



Australian Government

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Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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UNITED KINGDOM

Dear David

AASB comments on IASB Exposure Draft ED/2009/8 *Rate-regulated Activities*

The Australian Accounting Standards Board (AASB) is pleased to provide comments on Exposure Draft ED/2009/8 *Rate-regulated Activities*. In formulating its views, the AASB sought the views of Australian constituents. The comment letters received are published on the AASB's website.

The AASB does not support the proposals in this ED. It has serious concerns that the way in which the IASB has proposed assets and liabilities arise from regulation is not consistent with the IASB's Framework and other IFRSs, in particular the exceptions to existing IFRSs proposed in paragraph 16 and BC 49-52. In deciding not to add this project to the agenda, the IFRIC noted that the recognition criteria in SFAS 71 were not fully consistent with the recognition criteria in IFRSs and would require the recognition of assets under certain circumstances which would not meet the recognition criteria of relevant IFRSs. Accordingly the requirements of US generally accepted accounting principles (US GAAP) are not indicative of the requirements of IFRSs.

The AASB also has strong concerns regarding the lack of clarity on the nature of the assets and liabilities that would be recognised, and their interaction with other assets/liabilities.

The AASB supports the alternative views of Stephen Cooper and Wei-Guo Zhang set out after the Basis for Conclusions of the ED.

The AASB questions whether this ED indeed meets the needs of the majority of IASB's constituents and the conclusion that the criteria for adding this project to the IASB's work plan are met. The AASB recommends that the IASB only develop standards that address issues of concern to a wide range of constituents rather than developing standards addressing industry-specific needs.

Although the AASB strongly recommends that the IASB does not proceed with the proposals in this ED, responses to the individual questions raised in the ED are included as an attachment to this letter for the IASB's consideration in the event that the project continues.

If you have any queries regarding any matters in this submission, please contact me or Jessica Lion (jlion@asb.gov.au).

Yours sincerely,

A handwritten signature in black ink, appearing to read "Kevin M. Stevenson". The signature is fluid and cursive, with a long horizontal flourish extending to the right.

Kevin M. Stevenson
Chairman

AASB comments on IASB Exposure Draft ED/2009/8 *Rate-regulated Activities*

Specific matters for comment

The AASB provides the following responses to the IASB's Exposure Draft ED/2009/8 *Rate-regulated Activities*.

Scope

Question 1

The exposure draft proposes two criteria that must be met for rate-regulated activities to be within the scope of the proposed IFRS (see paragraphs 3–7 of the draft IFRS and paragraphs BC13–BC39 of the Basis for Conclusions).

Is the scope definition appropriate? Why or why not?

The AASB does not support the proposals in this ED, however the following responses are provided for the IASB's consideration in the event that the project continues. Our responses below include the AASB's technical views on the scope of the proposals and the arguments given by the IASB. However given the AASB's objection to the project, if the project goes ahead it would want the scope to be as narrow as possible to limit those entities that would be required to apply this accounting. Therefore, for example, although the AASB has technical concerns with use of the word 'must' in the scope (as noted below), it would prefer its inclusion in the event that the project proceeds in order to limit the application.

Use of the word 'must'

The proposals are inconsistent with the IASB's policy of developing Standards that are founded on principles. Instead, the scope of the proposals is the subject of narrowly-focused rules. . For example, use of the word 'must' in relation to the price set by regulators that 'the entity **must** charge' (emphasis added). In some regulatory environments it is common to have a 'price-cap' basis of regulation. Assuming the second criteria of the scope is met, the same arguments in the Basis for Conclusions as to why regulatory assets/liabilities arise can also be applied to a price-cap scenario (that is, the entity has an asset, the right to recover its costs through a future price increase, and the entity can choose to exercise that full right). Based on all the same arguments in the Basis for Conclusions an asset would exist in a price-cap scenario, and the entity's decision as to whether to exercise their full right to charge a particular price could be built into the measurement of the asset. The arguments in the Basis for Conclusions are not dependent on the price being one the entity **must** charge.

The proposal that the entity must charge the price set is inconsistent with paragraph B4 in the additional guidance. Point c) mentions a 'price cap' plan which is used as an example to clarify what is within the scope of the ED, but appears to contradict the scope as currently drafted. Point d) mentions rate discounts, which again implies that an entity is able to set a rate below that set by the regulator.

