NZ ACCOUNTING STANDARDS BOARD

[Date] January 2015

Mr Hans Hoogervorst
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Dear Hans

IASB Discussion Paper DP/2014/2 Reporting the Financial Effects of Rate Regulation

The New Zealand Accounting Standards Board (NZASB) is pleased to submit its comments on the International Accounting Standards Board (IASB) Discussion Paper DP/2014/2 *Reporting the Financial Effects of Rate Regulation* (Discussion Paper).

Our general comments, set out in this letter, provide some context for our answers to the questions in the Discussion Paper.

New Zealand context

In developing our response to the Discussion Paper we consulted with the Commerce Commission, which is New Zealand's primary competition regulatory agency.

We note that there is the potential for all entities regulated by the Commerce Commission to be captured within the scope of defined rate regulation envisaged in the Discussion Paper. This is because the Commerce Commission regulations:

(a) regulate monopoly providers of essential goods and services;

(b) set parameters for availability and quality of supply those goods and services;

(c) take into consideration stability of price for customers and the financial viability of the rate-regulated entity in setting rates (or revenue or price caps); and

(d) create enforceable rights and obligations between the Commerce Commission and the rate-regulated entity.

The types of entities that would be affected by any standards-level requirements relating to rate regulation include:

(a) providers of electricity transmission services;

(b) electricity and gas distributors (i.e. electricity lines companies). Although there are a number of electricity lines companies, each operates in a particular geographical area and is the only provider for that area. Each distributor is therefore a monopoly provider in its area; and

(c) telecommunication service providers. Telecommunications lines are regulated but there is competition in the retail market.

Other entities that could be affected by such requirements if current regulatory requirements were to change include:

(a) port companies; and

(b) airports (currently subject to disclosure requirements only).

General Purpose Financial Reporting vs Regulatory Accounting

In any discussion of potential requirements for rate regulated activities in financial reporting standards we consider that it is important to keep in mind the different objectives of the two types of reporting. The Discussion Paper touches on this point in paragraph 5.50(d). Reiterating the points made in paragraph 5.50(d):

> The objective of general purpose financial statements is to provide financial information about the entity that is useful to existing and potential investors and lenders in making decisions about providing resources to the entity.
>
> The objective of regulatory accounting is to support the rate-setting mechanism employed by the rate regulator to balance the needs of customers with the financial viability of the rate-regulated entity and, in some cases, to help achieve the government's social, environmental or fiscal policies.

These objectives are quite different, with regulatory reporting having a strong focus on compliance and monitoring. The information needs of those using financial statements differ from those using regulatory information. In some cases the same information may be of interest to both groups of users but we would urge caution against allowing the information needs of regulators to influence judgements about the information needs of users of general purpose financial statements. In New Zealand the regulatory body may refer to general purpose financial statements to form an overall impression of an entity's financial performance and financial position, but it does not rely on general purpose financial statements to assess the effectiveness of its regulations.

General purpose financial reporting and regulatory accounting can differ significantly and those differences can change over time as regulators change their requirements. We offer the following examples of such differences to highlight that regulatory accounting can specify detailed requirements intended to meet the needs of regulators at a point in time. Changes in circumstances or policy can lead to changes in the calculations required. Regulators' decisions are not influenced by the conceptual definitions of assets and liabilities and the qualitative characteristics that guide the development of financial reporting standards. For example:

(a) Assets may be measured below cost, at cost or adjusted by an index. Different requirements may apply to different classes of assets.

(b) There may be specific rules regarding depreciation, such as treating the first year's depreciation in a different way to the remaining depreciable amount.

(c) Some assets may not be permitted to be written off unless they are completely destroyed.

(d) The requirements for recognition and measurement of deferred tax can vary between entities and can differ from generally accepted accounting practice.

(e) Most intangible assets may be expensed.

(f) There may be specific requirements for the recognition of revenue and expenses, such as deferring a portion of "overcharging" of customers in the current year to a future period.

Another key difference between the two forms of reporting is that the aim of general purpose financial reporting is to report on all the activities of an entity, whereas only one component of an entity may be regulated.

