July 2009

Basis for Conclusions
Exposure Draft ED/2009/8

Rate-regulated Activities

Comments to be received by 20 November 2009

International
Accounting Standards
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Basis for Conclusions on Exposure Draft

RATE-REGULATED ACTIVITIES

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This Basis for Conclusions accompanies the proposed International Financial Reporting Standard (IFRS) set out in the exposure draft *Rate-regulated Activities* (see separate booklet). Comments on the draft IFRS and its accompanying documents should be submitted in writing so as to be received by **20 November 2009.** Respondents are asked to send their comments electronically to the IASB website (www.iasb.org), using the 'Open to Comment' page.

All responses will be put on the public record unless the respondent requests confidentiality. However, such requests will not normally be granted unless supported by good reason, such as commercial confidence.

ISBN for this part: 978-1-907026-27-0

ISBN for complete publication (set of three parts): 978-1-907026-25-6

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Basis for Conclusions on the exposure draft *Rate-regulated Activities*

This Basis for Conclusions accompanies, but is not part of, the draft IFRS.

Introduction

BC1 This Basis for Conclusions summarises the considerations of the International Accounting Standards Board in reaching the conclusions in the exposure draft *Rate-regulated Activities*. Individual Board members gave greater weight to some factors than to others.

BC2 The Board added this project to its agenda in December 2008 because of ongoing differences of views in practice regarding whether it was appropriate for entities to recognise assets and liabilities arising from rate regulation.

BC3 In June 2005 the International Financial Reporting Interpretations Committee (IFRIC) received a request about the US standard SFAS 71 *Accounting for the Effects of Certain Types of Regulation*. The request asked whether SFAS 71 could be applied in accordance with the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to select an accounting policy in the absence of specific guidance in IFRSs.

BC4 US generally accepted accounting principles (GAAP) have recognised the economic effect of rate regulation on US rate-regulated entities since at least 1962. In 1982, SFAS 71 formalised many of those principles. In the absence of specific national guidance, practice in many other jurisdictions followed SFAS 71.

BC5 The IFRIC discussed the possible recognition of regulatory assets as part of its project on service concessions. As a result of its consideration of the issues at that time, 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*.' In other words, the IFRIC thought that an entity should recognise regulatory assets to the extent that they meet the criteria to be recognised as assets in accordance with existing IFRSs.

BC6 Following this first request, the IFRIC published an agenda decision in August 2005 not to add a project on regulatory assets to its agenda. The IFRIC agenda decision did not preclude the recognition of regulatory assets and regulatory liabilities.

BC7 In January 2008 the IFRIC received a second request to consider whether regulated entities could or should recognise a liability (or an asset) as a result of regulation by regulatory bodies or governments. This indicated that the previous agenda decision had not resolved the practice problems related to this issue. The IFRIC again decided not to add the issue to its agenda for several reasons. Importantly, it concluded that divergence did not seem to be significant in practice for entities that were already applying IFRSs. However, the IFRIC also noted that rate regulation is widespread and significantly affects the economic environment of many entities.

BC8 The Board noted the ongoing requests for guidance on this issue. It also considered the comments received on the IFRIC's tentative agenda decision. Those comments pointed out that although divergence in practice did not currently exist, several jurisdictions whose local accounting principles permitted or required the recognition of regulatory assets and regulatory liabilities would be adopting IFRSs in the near future. This would increase pressure for a definitive conclusion on the question. Consequently, the Board added the project to its agenda.

Background

BC9 Rate regulation is a restriction on the setting of prices that can be charged to customers for services or products. The goal of some forms of rate regulation is to set 'just and reasonable rates', ie rates that charge the customer a reasonable price and allow the entity to earn a fair rate of return.

BC10 Generally, rates are regulated when an entity has a monopoly or a dominant market position that gives it excessive market power. In such situations, there is a lack of effective competition to constrain the prices the entity can charge. To compensate, governments impose rate regulation by setting up a regulatory authority and giving it jurisdiction to approve the rates of a specific entity or categories of entities (for example, electricity distribution utilities). Entities within the jurisdiction of the regulatory authority are not allowed to charge prices for regulated goods or services other than those approved by the regulatory authority. In those circumstances, the regulator acts on behalf of the customers who individually would have no bargaining power with the entity.

