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**International
Accounting Standards
Board**

This observer note is provided as a convenience to observers at IFRIC meetings, to assist them in following the IFRIC's discussion. Views expressed in this document are identified by the staff as a basis for the discussion at the IFRIC meeting. This document does not represent an official position of the IFRIC. Decisions of the IFRIC are determined only after extensive deliberation and due process. IFRIC positions are set out in Interpretations.

Note: The observer note is based on the staff paper prepared for the IFRIC. Paragraph numbers correspond to paragraph numbers used in the IFRIC paper. However, because the observer note is less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IFRIC meeting: September 2008, London
**Project: Agenda Paper 6 at the March 2008 Meeting of National
Standard Setters (Agenda Paper 5 Appendix 2)**

**This paper was presented as Agenda Paper 6 at the March 2008 Meeting of National
Standard Setters**

Background

1. This agenda item continues discussions on rate-regulated operations held at the March and September 2007 National Standard Setters (NSS) meetings. Participants in these meetings acknowledged the potential usefulness of an NSS discussion paper on this topic, as both the documentation of views and a potential contribution towards the initial development of international guidance in this area. However, there was general agreement that the first priority should be to put the issues before the International Financial Reporting Interpretations Committee (IFRIC), with a view to obtaining the views of this body on certain aspects of the application of International Financial Reporting Standards (IFRSs) to this sector. Time is of the essence given the uncertainty, on the part of rate-regulated entities and their auditors in jurisdictions

about to adopt IFRSs as their primary basis for financial reporting, about how IFRSs apply to their circumstances. Absent guidance, practice could develop that varies from jurisdiction to jurisdiction and incorrectly applies IFRSs.

2. This paper outlines the issues that might be considered by the IFRIC. The paper neither proposes solutions, nor frames the issues in the context of whether a particular solution (for example, the US's Statement of Financial Accounting Standards No. 71, *Accounting for the Effects of Certain Types of Regulation*, which includes specific criteria, definitions and guidance specific to rate-regulated operations not found in IFRSs) works. It takes the view that the answers lie wherever IFRSs happen to lead.
3. The underlying premise of the paper is that IFRSs apply fully to rate-regulated operations. This is supported by an IFRIC agenda decision of 2005, in which the IFRIC declined to add a project on regulatory assets to its agenda. As noted in the August 2005 IFRIC Update, the IFRIC concluded that "entities applying IFRSs should recognise only assets that qualified for recognition in accordance with the IASB's Framework for the Preparation and Presentation of Financial Statements and relevant accounting standards, such as IAS 11 Construction Contracts, IAS 18 Revenue, IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets," and "expenses incurred in performing price-regulated activities should be recognised in accordance with applicable IFRSs."
4. The paper's premise is also supported by the views of the IASB directors and staff recently consulted on the question of whether, as a consequence of the aforementioned IFRIC agenda decision, it is not possible to recognize assets and liabilities arising from rate regulation (regulatory assets and liabilities) in accordance with IFRSs. These views are summarized in a letter, dated October 4, 2007, from Patricia O'Malley, IFRIC Coordinator, to AcSB Chair Paul Cherry (see Attachment 1). Although not an official position of the IASB or the IFRIC, Ms. O'Malley's comments are helpful to an analysis of the issues addressed in this paper.

5. Ms. O'Malley repeats the view of the IFRIC, in 2005, that an entity should recognize regulatory assets to the extent that they meet the criteria to be recognized as assets in accordance with existing IFRSs, and notes that whether the assets are labelled as "regulatory" should not affect their recognition. Ms. O'Malley summarizes her understanding (and that of the others at the IASB who were consulted) of the 2005 agenda decision of the IFRIC as follows:

In summary, the IFRIC agenda decision does not preclude the recognition of regulatory assets and liabilities. It does require entities to apply existing standards, including the *Framework*, carefully to items it is considering recognising and does not permit the automatic application of the requirements of SFAS 71.

