an Exposure Draft that can subsequently be finalised without the need for extensive further consultation.

### Question for the IASB

| Question |
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| Do you agree with the staff recommendation to retain the project in the Research Programme and to develop a second Discussion Paper? |

## Appendix 1: Extract from *IASB Update* February 2015

### Rate-regulated Activities (Agenda Paper 9)

The IASB met on 18 February 2015 to discuss a summary of the comments received in response to the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the Discussion Paper).

*Agenda Paper 9: Initial analysis of responses to the Discussion Paper*
The IASB reviewed the main messages received through outreach and comment letters, namely:

a. Most respondents agree that the Discussion Paper provides a good description of the distinguishing features of rate regulation. Many suggest that the scope of any future guidance should focus more on the rights and obligations and how they relate to the rate-setting mechanism, with other features being considered more as supporting features.

b. Many respondents suggest that the combination of rights and obligations created by defined rate regulation may not always be faithfully represented in IFRS financial statements and that the project should lead to the recognition of at least some regulatory deferral account balances in IFRS financial statements.

c. Many respondents agree that IFRS 14 *Regulatory Deferral Accounts* is a good starting point for disclosure requirements.

d. Of the four approaches outlined in the Discussion Paper, there was the most support for the recognition of the financial effects of rate regulation through specific IFRS requirements.

No decisions were made at this meeting. However, the IASB highlighted the following issues for the staff to explore further:

- how to define the scope for the proposed Standard, based on the description of rate regulation;
- 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 end customer;
- 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;

- the interaction of this project with the *Conceptual Framework* project and its definitions of assets and liabilities; and
- how the principles of IFRS 15, in particular relating to the identification of performance obligations, could be adapted to rate-regulated activities.

***Next steps***

The Rate-regulated Activities Consultative Group will meet in early March. The staff will consider the matters discussed at that meeting before developing recommendations for the IASB to consider about specific topics.

## Appendix 2: Summary of the contents of, and feedback from, the Discussion Paper *Reporting the Financial Effects of Rate Regulation*

### Summary of the contents of the Discussion Paper

A1. In September 2014, the IASB published the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the Discussion Paper) to gather input from a wide range of stakeholders about the perceived financial reporting challenges created when an entity's activities are subject to various forms of rate regulation.

A2. The Discussion Paper considers the common features of a defined type of rate regulation. This defined rate regulation is a 'hybrid' type of rate regulation, which contains a combination of cost-recovery and incentive-based mechanisms. The Discussion Paper explores which of the common features of defined rate regulation, if any, create a combination of rights and obligations that is distinguishable from the rights and obligations arising from activities that are not rate-regulated.

A3. The Discussion Paper seeks to identify what information about the economic and financial effects of rate regulation are most relevant to users of financial statements. It considers how that information might best be presented or disclosed, either within IFRS financial statements or through other routes, such as the management commentary.

A4. The Discussion Paper does not include detailed accounting proposals. Instead, it explores several possible approaches that the IASB could consider when deciding how best to report the financial effects of rate regulation. The possible approaches range from prohibiting the recognition of regulatory deferral account balances through recognising them as assets and liabilities within the *Conceptual Framework* definitions or as 'other items' in the financial statements.

A5. The closing date for comments on the Discussion Paper was 15 January 2015. In February 2015, the staff presented an initial analysis of the feedback received in the comment letter responses and other outreach performed.[3] The feedback was also considered by the IASB's Rate-regulated Activities Consultative Group (the Consultative Group) at its meeting held on 4 March 2015. In addition, the Consultative Group began a more in-depth analysis of some of the issues raised by stakeholders in response to the Discussion Paper.

A6. The following paragraphs summarise the high-level messages contained within the analysis presented to the IASB and the Consultative Group.

## Summary of high-level messages received

A7. The Discussion Paper contains thirteen questions, which can be grouped into the following three broad categories:

(a) What information about rate regulation is most relevant to users of financial statements and where in the annual report should it be presented?

(b) What are the distinguishing features of rate regulation and do they create a distinctive combination of rights and obligations for which specific financial reporting requirements or guidance is needed?

(c) If IFRS financial statements do not currently provide users of financial statements with the information that they need, what accounting approach is most likely to provide that information, or would disclosure-only be sufficient?