BC11 A number of regulatory methodologies exist and, for each, application can vary by regulator, the entity being regulated and the particular circumstances. One regulatory methodology for essential services charged to individual customers is cost-of-service regulation (also referred to as return-on-rate-base regulation). Under this approach, rates are set to give the entity the opportunity to recover its costs of providing the good or service plus a fair return.

BC12 In cost-of-service regulation, the rates are set by working backwards from the desired return on the previously incurred costs (the rate base), to derive a revenue requirement and using an estimate of volume to set the rate. In recent years there has been a trend to incentive-based regulatory methodologies, such as so-called 'price cap' regulation. With price cap regulation, initial rates may reflect the cost of service, but are allowed to increase, or are required to decrease, over time in accordance with a formula. Hybrid methodologies that are combinations of price cap and cost-of-service approaches also exist.

Scope

BC13 The exposure draft does not address an entity's accounting for reporting to regulators (regulatory accounting). Regulators may require a regulated entity to maintain its accounts in a form that permits the regulator to obtain the information needed for regulatory purposes. The exposure draft would neither limit a regulator's actions nor endorse them. Regulators' actions are based on many considerations. The exposure draft specifies how an entity reports the effects of rate regulation in its financial statements prepared in accordance with IFRSs.

BC14 In the past, rate regulation tended to be applied to an entire entity. With acquisitions, diversification and deregulation, rate regulation may now be applied to only a portion of an entity's activities. In some cases, an entity may have both regulated and non-regulated activities. In others, the entity may be permitted to negotiate rates individually with some customers. The exposure draft applies only to the activities of an entity that meet the two criteria set out in paragraph 3 of the draft IFRS.

Can regulation create assets and liabilities?

BC15 The threshold question the Board had to address was whether the effects of rate regulation could result in items that meet the definitions of assets and liabilities in the *Framework*. If the answer to that question was yes, the Board then had to consider the circumstances in which those assets and liabilities could arise. This second question is discussed in paragraphs BC26–BC39. The two issues are interrelated.

Regulatory assets

BC16 The definition of an asset set out in paragraph 49(a) of the *Framework* is 'a resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to the entity.' The Board concluded that in some forms of regulation, the resource is a promise by the regulator that the costs the entity incurs will result in future cash flows. In such environments, incurring costs creates an enforceable right to set rates at a level that permits the entity to recover those costs, perhaps plus a specified return, from an aggregate customer base. The adjustment of future rates is the mechanism the regulator uses to implement its promise.

BC17 The Board decided that the cause-and-effect relationship between an entity's costs and its rate-based revenue is important to the conclusion that an asset exists. In this case, the entity's right that arises as a result of regulation relates to identifiable future cash flows linked to costs it previously incurred, rather than a general expectation of future cash flows based on the existence of predictable demand. Without a cause-and-effect relationship with previously incurred costs, the Board agreed with those who believe that the effect of rate regulation is just the permission to charge customers a specified price in the future. Such permission does not satisfy the definition of an asset because the regulator provides no assurance that future economic benefits will result.

BC18 Some who do not support the recognition of regulatory assets believe that a rate-regulated entity does not control the recoverability of future economic benefits because it does not control whether the customers will use the good or service. They believe that because the entity cannot force individual customers to purchase goods or services in the future, the entity's right to increase future rates does not create an asset.

BC19 However, in the Board's view, because regulation governs the entity's relationship with its customer base as a whole, rate regulation creates a present right to receive from or a present obligation to pay economic benefits to that aggregate customer base. Although the individual members of that group may change over time, the relationship the regulator oversees is between the entity and the group. The regulator has the authority to permit the entity to set rates at a level that will ensure the entity receives the promised cash flows from the customers as a whole. Therefore, the Board concluded that recognition of regulatory assets and regulatory liabilities should be considered at the aggregate customer level.

BC20 The Board also noted that the *Framework* states that control over the future economic benefits is sufficient for an asset to exist, even in the absence of legal rights. In many examples involving the definition of an asset, an entity will have power, as well as the ability, to obtain cash inflows. For example, in the case of some economic resources an entity owns, the entity has the power to cause cash inflows to arise from those resources either from sale or from use. However, in other examples, the entity need not have the power to cause the cash inflows to arise (ie although the power criterion is a sufficient condition, it is not a necessary condition). The key notion is that the entity has access to a resource and can limit others' access to that resource.