6. The IFRIC cannot and should not be asked to speak to the specific circumstances of a certain rate-regulated entity or group of entities in a particular industry or jurisdiction. This is not possible given the variety of rate-setting infrastructures and mechanisms found throughout the world. The IFRIC must necessarily restrict its examination to the common effects produced by all such mechanisms. Further, any guidance produced by the IFRIC on this topic must be interpretative in nature, and not application guidance.

Potential issues for the IFRIC

7. The first basic question to be answered is whether rate regulation can create an asset or liability meeting the definitions and recognition criteria for these financial statement elements found in the IASB's *Framework for the Preparation and Presentation of Financial Statements (Framework)*. In conversation with Mr. Cherry and AcSB staff, Ms. O'Malley has suggested that the IFRIC is unlikely to express an opinion on this, i.e., it is unlikely to test the *Framework* concepts in the context of rate-regulated operations. However, it could be amenable to confirming the nature of the asset or liability created by rate regulation, by suggesting the IFRSs it thinks

apply if such an asset or liability exists. Issues relating to the nature of assets and liabilities that may result from rate regulation are discussed later in this paper.

8. It is not the job of the IFRIC to decide whether the rate-setting actions of a regulator can sometimes create an asset or liability meeting the *Framework* definitions and recognition criteria. Furthermore, this task should not fall to standard setters, for the reasons set out below.
9. The *Framework* currently defines an asset as “a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.” An asset is recognized in the balance sheet when “it is probable” that such a inflow will occur and “the asset has a cost or value that can be measured reliably.” [emphasis added]
10. The *Framework* currently defines a liability as “a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.” A liability is recognized in the balance sheet when “it is probable” that such an outflow will occur and “the amount at which the settlement will take place can be measured reliably.” [emphasis added]
11. The underlined words in paragraphs 9 and 10 are subject to a considerable amount of interpretation when applied to rate-regulated operations, and illustrate the difficulty in arriving at a conclusion that one can say definitively applies to rate-regulated entities worldwide. The determination of whether a particular rate-setting action has created a bona fide asset or liability requires the careful evaluation of all of the relevant facts and circumstances pertaining to that action. For this reason, any standard or interpretation in this area must necessarily be rather general in nature.
12. In the case of an asset recognized as a result of rate regulation, the related “future economic benefits” are the higher revenues expected to be collected from future

customers as a result of a particular rate order. However, there may be a question as whether the entity “controls” the related resource. Control can vary from entity to entity, industry to industry, and jurisdiction to jurisdiction. It is influenced to a large degree by the regulatory regime in place. For example, is the rate regulator’s decision binding? Can the regulator reverse a previous decision? Can a regulatory decision be challenged or overturned by the government of the jurisdiction in which the entity and the rate regulator operate?

13. Control over the resource aside, the realization of future revenues expected to flow to the entity as a result of this resource (in other words, the recoverability of the asset) depends in part on the entity’s customers. An entity may control the regulator-approved right to charge higher rates in the future. However, this right is worth little unless there is demand for the entity’s product in the future. Will this future demand be sufficient to recover the entire amount of the asset (can the entity’s customers choose an alternative product or supplier)?

14. In the case of a regulatory liability, a component of the *Framework* definition that causes difficulties when applied to rate-regulated operations is the requirement that there be a “present obligation.” The existence of a present obligation, or not, would seem to depend on what is considered to be the obligating event. Regulatory liabilities are sometimes recognized as a result of an obligation, imposed by the rate regulator for a variety of reasons, to return excess revenues already collected from customers. The “return” often takes the form of reduced billings for services to be provided by the entity in the future, rather than a cash rebate. In this case, if the obligating event is the regulator’s order to return excess revenues, it can be said that there is a present obligation. However, if the obligating event is the provision of future services at lower rates, it can be argued that the obligation does not yet exist.