A8. The following paragraphs summarise the high-level messages received. Further detail is provided in the February 2015 Agenda Paper 9 *Initial analysis of responses to the Discussion Paper*. The high-level messages are grouped into the following categories:

(a) overall direction and scope of the project; and

[3] Agenda Paper 9 *Initial analysis of responses to the Discussion Paper*, February 2015, available to download from http://www.ifrs.org/Current-Projects/IASB-Projects/Rate-regulated-activities/Pages/Discussion-and-papers-stage-4.aspx.

(b) support for developing specific guidance to recognise regulatory balances.

### *Overall direction and scope of the project*

A9. There is almost unanimous support for the general approach of the project; that is, identifying the distinguishing characteristics of rate regulation, the related rights and obligations and what information users of financial statements find most useful before developing an accounting model.

A10. Most respondents agree that the description of the hybrid type of rate regulation, termed 'defined rate regulation' in paragraph 4.2 of the Discussion Paper, appropriately captures the common characteristics of a wide variety of rate-regulatory schemes found in practice, together with the rights and obligations created by the schemes. Consequently, there is strong support for using this as the basis for ongoing discussions about how best to report the financial effects of rate regulation.

A11. In addition, there is strong support for developing the scope of any future specific accounting requirements for rate regulation around the description of defined rate regulation. In particular, the respondents suggested focusing the scope criteria around the rights and obligations that have the most direct effect on the rate-setting mechanism.

A12. Many respondents suggest that the combination of rights and obligations created by defined rate regulation creates unique or distinguishable economic conditions that are not faithfully represented by the current predominant practice in IFRS financial statements. As a result, we heard that users of financial statements seek information about the financial effects of the rate regulation from other sources. Although some users are content with this situation, others would prefer to obtain the information in a more accessible and comparable format within audited IFRS financial statements.

A13. Some of the outreach discussions and comment letter responses highlighted that there is some diversity in IFRS financial statements that is affecting comparability. We have identified some entities that already recognise, in IFRS financial statements, some regulatory deferral account balances as assets and liabilities, typically within categories containing receivables and payables. Others recognise only regulatory 'liabilities' but it is not clear if this is merely the net amount after netting any regulatory deferral account debit balances or whether it is the sum of regulatory deferral account credit balances.

### *Support for developing specific accounting requirements*

A14. There is strong support for developing principle-based, specific accounting requirements that will lead to the recognition of at least some regulatory deferral account balances in IFRS financial statements. However, views are mixed about whether this should be done through a separate Standard to replace IFRS 14 *Regulatory Deferral Accounts* or through amendments to, or an Interpretation of, existing Standards.

A15. Most respondents who support the recognition of regulatory deferral account balances in IFRS financial statements consider that this can, and should, be achieved within either the existing *Conceptual Framework* or the updated version that is currently being developed. The most common suggestion made is an approach that is based on the principles contained in IFRS 15 *Revenue from Contracts with Customers*, focusing on the entity's rights and obligations relating to the customers as a whole (the customer base), instead of its rights and obligations relating to individual customers.

A16. There is a little support for recognising regulatory deferral account balances if the IASB ultimately decides that they do not meet the *Conceptual Framework* definitions of assets and liabilities. However, several respondents who are currently undecided suggest that they could only support recognition within the *Conceptual Framework*.

A17. There is limited support for the IASB to develop disclosure-only requirements. However, many who support the recognition of regulatory deferral account balances acknowledge that disclosure-only requirements would be better than nothing if the IASB was ultimately to decide to prohibit recognition. This is because they consider that IFRS financial statements currently do not provide investors and lenders with the relevant information needed to make investing and lending decisions. Instead, they say that users of financial statements need to rely on non-GAAP information obtained from a variety of sources outside the audited financial statements, which concerns them, because such non-GAAP information typically lacks comparability.

A18. There is strong support for using the disclosure requirements of IFRS 14 as a starting-point for developing any disclosure requirements that may result from this project. There are many suggestions for additional disclosures, but few for omitting any of the IFRS 14 disclosures, although some concerns were expressed about requiring too much detail, particularly in cases in which an entity is subject to rate regulation in several jurisdictions.

A19. There is also strong support for identifying separately any regulatory deferral account balances and related income statement movements that are recognised, if any. However, there is little support for the current approach of IFRS 14, which results in the isolation of such amounts from the assets, liabilities, income and expenses recognised in accordance with other IFRSs. Instead, the most common suggestions are for the rate-regulatory amounts to be shown separately, either in the disclosure notes or as separate line items adjacent to related items.