BC21 For example, in the case of established customer relationships, an entity does not have the power to force its existing customers to do business with the entity. But, if they do, the entity will obtain future cash inflows. The entity has an asset resulting from the existing relationship between the entity and its customers that can result in future cash inflows to the entity. This conclusion is reflected in accounting for customer relationship intangible assets in business combinations. Another example is intangible assets recognised by operators in service concession arrangements in accordance with IFRIC 12 *Service Concession Arrangements*. The operator recognises as an intangible asset the right it receives (a licence) to charge users of the public service, even though the amount to be received under the licence is contingent on the public's use of the service.

BC22 In the Board's view, these examples illustrate the general conclusion that an asset exists because the entity has a present right to a resource (the regulator's promise). The fact that the cash flows the right will generate are uncertain because they are subject to risks relating to future demand affects the measurement of the right not its existence or recognition. Any other conclusion would result in a failure to recognise a wide variety of intangible assets, such as royalty and franchise agreements, among others. Moreover, the Board notes that an entity does not control the recoverability of many other types of assets, recoverability being often dependent on the actions of others. For example, even though an entity may have a contractual right to repayment of a loan, recoverability will depend on the counterparty's willingness and ability to pay. That uncertainty does not mean the right is not recognised as an asset. Consequently, the Board believes that those who do not support the recognition of regulatory assets because the rate-regulated entity does not control the recoverability of future economic benefits are confusing the issues of recognition and measurement.

Regulatory liabilities

BC23 Paragraph 49(b) of the *Framework* 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.' The Board concluded that in some forms of regulation, an obligation arises because of a requirement to refund to customers amounts collected in previous periods. In such environments, collecting amounts in excess of costs and the allowed return creates an obligation to return the payments to the aggregate customer base.

BC24 Some believe that the obligation arising from the arrangement with the regulator is not a present obligation but a possible future obligation because its existence depends on the occurrence of uncertain future events: the future sales. If a sale is made in the future period, the customer's usage will be billed at a decreased rate in that future period because of the regulator's requirement. Once again, the Board concluded that the regulator has the authority to ensure that future cash flows from the customer base as a whole would be reduced to refund amounts previously collected.

BC25 Much of the basis for the Board's conclusion that rate regulation can result in items that meet the definition of liabilities parallels its analysis of the recognition of assets set out in paragraphs BC16–BC22:

(a) The obligation relates to amounts the entity has already collected from customers.

(b) The obligation is owed to the entity's customer base as a whole, not to individual customers.

(c) The obligation exists even though its amount may be uncertain because it depends on the actions of others. In this respect, a regulatory liability is similar to a mortgage with a feature that obliges the borrower to share some portion of the profits from the use of the property with the lender.

The Board also concluded that an economic obligation is something that results in reduced cash inflows, directly or indirectly, as well as something that results in increased cash outflows. A regulator has the ability to enforce the entity's obligation to reduce rates until the specified amount has been returned to the customers.

Circumstances in which assets and liabilities can arise

BC26 Having concluded that regulation can result in items that meet the definitions of assets and liabilities, the Board then considered the circumstances in which those assets or liabilities could arise. The Board identified two criteria that an entity's activities must satisfy to be within the scope of the proposed IFRS. In other words, an entity is not within the scope of the proposed IFRS and therefore would not recognise regulatory assets and regulatory liabilities simply because it was subject to some form of rate regulation.

BC27 The Board concluded that the situation of an entity that satisfies these criteria is not economically similar to the situation of an entity that does not. Therefore, failure to recognise regulatory assets and regulatory liabilities when they exist would make unlike situations look alike. This outcome is just as detrimental to comparability as making like situations look different. The Board also noted that the return an entity reports in its financial statements is the result of the appropriate recognition and measurement of items that meet the *Framework*'s definitions of assets and liabilities, not the application of any type of mechanism.

Criterion 1 – Prices that bind customers

BC28 The first criterion requires an entity to satisfy two conditions:

(a) An identifiable body is authorised to set prices for the regulated goods or services it provides to its customers.

(b) The prices set by that body bind the entity's customers.

BC29 The Board noted that the existence and authority of the price-setting body should be readily determinable because it is established by statute or contract.