15. This paper suggests that the entity itself, and its auditor, are best positioned to determine whether an asset or liability exists as a result of a rate regulator’s action. Only they have the understanding of the entity’s regulatory environment, and the

knowledge of the facts surrounding a particular regulatory action, needed to make this determination. Hereafter, this paper assumes that an entity has performed the necessary analysis and concluded that an asset or liability exists as a result of a rate-regulator's action. The issues identified below are framed in this context.

Issue #1: Does recognizing a regulator's rate-setting action for financial reporting purposes involve accounting for one event or two? If two, how should the asset resulting from the second event be measured?

16. Regulators sometimes allow an entity to recover all or part of a cost incurred in the current period by including it in future rates. Rate-regulated entities typically account for such rate-setting actions by simply recognizing as an asset that portion of the cost that the regulator has permitted to be recovered through future rates, and which would otherwise be expensed in the absence of rate regulation.
17. As an example, take the case of a rate-regulated utility that has incurred significant costs to repair the damage caused by a storm, that the regulator has specified should be recovered through future rates. In the absence of rate regulation, the storm costs would be expensed in the current period, and any increase in revenues due to the inclusion of these costs in future rates would be recognized when the revenues were earned in future periods. However, instead, many rate-regulated entities in North America would recognize a regulatory asset for the amount of the storm costs, and amortize this asset over the future periods in which the increased future revenues are expected. This, in effect, accounts for the incurrence of the cost and the regulator's action as one event and, it might be argued, misrepresents the asset, which is the right to charge higher rates in the future, rather than the storm costs themselves.
18. A more appropriate model for recognizing the effects of rate regulation might be to account for the incurrence of the storm costs and the rate-setting action as the two separate events that they are. This would mean expensing the storm costs in the normal fashion, then recording any asset created by the rate-setting action (the credit would be to a "regulatory gain or loss" account of some sort). This alternative model

“layers” the effects of rate regulation on to the entity’s financial statements as they would appear in the absence of rate regulation.

19. While these two models may have the same bottom line effect, they differ greatly in terms of how the value of the resulting asset is measured. In the model currently in use, there is an implicit presumption that the value of the asset equals the incurred cost. This may or may not be the case. The “two-step” approach described in paragraph 18 would measure the asset differently, considering the various factors influencing the timing and amount of the expected higher future revenues. This aligns with a fundamental objective of financial reporting, which is to enhance users’ understanding of the amount, timing and uncertainty of future cash flows.
20. This alternative model works similarly for liabilities created as a result of rate regulation.

Issue #2: Assuming that rate regulation can sometimes create an asset meeting the Framework definition and recognition criterion, what is the nature of this asset and which IFRSs apply?

21. The consensus among those attempting to categorize assets created as a result of rate regulation appears to be that they fit the definition of an intangible asset more closely than that of a financial asset (see, for example, India’s draft paper entitled “Accounting for Tariff Regulated Entities,” included as an attachment to Agenda Paper 6 for the September 2007 NSS meeting). In order to be a financial asset, a regulatory asset would (in accordance with IAS 32, *Financial Instruments: Disclosure and Presentation*) need to involve a contractual right to the higher future revenues expected as a result of the regulator’s action. This is not usually the case, although some might argue that the regulatory compact between the entity, the regulator, and its enabling government body creates conditions resembling those of a contract.

22. IAS 38, *Intangible Assets*, defines an intangible asset as an identifiable non-monetary asset without physical substance. It further defines monetary assets as money held and assets to be received in fixed or determinable amounts of money. Regulatory assets are non-monetary in that they represent the right to charge higher rates in the future, and not the right to receive a fixed amount of money. They also lack physical substance.
23. Paragraph 12 of IAS 38 specifies that in order to meet the identifiability criterion in the definition of an intangible asset, an asset must either be separable or arise from contractual or other legal rights (regardless of whether those rights are transferable or separable from the entity or from other rights and obligations). As noted previously, regulatory assets are not usually contractual. Further, at least in North America, even if legally enforceable, the right to charge higher rates is not enforceable in a way that directly generates future economic benefits. This is because it is enforceable against the rate regulator or the government, rather than the customer. This leaves the question of whether regulatory assets are separable.
24. Paragraph 12 of IAS 38 states that an asset is separable when it “is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, asset or liability.” When conducting roundtables in 2004 in connection with the AcSB’s now-completed domestic project on rate-regulated operations, AcSB staff was informed by investor participants of instances in which North American utilities had successfully securitized a regulatory asset. This was achieved through the issuance of debt instruments, such as bonds, backed by the expected future cash streams associated with the asset. This may or may not be the experience elsewhere in the world.
25. An asset must meet other conditions in order to meet the definition of an intangible asset. As noted in paragraph 10 of IAS 38, in addition to the asset being identifiable, there must also be control over a resource and the existence of future economic benefits. Paragraph 12 of this paper discusses the difficulties involved in determining