The Discussion Paper does consider the requirements in the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*), but we consider that there has been too much emphasis on the issues faced by rate regulated entities, rather than asking whether the issues faced by rate regulated activities differ sufficiently from the issues faced by other entities to warrant separate reporting requirements or to warrant changes to existing standards.

We support the original position taken by the Interpretations Committee, as outlined in paragraph A54 of the Discussion Paper. Regulations may give rise to items that meet the definitions of, and recognition criteria for, assets and liabilities, in general purpose financial statements. In such cases they should be recognised. However, there are many forms of regulation that could give rise to assets and liabilities and we do not consider that the transactions and balances associated with rate regulated activities should be treated any differently to those other situations. Although the IASB has indicated that the initial focus on defined rate regulation is not intended to define permanently the scope of the project, we consider that the wide range of rights and obligations created by different types of rate regulation mean that the issue should be tackled in a more holistic way.

We consider that the phrase "general purpose financial reporting" is fundamental to any consideration of financial reporting of rate regulated activities and should be at the forefront of all such discussions. Rather than considering whether it is appropriate to develop special requirements for rate regulated activities we think that the issues should be phrased more generally. For example:

(a) Does rate regulation give rise to intangible assets? If so, what are the similarities and differences between such intangible assets and intangible assets arising in different types of entities? What issues would be encountered in applying IAS 38 *Intangible Assets* to rate regulated activities (some of these issues are referred to in the Discussion Paper). How would these issues compare with other issues experienced by entities applying IAS 38?

(b) How could the existing disclosure requirements in International Financial Reporting Standards (IFRS) be used by a rate regulated entity to provide information about the risks and opportunities associated with its operating environment? Are these risks and opportunities significantly different from the risks and opportunities faced by other entities reporting in accordance with IFRS? How would creating specific disclosure requirements for rate regulated activities fit with the more general objective of managing the volume of information provided in a general purpose financial report?

(c) To what extent should users obtain information about cash flows and risks from general purpose financial reports compared to other sources of information?

Next Steps

We support the IASB's efforts to find out more about the information relevant to users of financial statements in making investment and lending decisions. We would encourage the IASB to keep a broad focus in considering any future proposals to provide information about rate regulation. There are many aspects of the regulatory environment that have an impact on the amount, timing and certainty of cash flows. We do not consider that the fact that defined rate regulation is seen as having a more significant effect than other forms of rate regulation, necessarily implies that there should be any different reporting for defined rate regulation.

Note to the Board: This comment was intended to address the point in paragraph 2.12 of the Discussion Paper which explains why the IASB is focusing on defined rate regulation.

If you have any queries or require clarification of any matters in this submission, please contact Clive Brodie (clive.brodie@xrb.govt.nz) or me.

Yours sincerely

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Question 1

(a) What information about the entity's rate-regulated activities and the rate-regulatory environment do you think preparers of financial statements need to include in their financial statements or accompanying documents such as management commentary?

Please specify what information should be provided in:

(i) the statement of financial position;

(ii) the statement(s) of profit or loss and other comprehensive income;

(iii) the statement of cash flows;

(iv) the note disclosures; or

(v) the management commentary.

(b) How do you think that information would be used by investors and lenders in making investment and lending decisions?

We consider that information about an entity's rate-regulated activities and the rate-regulatory environment should be disclosed. Useful information would include information about:

(a) the components of the entity's business that are subject to rate regulation;

(b) the elements subject to regulation (such as selling price or profit margins);

(c) how the regulation operates and is enforced;

(d) the effect of past regulation on the current period; and

(e) the estimated effect of the current regulatory cycle on future reporting periods (such as whether or not the regulator is expected to require or allow selling prices to increase or decrease).

We note that IAS 1 *Presentation of Financial Statements* already requires the disclosure of information about the assumptions an entity makes about the future, and other major sources of estimation uncertainty at the end of the reporting period, that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. We consider that the information we have outlined above could be provided in meeting the requirements of IAS 1 (paragraphs 125 to 133).

We also note that the IFRS Practice Statement *Management Commentary* contains guidance that could usefully be applied in reporting on rate regulated activities. In particular, the sections dealing with "nature of the business" and "resources, risks and relationships" would be especially relevant.