BC30 Agreements between a rate-regulated entity and its customers cannot be understood without reference to the regulation. Therefore, some believe that such agreements are different from agreements between an entity and its customers in a non-regulated environment. An alternative view is the one adopted by the Board in its revenue recognition project. In that project the Board concluded that the terms required by relevant regulation did not need to be included in a customer contract for them to affect the accounting for that contract. Thus, customer contracts in rate-regulated environments have the same effect as those in non-regulated environments in that the terms imposed by legislation/regulation have to be considered. Therefore, no matter which view is adopted, the effect of regulation needs to be considered as part of the agreement with the customer.

BC31 Some believe that the ability to charge a higher or lower price is not a differentiating feature. In fact, all entities have this ability and it does not give rise to an asset or a liability. For example, as a result of a new competitor entering the market, an entity may decide to decrease its prices, but such a decision does not give rise to a liability.

BC32 However, rate-regulated entities are not allowed to charge rates for regulated goods or services other than those approved by the regulator. The regulator has the ability to require price reductions until a specified amount has been returned to customers through those decreases. When an entity reduces its prices to match competition, there is no link to previous profits.

BC33 As previously discussed, regulatory assets and regulatory liabilities arise when the regulator acts on behalf of the customers who individually would have no bargaining power with the regulated entity. It is this aggregate customer base that is both represented by the regulator and bound by the regulator's actions.

Criterion 2 – Cost-of-service regulation

BC34 As discussed in paragraphs BC16 and BC17, the Board concluded that a cause-and-effect relationship between the entity's costs and the future revenue cash flows is the principal economic effect of regulation on the accounting for regulated entities. The regulator's action promising the recovery of a cost creates a future economic benefit, which is the critical feature in the definition of an asset. Consequently, the Board concluded that only regulation in which rates are designed to recover the specific costs the entity incurs in providing the regulated goods or services and to earn a return would result in items that meet the definitions of assets and liabilities.

BC35 In many cases, determining whether the entity's regulatory regime qualifies as cost-of-service regulation will be straightforward. In others, significant judgement will be required. The Board included in Appendix B of the draft IFRS indicators to help an entity determine whether its regulatory regime is cost-of-service regulation.

BC36 The Board noted that the definition of cost-of-service regulation, to some extent, is similar to the definition of a cost plus contract in IAS 11: 'a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.' From the perspective of the regulated entity, contracts with the customers together with the cost-of-service regulation have, in substance, economic effects similar to cost plus contracts directly negotiated with customers in a non-regulated environment. In the case of regulated entities, the regulator acts on behalf of the customers as a group to identify which costs are allowable.

BC37 In considering rate-regulated activities, the Board noted that IFRIC 12 provides guidance on determining the nature of the asset received (an intangible or a financial asset) by the operator in exchange for the acquisition or construction of the infrastructure used in the service concession. Paragraph 17 of IFRIC 12 states that 'the operator shall recognise an intangible asset to the extent that it receives a right (a licence) to charge users of the public service.' Thus, IFRIC 12 requires an entity to recognise an asset for a right to charge customers for use of a public service at a price controlled or regulated by the grantor even though the entity bears the demand risk. The Board concluded that it would be inconsistent not to recognise regulatory assets when an entity has a similar right as a result of regulation rather than a contract.

BC38 Some believe that rate regulation does not give rise to the recognition of an intangible asset because it does not change the nature of the existing licence. First, in most cases, the licence is not recognised as an intangible asset as it is when it is acquired in circumstances such as those covered by IFRIC 12 or a business combination. Second, the nature of the licence or the service provided under it may not have changed but the rates charged for that service have been changed by the regulation. The Board concluded that the value of the licence reflects the general regulatory environment. In other words, the value of the licence reflects the regulator's promise that, in return for the entity providing reliable service, the regulator will set 'just and reasonable rates' permitting the entity to recover its costs and make a fair return. The permission for the entity to recover specific costs that it has incurred creates an intangible asset separate from the licence.

BC39 The Board also noted that an entity with an arrangement within the scope of IFRIC 12 would have to consider whether it has rate-regulated activities that are within the scope of the proposed IFRS. For example, in one service concession arrangement, the grantor may give the operator only the right to charge customers for use of the public service at the price the grantor controls. In another service concession arrangement, the grantor may give the operator the right to recover the operator's costs and earn a specified return as well as the right to charge customers to use the public service. If it does, the entity would apply both IFRIC 12 and the proposed IFRS on rate-regulated activities.