The AASB also believes that the same arguments can apply if the regulator allows only a proportion of the entity's costs to be included in rate determination, and that a regulatory asset could exist for that proportion of the entity's costs. The same arguments also apply if

only a portion of the price is on a cost of service basis, in which case the entity could apply these proposals to that portion of the cost. The AASB believes that if the proposals proceed, they must be based on a principle relating to the recovery/reimbursement of costs.

Notwithstanding the desirability of IFRS being founded on principles rather than rules, the AASB is so strongly opposed to there being a Standard on this topic that, if one does proceed, the AASB would advocate that it has the narrowest possible scope to limit the impact of the inappropriate accounting that would result.

Application by analogy

Although the Basis for Conclusions explains that the IASB believes regulatory assets and liabilities can arise only if an activity is within the scope of the ED, this is not explicitly stated in the ED. Therefore we understand that some entities could apply this ED to other scenarios by analogy by applying the hierarchy in IAS 8 *Accounting Policies Changes in Accounting Estimates and Errors*. If it is the Board's intention that regulatory assets/liabilities can only arise if an activity is within the scope of this ED, the AASB suggests that this is explicitly stated. The AASB is also concerned that these principles could be applied more widely under IAS 8 to other forms of intangible assets.

Other points

The scope states that the 'price binds the customer'. We do not agree with this statement as the customer could walk away and not buy the product and hence they are not bound by this price. The Basis for Conclusions uses the expression 'non-negotiable price' which is more accurate and hence the IASB should consider using this terminology in the scope instead.

It would be helpful if paragraph BC9 stated what the ED is not accounting for, that is, the existing or granted market position.

In the scope guidance, paragraph B6 notes that the entity needs to conclude that the regulatory plan provides a 'sufficient return' to shareholders to justify the application of the ED. This condition is not included in the scope paragraph in the ED (which only mentions 'specified return' and it is not clear why a 'sufficient return' is relevant to the application of the ED. Some could conclude that the regulatory plan must ensure that the rate-regulated activity is profitable in order for an entity to be able to apply the proposals in the ED.

Recognition and measurement

Question 2

The exposure draft proposes no additional recognition criteria. Once an activity is within the scope of the proposed IFRS, regulatory assets and regulatory liabilities should be recognised in the entity's financial statements (see paragraphs BC40–BC42 of the Basis for Conclusions).

Is this approach appropriate? Why or why not?

The AASB does not support the proposals in this ED as it has serious concerns that the way in which the IASB has proposed assets and liabilities arise from regulation is not consistent with the IASB's Framework and other IFRSs. In particular the AASB believes that there has been no 'past event' to enable the recognition of an asset and liability. Even though the AASB does not support the proposals in the ED, the following responses are provided for the IASB's consideration in the event that the project continues.

Yes, we prefer this approach to the approach adopted in SFAS 71 *Accounting for the effects of certain types of regulation*.

Nature of asset

The nature of a regulatory asset is not made clear, and the economic resource controlled by a regulated entity is not identified. Some Australian constituents agree that regulation creates an asset but disagree with the basis on which the ED proposes that this asset be created. The ED proposes to capitalise costs that would otherwise be expensed under current IFRSs. This has caused a significant amount of concern. Those who support the arguments that regulation creates assets and liabilities have suggested that this would be better based on approaches in existing IFRSs.

Intangible Asset Approach

The ED and Basis for Conclusions often mention that regulation creates a right. This would therefore suggest that the regulatory asset is an intangible asset that should be accounted for in accordance with IAS 38 *Intangible Assets* or at least in a manner consistent with IAS 38. Most consider that, if this were the case, capitalisation of costs as a regulatory asset would not be allowed on the basis that they are internally generated. If the IASB continues with these proposals and states that the regulatory asset is a right, the IASB needs to be very clear that it is the right to recover costs that is being recognised and not the right to increase prices as sometimes referred to in the ED. The AASB would disagree with the recognition of the asset if it were being based on regulation providing a right to increase a price as it believes all entities have the right to increase their prices.

In either case the economic resource creating the asset needs to be clearly identified. For example, the Basis for Conclusions identifies that the economic resource controlled by the entity is the regulator's promise to raise prices (BC38 & BC16). The AASB considers that use of the word 'promise' is unhelpful.