We have not specifically answered part (b) of Question 1 because we consider that this information would be used in the same way as other information about sources of estimation uncertainty.

Question 2

Are you familiar with using financial statements that recognise regulatory deferral account balances as regulatory assets or regulatory liabilities, for example, in accordance with US GAAP or other local GAAP or in accordance with IFRS 14? If so, what problems, if any, does the recognition of such balances cause users of financial statements when evaluating investment or lending decisions in rate-regulated entities that recognise such balances compared to:

(a) non-rate-regulated entities; and

(b) rate-regulated entities that do not recognise such balances?

We are not familiar with using financial statements that recognise regulatory deferral account balances as regulatory assets or regulatory liabilities. In New Zealand, for-profit entities with rate regulated activities report in accordance with IFRS. They do not recognise regulatory deferral account balances. Nor did they recognise regulatory deferral account balances prior to the adoption of IFRS.

Question 3

Do you agree that, to progress this project, the IASB should focus on a defined type of rate regulation (see Section 4 of the Discussion Paper) in order to provide a common starting point for a more focused discussion about whether rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed (see paragraphs 3.6–3.7 of the Discussion Paper)? If not, how do you suggest that the IASB should address the diversity in the types of rate regulation summarised in Section 3 of the Discussion Paper?

As noted in our covering letter, we consider that the IASB should keep a broad focus in this project. Although it might be possible to identify a subset of rate regulated activities with similar characteristics, we consider that the project should be progressed by looking at the application of existing IFRS to the issues associated with rate regulation. In our response to question 1 we noted that both IAS 1 and the IFRS Practice Statement *Management Commentary* would lead to the disclosure of information about rate regulated activities. In addition, we suggest that the application of IAS 38 to the broad collection of rights associated with rate regulated activities be considered. We consider that defined rate regulation and market regulation should be considered in the context of the project.

If the IASB decides to proceed with a more narrow focus on defined rate regulation, we would have concerns that an industry-specific standard could undermine the comparability of financial statements.

Question 4

Paragraph 2.11 notes that the IASB has not received requests for it to develop special accounting requirements for the form of limited or 'market' rate regulation that is used to supplement the inefficient competitive forces in the market (see paragraphs 3.30–3.33 of the Discussion Paper).

(a) Do you agree that this type of rate regulation does not create a significantly different economic environment and, therefore, does not require any specific accounting requirements to be developed? If not, why not?

(b) If you agree that this type of rate regulation does not require any specific accounting requirements, do you think that the IASB should, alternatively, consider developing specific disclosure requirements? If so, what would you propose and why?

Please see our comments in our covering letter and our response to question 3. Although our response to (a) would be that we agree that market regulation does not require specific accounting requirements to be developed, we would also make similar comments about defined rate regulation and consider that the application of existing IFRS to both types of regulation should be carefully considered.

Question 5

Paragraphs 4.4–4.6 of the Discussion Paper summarise the key features of defined rate regulation. These features have been the focus of the IASB's exploration of whether defined rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might be developed in order to provide relevant information to users of general purpose financial statements.

(a) Do you think that the description of defined rate regulation captures an appropriate population of rate-regulatory schemes within its scope? If so, why? If not, why not?

(b) Do you think that any of the features described should be modified in order to include or exclude particular types of rate-regulatory schemes or rate-regulated activities included within the scope of defined rate regulation? Please specify and give reasons to support any modifications to the features that you suggest, with particular reference to why the features may or may not give rise to circumstances that result in particular information needs for users of the financial statements.

(c) Are there any additional features that you think should be included to establish the scope of defined rate regulation or would you omit any of the features described? Please specify and give reasons to support any features that you would add or omit.

We have not responded to this question because we disagree with the separate identification of defined rate regulation.

Question 6

Paragraphs 4.62–4.72 of the Discussion Paper contain an analysis of the rights and obligations that arise from the features of defined rate regulation.

(a) Are there any additional rights or obligations that you think the IASB should consider? Please specify and give reasons.

(b) Do you think that the IASB should develop specific accounting guidance or requirements to account for the combination of rights and obligations described? Why or why not?

We have not responded to part (a) of this question.