Recognition and measurement

Recognition of regulatory assets and regulatory liabilities

Recognition criterion and probability of recovery

BC40 The Board considered whether the proposed IFRS should include a separate recognition criterion for regulatory assets and regulatory liabilities. Paragraph 83 of the *Framework* indicates that an asset or liability should be recognised if:

(a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and

(b) the item has a cost or value that can be measured reliably.

BC41 Paragraph 85 of the *Framework* explains that this notion of probability is used in the same sense as it is employed in other standards and defined in the Glossary, ie 'more likely than not'. The Board concluded that if rate-regulated activities satisfied the scope criteria in the proposed IFRS, the actions of a regulator provide reasonable assurance that the economic benefit will flow to or from the entity. In addition, because regulatory assets and regulatory liabilities relate to specifically identifiable amounts expended or collected by the entity, the Board concluded that reliable measurement was possible.

BC42 The Board decided that the scope criteria are both necessary and sufficient for the recognition of regulatory assets and regulatory liabilities. Consequently, once the scope criteria have been satisfied, assets and liabilities exist that meet the criteria for recognition. As a result, the Board decided not to propose a separate recognition criterion in the draft IFRS.

Type of assets or liabilities

BC43 Typically, regulatory assets or regulatory liabilities that would be recognised as a result of applying the proposed IFRS are not financial instruments subject to the requirements of IAS 39. The entity does not have the right to request reimbursement from, or the obligation to make payments to, individual customers for fixed or determinable amounts. Rather, rights or obligations created as a result of rate regulation are rights from or obligations to an aggregate customer base. In this respect, regulatory liabilities are similar to some liabilities recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, in which the identity of the party to whom the obligation is owed is not known. In other respects, regulatory liabilities resemble obligations to perform future services recognised in accordance with IAS 18 *Revenue*. In rare circumstances, the regulator may direct that specific amounts should be paid to or recovered from specific customers. In that case, the definition of a financial instrument would be satisfied.

Measurement of regulatory assets and regulatory liabilities

Probability-weighted average of possible outcomes

BC44 The Board decided that measuring regulatory assets and regulatory liabilities at the present value of expected future cash flows is consistent with the current guidance in IAS 37. Moreover, this approach is consistent with the approach to the determination of expected cash flows the Board recently proposed in its exposure draft *Income Tax* published in March 2009.

BC45 The Board concluded that this measurement approach more faithfully reflects the entity's expectations of future cash flows than does an approach in which satisfying a recognition requirement results in the recognition of the entire asset or liability as if it was certain. The Board concluded that a recognition criterion was unnecessary given the scope criteria. In addition, such a recognition criterion would postpone the recognition of assets and liabilities with future cash flows that can be estimated. Consequently, the Board decided that it was preferable to include the probability of the cash flows in the measurement of the regulatory asset or regulatory liability.

BC46 The draft IFRS requires an entity, in estimating future cash flows, to consider the probability that the regulator will allow or require the entity to include a specific item in the determination of future rates. Usually, the rate-making process is initiated by the entity preparing and filing a rate case designed to show the costs of providing service to customers. When a cost has been considered as part of a finalised rate case, the regulator has provided clear evidence of its agreement on costs that are allowable. Such evidence can be in the form of a formal approval (eg a final rate order), setting out findings of fact and of law, issued by the regulator to support its decisions. Appendix B of the draft IFRS describes additional evidence an entity would consider in estimating the probability of regulatory approval to assist entities in applying its requirements.

Discount rate

BC47 In some jurisdictions regulators allow entities to earn a rate of return that is intended to be consistent with their market-based cost of capital. In these situations, the rate of return set by the regulator may be a reasonable approximation of the discount rate appropriate for the measurement of the regulatory assets and regulatory liabilities. However, this cannot be assumed. Therefore, the Board proposes in paragraph B13 of the draft IFRS that the discount rate should be determined in accordance with the draft IFRS independently of the rate allowed for reimbursement by the regulator.

BC48 The Board noted that the general principle for determination of an appropriate discount rate in an expected present value measurement proposed in paragraph 15 of the draft IFRS is consistent with both paragraph 55 of IAS 36 *Impairment of Assets* and paragraph 47 of IAS 37.