the control an entity subject to rate regulation has over the resource in this instance. Is it sufficient to meet the definition of an intangible asset?

26. A sub-issue has to do with the current practice of North American entities subject to rate regulation with respect to the capitalization of borrowing costs relating to property, plant and equipment (PP&E) constructed or developed over time. For general financial reporting purposes, such entities usually capitalize the “allowance for funds used during construction (AFUDC)” approved by the rate regulator for inclusion in rates. Since AFUDC typically includes not only an interest component but also a component for the imputed cost of equity, financing costs capitalized by these entities generally exceed those capitalized in similar circumstances by entities not subject to rate regulation. Can borrowing costs, as defined in IAS 23, *Borrowing Costs*, include an imputed cost of equity? If not, then a regulatory asset may exist to the extent that AFUDC exceeds the amount permitted to be capitalized in accordance with that standard. If so, what is the proper balance sheet classification of this asset, i.e., should it be reported as an intangible asset (if, as discussed above, it is determined that regulatory assets best fit into this category of asset) or as part of property, plant and equipment?

Issue #3: Assuming that rate regulation can sometimes create a liability meeting the Framework definition and recognition criterion, what is the nature of this liability and which IFRSs apply?

27. The European Commission (EC) has recently written to the IFRIC with a request that it take on a project on regulatory liabilities (see Attachment 2). The request was limited to regulatory liabilities in view of the aforementioned IFRIC decision of 2005 not to add to its agenda a project on regulatory assets. However, the EC notes that a comprehensive project should address both assets and liabilities.
28. Attached to the EC letter to the IFRIC is a paper discussed at the October 18, 2007 meeting of the EC Roundtable for the Consistent Application of IFRSs (Roundtable).

The paper sets out a high-level fact pattern on rate-regulated operations and examines whether IFRSs permit or require the recognition of a regulatory liability as deferred revenue (IAS 18, *Revenue*, or IAS 11, *Construction Contracts*), a financial liability (IAS 32, *Financial Instruments: Disclosure and Presentation*), or a provision or contingent liability (IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*). The Roundtable paper draws no conclusions, but makes interesting arguments that can be read in Attachment 2. It is cited in order to illustrate the challenge involved in classifying a regulatory liability under IFRSs, once it has been determined that a liability exists.

Questions for NSS participants

1. Do you agree that the NSS should request that the IFRIC take on a project on rate-regulated operations of the scope outlined in this paper? Why or why not? This request would be in addition to the request already made by the EC, which Canada understands has not yet been discussed by the IFRIC.
2. If you think that the IFRIC should be requested to take on such a project:
 - (a) do you agree with the issues this paper suggests be put before the IFRIC? Are there other issues that should be added?
 - (b) should the issues be set out for the IFRIC with or without a proposed solution? (This paper took the latter approach.)
3. Should preparation of a more comprehensive discussion paper remain a goal of the NSS whether or not the IFRIC decides to take on the suggested project? Such a discussion paper could add value even if the IFRIC issues interpretative guidance on rate-regulated operations, given the diverse views of stakeholders on the basic question of whether rate regulation can create bona fide assets and liabilities. On the other hand, the NSS may not wish to express its views on this issue for the reasons stated in paragraph 15 of this paper.