Furthermore, use of the word 'right' versus 'opportunity' (BC11 and BC17) is problematic. The AASB suggests that, if the IASB proceeds with this project, there should be consistent application of the term 'right' if that is what the IASB intends that entities would recognise.

The AASB considers that the arguments supporting the recognition of an asset as currently proposed, depends on there being certainty about the customer pool. It is the customer pool creates the assurance that the costs will be recovered. Such certainty generally only exists in a monopoly situation in relation to an essential item. In other situations, for example, if there are two regulated suppliers of electricity in

one area, there is no certainty over the customer pool as theoretically customers could change to the other supplier. However, the AASB notes that an asset (certainty over the customer pool) is present in this situation regardless of whether the entity is regulated, and this asset is already dealt with by IAS 38. If the IASB were to adopt an intangible asset approach, the AASB would still prefer that rights arising from rate-regulation be dealt with as part of a comprehensive review of IAS 38, rather than as a separate project.

A final point is that the proposals need to be clear on how an entity can distinguish these cash flows from the cash flows of any other intangible asset, for example a 'licence', which could be already recognised if the entity had applied IFRS 3 *Business Combinations*. Guidance would be useful in this area as to the unit of account that entities should work to, in order to ensure that entities do not double count cash flows.

Accrued income approach

An alternative approach would be to recognise the relevant costs in accordance with existing IFRSs and instead propose that when there is a 'cost-of-service' type regulation, any specific costs incurred to be reimbursed by customers create revenue and regulatory asset (accrued income).

This could be considered to be consistent with IAS 11 *Construction Contracts* as when a contractor seeks to collect from the customer reimbursement for costs not included in the contract price. Revenue is recognised when negotiations have reached an advanced stage such that it is probable that the customer will accept the claim and the amount that is probable will be accepted by the customer can be measured reliably.

A variation on this approach would be to adopt the alternative model suggested in the AASB's comment letter in response to *Preliminary Views on Revenue Recognition in Contracts with Customers*. This would involve recognising an asset and revenue when the entity becomes unconditionally entitled to be compensated for costs incurred.

Even under the existing IAS 18 *Revenue* the IASB would need to consider if the entity had performed all of its obligations to enable deferred income to be recognised.

A revenue approach to accounting for the effects of rate regulation would potentially be a significantly more robust model than that proposed in the ED, and one that is consistent with other existing IFRSs.

Contingent assets approach

Another approach would be to treat regulatory assets/liabilities as contingent assets and liabilities, conditional on the customer continuing to purchase from the entity and the entity providing the future service.

Nature of liability

The AASB notes concerns with how the requirements of IAS 37 and/or IAS 39 would be met regarding recognition of a liability, as the AASB does not consider there to be a present obligation that cannot be avoided. The proposals should clearly identify the nature of the liability, the past event that has occurred and how the liability interacts with other IFRSs. In particular why this liability is, or is not able to be accounted for by IAS 37 and/or IAS 39. Given that IAS 37 is currently being redrafted the IASB should consider including the effects of rate-regulation in that project rather than having separate accounting.

Question 3

The exposure draft proposes that an entity should measure regulatory assets and regulatory liabilities on initial recognition and subsequently at their expected present value, which is the estimated probability-weighted average of the present value of the expected cash flows (see paragraphs 12–16 of the draft IFRS and paragraphs BC44–BC46 of the Basis for Conclusions).

Is this measurement approach appropriate? Why or why not?

The AASB does not support the proposals in this ED, however the following responses are provided for the IASB's consideration in the event that the project continues.

Measurement of Liability

The AASB appreciates the advantages and disadvantages of using the probability-weighted basis for measuring regulatory liabilities. However, the AASB considers that the approach to measuring regulated liabilities should be consistent with the outcomes of the current Liabilities project.

Paragraph BC44 states that the proposals ensure consistency with the current guidance in IAS 37, however, IAS 37 requires a best estimate measurement, with the probability-weighted approach being one method of arriving at this estimate. Furthermore, if IAS 37 is revised substantially (for example, by moving to an exit price basis of measurement), the proposals would presumably need to be updated to ensure consistency with IAS 37.

Day-one accounting

The AASB is concerned that the ED does not deal with issues that would arise when an entity becomes regulated. It can be argued that on becoming regulated an entity may be under an immediate obligation to reduce its prices or may have an immediate right to charge higher prices.