Cost of self-constructed or internally generated assets

BC49 The Board noted that in some cases, a regulator requires an entity to include as part of the cost of property, plant and equipment or internally generated intangible assets amounts that would not be included by non-regulated entities. Such amounts may be indirect overheads not permitted in accordance with IAS 16 or IAS 38 or the cost of financing construction or development that is not in accordance with IAS 23 *Borrowing Costs*. The regulator may require a computed interest cost and a designated cost of equity funds to be included in the cost of the asset.

BC50 The Board acknowledged that two alternatives exist for accounting for these costs. Proponents of the first alternative believe that regulatory assets that would be recognised as a result of the proposed IFRS do not have the same characteristics as assets recognised in accordance with other IFRSs. Therefore, proponents of this alternative believe that all regulatory assets should be presented separately from assets recognised in accordance with other IFRSs.

BC51 Proponents of the second alternative believe that some regulatory assets that would be recognised as a result of the proposed IFRS are so closely related to other assets of the entity that accounting for them separately does not provide additional information to users. Proponents of this alternative believe that when regulatory assets are complementary to other assets and have similar useful lives, there is no need to incur the costs of separate accounting. In accordance with this alternative, an entity includes the cost of the regulatory asset in the cost of the asset recognised in accordance with other IFRSs as a single asset.

BC52 The Board concluded that when it is highly probable that the regulator will require amounts to be included in the cost of self-constructed or internally generated assets that would not be permitted in accordance with IFRSs, those amounts should be included in the cost of the assets rather than being accounted for separately in accordance with the proposed IFRS. If it is highly probable that the regulator will require the amount to be included in the cost of the asset, only one possible difference exists between the accounting the Board proposes and the accounting that would otherwise be required by the proposed IFRS. The proposed IFRS would require a regulatory asset recognised separately to be adjusted for changes in interest rates. The Board concluded that an exception to the principles in the proposed IFRS was justified on cost-benefit grounds.

Recoverability

BC53 The Board concluded that an entity may determine that individual regulatory assets and regulatory liabilities exist and that it should recognise them. However, the Board also concluded that there may be situations in which the net effect of the regulatory assets and regulatory liabilities an entity recognises will result in significant increases in future rates to be charged to customers. A significant increase in an entity's future rates may create a strong incentive for customers to reduce their consumption or switch to an alternative good or service. In these cases, even though rates are increased, expected reductions in volume might mean that the entity will not achieve its total revenue requirements.

BC54 The Board concluded that when it is not reasonable to assume that the entity will be able to collect sufficient revenues from its customers to recover its costs and earn a fair return, an indicator of impairment exists. The regulatory assets and regulatory liabilities should then be included with the other assets and liabilities of the cash-generating unit and tested for impairment in accordance with IAS 36. The Board concluded that this treatment is appropriate because regulatory assets and regulatory liabilities do not generate cash inflows that are largely independent from other assets of the entity.

Derecognition

BC55 The exposure draft proposes that all items that meet the scope criteria of the draft IFRS should be recognised. As a consequence, the draft IFRS does not include additional criteria specifying when regulatory assets and regulatory liabilities should be derecognised. Failure to satisfy the scope criteria for some activities would automatically result in the derecognition of all previously recognised regulatory assets and regulatory liabilities related to those activities.

Presentation

BC56 Regulatory assets and regulatory liabilities typically do not meet the definition of financial instruments because the assets and liabilities created as a result of regulation relate to the interaction of the entity with the aggregate customer base and not with individual customers. Consequently, they cannot meet the criteria to be presented net set out in IAS 32 *Financial Instruments: Presentation*.

BC57 IAS 12 *Income Taxes* permits (non-financial) current and deferred tax assets and liabilities to be offset if specified conditions are satisfied. One of those conditions is that the entity must have a legal right to set off the recognised amounts. This condition can be satisfied for income taxes because ultimately payments will be made to or received from a single taxing authority.

BC58 Regulatory assets and regulatory liabilities arise from specific costs to be collected from or amounts to be refunded to the aggregate customer base. The Board noted that all the regulatory assets and regulatory liabilities recognised that are related to a distinct regulatory activity will affect the determination of the same rate, but decided not to permit offsetting them as a single net position. However, the Board concluded that the presentation of a net regulatory asset or net regulatory liability for each category subject to the same regulator would be appropriate.