With respect to part (b), we do not consider that the IASB should develop specific accounting guidance or requirements to account for the combination of rights and obligations described. Our reasons are set out in our covering letter and our response to question 3.

Question 7

Section 5 of the Discussion Paper outlines a number of possible approaches that the IASB could consider developing further, depending on the feedback received from the Discussion Paper. It highlights some advantages and disadvantages of each approach.

(a) Which approach, if any, do you think would best portray the financial effects of defined rate regulation in IFRS financial statements and is most likely to provide the information that investors and lenders consider is most relevant to help them make their investing and lending decisions? Please give reasons for your answer?

(b) Is there any other approach that the IASB should consider? If so, please specify and explain how such an approach could provide investors and lenders with relevant information about the financial effects of rate regulation.

(c) Are there any additional advantages or disadvantages that the IASB should consider before it decides whether to develop any of these approaches further? If so, please describe them.

If commenting on the asset/liability approach, please specify, if it is relevant, whether your comments reflect the existing definitions of an asset and a liability in the *Conceptual Framework* or the proposed definitions suggested in *the Conceptual Framework* Discussion Paper, published in July 2013.

We believe the most effective approach to making users aware of the effects of rate regulation on an entity would be to require appropriate disclosure of information regarding activities subject to rate regulation. Such information is relevant for all entities subject to rate regulation, not only entities subject to regulation that meets specific criteria.

If the IASB were to pursue any of the approaches set out in Section 5, our preference would be to review the requirements of IAS 38. As noted in the Discussion Paper, any proposals to amend IAS 38 would raise other issues. In addition to the issues raised in the Discussion Paper we think that the IASB would also need to consider the justification for amending IAS 38 to address the needs of some constituents rather than others. We note that many constituents derecognised intangible assets on adoption of IFRS because those intangible assets did not meet the recognition criteria in IAS 38. We consider that this approach is worth exploring, but we would urge the IASB to think broadly when undertaking any such review. We note also that in the case of potential assets, assessments could vary between jurisdictions and industries due to differences between the regulatory schemes.

Question 8

Does your organisation carry out activities that are subject to defined rate regulation? If so, what operational issues should the IASB consider if it decides to develop any specific accounting guidance or requirements?

No, our organisation is not subject to rate regulation.

Question 9

If, after considering the feedback from the Discussion Paper and the *Conceptual Framework* project, the IASB decides to prohibit the recognition of regulatory deferral account balances in IFRS financial statements, do you think that the IASB should consider developing specific disclosure-only requirements? If not, why not? If so, please specify what type of information you think would be relevant to investors and lenders in making their investing or lending decisions and why.

If the IASB were to prohibit the recognition of regulatory deferral account balances in financial statements prepared in accordance with IFRS we consider that the IASB should review the existing disclosure requirements in IFRS, but more with the aim of checking how well these disclosures work in providing information about rate regulated activities than to develop new disclosure requirements.

We also consider that it is important to acknowledge that investors use general purpose financial statements as a key source of information about an entity, but they do not, and should not, rely solely on financial statements in making assessments about future cash flows and risks.

Question 10

Sections 2 and 6 of the Discussion Paper discuss some of the information needs of users of general purpose financial statements. The IASB will seek to balance the needs of users of financial statements for information about the financial effects of rate regulation on an entity's operations with concerns about obscuring the understandability of financial statements and the high preparation costs that can result from lengthy disclosures (see paragraph 2.27 of the Discussion Paper).

(a) If the IASB decides to develop specific accounting requirements for all entities that are subject to defined rate regulation, to what extent do you think the requirements of IFRS 14 meet the information needs of investors and lenders? Is there any additional information that you think should be required? If so, please specify and explain how investors or lenders are likely to use that information.

(b) Do you think that any of the disclosure requirements of IFRS 14 could be omitted or modified in order to reduce the cost of compliance with the requirements, without omitting information that helps users of financial statements to make informed investing or lending decisions? If so, please specify and explain the reasons for your answer.