Nature of measurement basis

The expected cash flow approach is a measurement method not a measurement basis. It is not clear as to what the intended measurement basis is for regulatory assets/liabilities. The IASB could also consider whether these regulatory assets could be revalued as under IAS 16 *Property, Plant and Equipment*. Paragraph BC 38 could also express a caution that

cashflows of other assets should not include cashflows covered by this ED (to avoid double counting). That is, where an entity measures its property, plant and equipment at fair value or recoverable amount, the effects of price regulation are likely to be already captured in the values of those assets.

Inclusion of profit margin

It is not clear from the ED whether the regulatory asset should include a profit margin. Paragraph 10 states that an asset is recognised initially at amounts “that would otherwise be recognised in that period in the statement of comprehensive income as an expense”. For an asset this would suggest that the profit margin is not included. However paragraph 13 states that the asset should be measured at the expected present value of the future cash flows, which would generally include a profit margin when the entity operates a profitable business.

Use of judgement and cost effectiveness

The AASB considers that the measurement of a regulatory asset as currently proposed involves considerable judgement to the point where the amounts may not be reliably measurable. Some regulatory legislation is very broad and hence some entities have stated that it is difficult to predict whether a cost will be allowed by a regulator to be recouped. The method proposed is therefore not only very difficult to apply but will also be a very costly exercise that may not outweigh any benefits. The AASB is also concerned that the requirement and the manner in which it might be applied would make the financial statements of regulated entities less comparable with one another (and with unregulated entities) as the scope is narrow and not all regulated entities would be able to apply this ED.

Guidance for entities whose regulatory period is greater than one year

The AASB is concerned that the ED does not address cases when the regulatory period is greater than one year, which is often the situation in Australia. In these cases, there is generally less certainty about the regulatory outcomes and a potentially greater cost burden in determining the relevant amounts and a need for additional guidance to determine the basis on which a regulatory asset would be released to the income statement.

Relationship to IAS 39

In paragraph BC43 (last sentence) it is implied that the lack of a specific counterparty means IAS 39 *Financial Instruments: Recognition and Measurement* does not apply. However, the AASB considers that a reason that IAS 39 would not apply is more likely to be the absence of a contract.

Question 4

The exposure draft proposes that an entity should include in the cost of self constructed property, plant and equipment or internally generated intangible assets used in regulated activities all the amounts included by the regulator even if those amounts would not be included in the assets' cost in accordance with other IFRSs (see paragraph 16 of the draft IFRS and paragraphs BC49–BC52 of the Basis for Conclusions). The Board concluded

that this exception to the requirements of the proposed IFRS was justified on cost-benefit grounds.

Is this exception justified? Why or why not?

The AASB does not support the proposals in this ED, however the following responses are provided for the IASB's consideration in the event that the project continues.

The AASB has serious concerns about the proposals that, when a regulator requires an entity to capitalise costs, as part of the cost of self-constructed property, plant and equipment or internally generated intangible assets, amounts that would otherwise be recognised as regulatory assets in accordance with the ED, the same treatments would be required under IFRSs. Standard setters, such as the IASB and the AASB have often been faced with the problem that regulators, such as taxation authorities or prudential regulators require particular treatments for their own specific purposes, and particular constituents bring pressure to bear to have those treatments included in accounting standards without regard to the needs of the users of general purpose financial statements. The AASB considers that it would be completely inappropriate for an IFRS to incorporate regulatory reporting within IFRSs and the AASB believes that the proposals in the ED have the potential to undermine efforts in other areas to convince constituents that the needs of the users of general purpose financial statements should prevail in determining the requirements of IFRSs. If the IASB considers that the relevant costs are part of a regulatory asset, those costs should be required to be part of a regulatory asset, rather than imposing exceptions from the requirements of other IFRSs. In the AASB's view, the ED would, for example, be establishing a precedent for LIFO being re-introduced to IAS 2 *Inventories* on the grounds that the taxation authorities in several jurisdictions require LIFO accounting to be used the financial statements in order for LIFO to be used for taxation purposes.