Disclosures

BC59 The Board is aware that most entities already recognising regulatory assets and regulatory liabilities in accordance with US GAAP or similar requirements in other jurisdictions currently provide virtually all of the information proposed to be disclosed by paragraph 24 of the draft IFRS. However, the Board observed that the information is often disclosed in various places throughout the financial statements in a way that can make it difficult for a user to appreciate the overall effect that rate regulation has had on the amounts recognised in the financial statements.

BC60 In the draft IFRS, the Board proposes that entities should meet the minimum disclosure requirements by providing a table showing a reconciliation, from the beginning to the end of the period, of the carrying amount in the statement of financial position of the various categories of regulatory items. This table will be required unless another format is more appropriate. This reconciliation should show in one place the changes in the amounts recognised in the statement of comprehensive income. The Board noted such a table would be useful in helping users to understand how the entity's reported financial results and position have been affected by rate regulation.

Effective date and transition

BC61 The Board will set the effective date for the proposals in the exposure draft when it approves the IFRS on rate-regulated activities. The Board intends to allow a minimum of one year between the date when wholly new IFRSs or major amendments to IFRSs are issued and the date when implementation is required.

BC62 The Board noted that jurisdictions throughout the world have a variety of types of rate regulation to serve a variety of purposes. The current accounting treatment may vary from one jurisdiction to another depending on the application of IFRSs to the specific regulations. The Board considered whether it should provide an exemption from retrospective application of the proposed IFRS because entities must obtain information necessary to determine the probability-weighted present value of future cash flows. The Board believes that this information may be available in many, but not all, instances given the regulatory environment in which such entities operate. The Board noted that determining the probability-weighted present value of future cash flows in these instances would require the use of hindsight and might not achieve comparability.

BC63 Accordingly, the Board proposes not to require full retrospective application. Instead, the Board proposes to require application of the proposed IFRS to regulatory assets and regulatory liabilities existing at the beginning of the earliest comparative period presented in the period in which the entity applies the proposed IFRS. The Board recognises that this requirement means that it may need to extend the normal period between the date of finalising the IFRS and its effective date.

Costs and benefits

BC64 The objective of financial statements is to provide information about an entity's financial position, financial performance and cash flows that is useful to a wide range of users in making economic decisions. To attain this objective, the Board tries to ensure that a proposed IFRS will meet a significant need and that the overall benefits of the resulting information justify the costs of providing it. Although the costs to implement a new IFRS might not be borne evenly, users of financial statements benefit from improvements in financial reporting, thereby facilitating the functioning of markets for capital and credit and the efficient allocation of resources in the economy.

BC65 The evaluation of costs and benefits is necessarily subjective. In making its judgement, the Board considers the following:

(a) the costs incurred by preparers of financial statements.

(b) the costs incurred by users of financial statements when information is not available.

(c) the comparative advantage that preparers have in developing information, compared with the costs that users would incur to develop surrogate information.

(d) the benefit of better economic decision-making as a result of improved financial reporting.

BC66 The Board concluded that the proposed IFRS would meet a significant need because questions continue to arise on the application of IFRSs to various types of regulated activities. In the Board's view, it is more efficient for the Board to develop an IFRS than to require each entity to reach its own conclusions on the application of the *Framework*.

BC67 The Board decided that particular types of regulation create assets and liabilities. The draft IFRS requires those assets and liabilities to be recognised in the financial statements. The Board believes that consistent recognition of elements that meet the definitions of assets and liabilities improves financial reporting and consequently economic decision-making.

BC68 In the case of regulatory assets and regulatory liabilities, the Board believes that the additional costs that preparers of financial statements need to incur should not be significant because the detailed information is already required in most circumstances for reporting to the regulator. Consequently, preparers have a large advantage in developing information when compared with the costs that users would incur to develop surrogate information.

Alternative views on exposure draft

Alternative views of Stephen Cooper and Wei-Guo Zhang

AV1 Messrs Cooper and Zhang voted against the publication of the exposure draft of the proposed International Financial Reporting Standard *Rate-regulated Activities* for the reasons set out below.

Definition of an asset or a liability

AV2 Messrs Cooper and Zhang do not agree that assets or liabilities should be recognised solely as a result of rate regulation. The definitions of an asset and a liability in the *Framework for the Preparation and Presentation of Financial Statements* are not met for items arising from rate regulation. By requiring them to be treated as assets and liabilities, the exposure draft proposes a departure from the *Framework*.

AV3 Regulators are empowered to establish the price charged for regulated activities or the rate of return allowed on assets used in such activities. In doing so they may approve, for the purposes of computation, accruals or deferrals of related costs to meet that specified rate of return. But in the view of Messrs Cooper and Zhang, those actions do not create an enforceable right to recover cost plus a rate of return. Nor do they assure the level of future demand. As a result, the entity cannot control adequate transactions in the future to enable its recovery of cost plus return.

AV4 The exposure draft uses the concept of 'a group of customers' or 'customer base' to justify the recognition of regulatory assets and regulatory liabilities. Messrs Cooper and Zhang's alternative view is that there is no justification to presume that the customers as a group will use a given level of service at a given price in the future. The rate allowed by regulation is not necessarily the rate the customers will be willing or able to pay for the level of demand envisaged. They acknowledge that the proposed IFRS includes recoverability and impairment tests. However, imposing such tests does not overcome their view that the regulatory asset should not be recognised in the first instance.

AV5 An entity cannot demand payment of any deferred cost until it forms part of an actual transaction in a future period. The reverse is equally true. Reducing the rate and/or the rate of return in the future does not mean that the regulated entity is liable to refund or reimburse any excess past return to the customers.

AV6 Since the regulator cannot ensure the demand, Messrs Cooper and Zhang cannot see how the right or obligation that arises as a result of regulation can be related to identifiable future cash flows. Furthermore, in practice, the pattern of cash flows is often complicated by: using estimated rather than actual cost to establish rates and to approve deferred debits or credits; time lags between the submission and approval; differences between expected and actual transaction volumes; different classes of customers subject to different rates; and activities that are subject to different regulations. These complications make it virtually impossible to establish any direct link between the regulatory right or obligation and the entity's future cash flows. The proposed treatment will confuse users and preparers of financial reports, as well as cause extra time and effort, which in their opinion outweigh any perceived benefits.

Inconsistencies with existing IFRSs and comparability

AV7 The exposure draft would require regulated entities to recognise as assets or liabilities items that unregulated entities are prohibited from recognising as assets or liabilities, for example, research costs, indirect overheads, damaged fixed assets, and the imputed cost of equity capital used in financing the construction of plant and equipment. Messrs Cooper and Zhang find no basis for overriding the principles that other IFRSs would require to be applied in such cases.

AV8 Messrs Cooper and Zhang believe that because of the inconsistent requirements with other IFRSs, this exposure draft will lead to a lack of comparability: economically similar situations will be accounted for differently within a regulatory entity over time, or among different regulatory entities, and between regulated and unregulated entities.

AV9 Furthermore, since jurisdictions may have different approaches to regulated activities with different sizes and different schemes that are evolving over time, Messrs Cooper and Zhang have deep concerns over whether the proposed IFRS will be interpreted and applied consistently.

Objective of financial reporting and the provision of useful information

AV10 The IASB has asserted that the objective of financial reporting is different from that of government regulation, and accounting principles serving the objective of financial reporting should not be the same as the one serving the objective of government regulation.

AV11 Messrs Cooper and Zhang consider the proposed treatment will result in the regulated entity reporting a stabilised rate of return allowed by the regulator in a particular period. They recognise that stability is clearly the objective of the regulator. However, they question whether such a profit-smoothing mechanism is desirable for financial reporting purposes. Actual results will always differ from regulatory decisions or expectations because of deviations in the volume of transactions, the cost of production etc. Financial reports will be more useful if they reflect the actual results of each period rather than the expected or stabilised results permitted by a regulator.

AV12 Messrs Cooper and Zhang do not deny that a regulated entity has some unique features, and the decisions taken by regulators may affect the entity's current or future financial position or operating results. In their judgement, what is called for is appropriate disclosure rather than setting accounting standards inconsistent with the existing *Framework* and IFRSs.

Transparency

AV13 If in due course the Board requires the recognition of regulatory assets and regulatory liabilities Messrs Cooper and Zhang consider it vital that the impact on the financial statements should be transparent so that investors can clearly identify how this accounting has affected profit or loss and financial position. In this regard, they do not believe that regulatory assets should be included as a component of self-constructed assets as proposed.