Question 5

The exposure draft proposes that at each reporting date an entity should consider the effect on its rates of its net regulatory assets and regulatory liabilities arising from the actions of each different regulator. If the entity concludes that it is not reasonable to assume that it will be able to collect sufficient revenues from its customers to recover its costs, it tests the cash-generating unit in which the regulatory assets and regulatory liabilities are included for impairment in accordance with IAS 36 *Impairment of Assets*. Any impairment determined in accordance with IAS 36 is recognised and allocated to the assets of the cash-generating unit in accordance with that standard (see paragraphs 17–20 of the draft IFRS and paragraphs BC53 and BC54 of the Basis for Conclusions).

Is this approach to recoverability appropriate? Why or why not?

The AASB does not support the proposals in this ED, however the following responses are provided for the IASB's consideration in the event that the project continues.

The AASB considers that the proposals regarding measurement of regulatory assets and liabilities need to better articulate with the proposals regarding impairment. As the regulatory asset is carried at an expected present value, it would be reasonable to conclude

that any decrease in demand would be factored into the expected cash flows. The AASB is of the view that a decrease in the regulatory asset would indicate that other assets in the CGU to which it relates could be impaired and hence the entity should test the CGU for impairment and allocate impairment to those other assets in accordance with IAS 36.

If these proposals proceed the AASB suggests using a different term from ‘reasonable to assume’ in paragraph 18, since this is not a term that is in general use within IFRSs. It may be preferable to use a term that is already used within IFRSs such as ‘probable’.

Disclosures

Question 6

The exposure draft proposes disclosure requirements to enable users of financial statements to understand the nature and the financial effects of rate regulation on the entity’s activities and to identify and explain the amounts of regulatory assets and regulatory liabilities recognised in the financial statements (see paragraphs 24–30 of the draft IFRS and paragraphs BC59 and BC60 of the Basis for Conclusions).

Do the proposed disclosure requirements provide decision-useful information? Why or why not? Please identify any disclosure requirements that you think should be removed from, or added to, the draft IFRS.

The AASB does not support the proposals in this ED, however the following responses are provided for the IASB’s consideration in the event that the project continues.

The AASB considers that the proposed disclosures would be useful to users. However, it is not clear if the disclosures should apply to all rate-regulated entities, which (if the project proceeds) the AASB considers would be appropriate, or only those entities within the in scope of the ED. It is suggested that the disclosures should apply to all rate-regulated entities by expanding the scope, and including the ‘cost-of-service’ type regulation as a recognition principle.

Income Statement information lost

The AASB is concerned that useful income statement information would be lost in terms of being able to assess an entity’s ongoing operating expenses. If the IASB proceeds with this proposal the disclosure requirements should be expanded to show where in the income statement capitalised costs would have been recognised had they not been included in a regulatory asset.

The IASB should also consider how the regulatory asset/liability would be presented in the income statement. For example could entities show only one line item ‘movement in regulatory asset’?

Terminology

A number of the disclosures refer to an entity’s ‘rate of return’. It would be useful to define this term so that readers understand which rate is intended: the implicit profit margin or a regulator’s discount rate.

Transition

Question 7

The exposure draft proposes that an entity should apply its requirements to regulatory assets and regulatory liabilities existing at the beginning of the earliest comparative period presented in the period in which it is adopted (see paragraph 32 of the draft IFRS and paragraphs BC62 and BC63 of the Basis for Conclusions). Any adjustments arising from the application of the draft IFRS are recognised in the opening balance of retained earnings.

Is this approach appropriate? Why or why not?

The AASB does not support the proposals in this ED, however in the event the project continues, the AASB agrees with the proposed transition arrangements.

First-time adoption

The exposure draft includes proposed amendments to IFRS 1 *First-time Adoption of International Financial Reporting Standards* (see paragraph C1 of the draft IFRS). These amendments are the result of the Board's exposure draft *Additional Exemptions for First-time Adopters* published in September 2008. These amendments reflect the comments received on that exposure draft and the Board's redeliberation's.

No comment.

Other comments

Question 8

Do you have any other comments on the proposals in the exposure draft?

The AASB does not support the proposals in this ED, however the following responses are provided for the IASB's consideration in the event that the project continues.

The examples given should be expanded to show how a regulatory asset would be measured and released to the income statement over a period.

The ED proposals appear rules based and to be based on a US-specific model of rate regulation. If the IASB proceeds with these proposals the AASB urges the IASB to consider the application of a principle-based approach from a global rate regulation perspective.