Extract from NZ IFRS 14 (paragraphs 27 and 30)

27 An entity that elects to apply this Standard shall disclose information that enables users to assess:

(a) the nature of, and the risks associated with, the rate regulation that establishes the price(s) that the entity can charge customers for the goods or services it provides; and

(b) the effects of that rate regulation on its financial position, financial performance and cash flows.

..

30 To help a user of the financial statements assess the nature of, and the risks associated with, the entity's rate-regulated activities, an entity shall, for each type of rate-regulated activity, disclose:

(a) a brief description of the nature and extent of the rate-regulated activity and the nature of the regulatory rate-setting process;

(b) the identity of the rate regulator(s). If the rate regulator is a related party (as defined in NZ IAS 24 *Related Party Disclosures*), the entity shall disclose that fact, together with an explanation of how it is related;

(c) how the future recovery of each class (ie each type of cost or income) of regulatory deferral account debit balance or reversal of each class of regulatory deferral account credit balance is affected by risks and uncertainty, for example:

(i) demand risk (for example, changes in consumer attitudes, the availability of alternative sources of supply or the level of competition);

(ii) regulatory risk (for example, the submission or approval of a rate-setting application or the entity's assessment of the expected future regulatory actions); and

(iii) other risks (for example, currency or other market risks).

We do not consider that the disclosures in IFRS 14 should be required for rate regulated activities. This is because we consider that IAS 1 already requires disclosure of the type of information set out in IFRS 14, paragraph 27. If the IASB develops specific accounting requirements for regulatory deferral balances then we would prefer that any associated disclosure requirements be linked to the existing requirements in IAS 1 and other standards.

Our response to this question is influenced by our view that general purpose financial statements are not intended to meet all the needs of regulators.

Question 11

IFRS 14 requires any regulatory deferral account balances that have been recognised to be presented separately from the assets and liabilities recognised in the statement of financial position in accordance with other Standards. Similarly, the net movements in regulatory deferral account balances are required to be presented separately from the items of income and expense recognised in the statement(s) of profit or loss and other comprehensive income.

If the IASB develops specific accounting requirements that would apply to both existing IFRS preparers and first-time adopters of IFRS, and those requirements resulted in the recognition of regulatory balances in the statement of financial position, what advantages or disadvantages do you envisage if the separate presentation required by IFRS 14 was to be applied?

If the IASB's proposals lead to the recognition of regulatory deferral balances, then we consider that the impact of rate-regulation on the financial statements should be clearly identified separately from other assets and liabilities to avoid undermining comparability between regulated and unregulated entities.

If the IASB proceeds to issue a standard, we are particularly concerned that useful information regarding operating expenses will be lost if expenditure that is currently disclosed separately in the statement of comprehensive income (or in the notes thereto) is combined into a single net movement in a regulatory asset or liability. Therefore, we would recommend that the entities be required to disclose a breakdown of the expenditure making up any regulatory asset.

Question 12

Section 4 of the Discussion Paper describes the distinguishing features of defined rate regulation. This description is intended to provide a common starting point for a more focused discussion about whether this type of rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements should be developed.

Paragraph 4.73 of the Discussion Paper suggests that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature of defined rate regulation. Do you think that this is a necessary condition in order to create enforceable rights or obligations, or do you think that co-operatives or similar entities, which operate under self-imposed rate regulation with the same features as defined rate regulation (see paragraphs 7.6–7.9 of the Discussion Paper), should also be included within defined rate regulation? If not, why not? If so, do you think that such co-operatives should be included within the scope of defined rate regulation only if they are subject to formal oversight from a government department or other authorised body?

We accept that there may be some situations in which rate regulation gives rise to enforceable rights or obligations. However, we do not envisage the creation of new financial reporting standards to explore the circumstances in which this would, or would not, occur and therefore do not wish to comment on whether "the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is a necessary condition". Rather, we would encourage the IASB to consider a broad range of circumstances in its project, including co-operatives or similar entities, which operate under self-imposed rate regulation.

We consider that the provision of information about an entity's operating environment and the impact this might have on the financial statements is a more useful way of tackling this issue than deciding which entities should be in, or out, of the scope of a possible new standard. Our comments on question 1 are also relevant.

Question 13

Paragraphs 7.11–7.22 of the Discussion Paper highlight some of the issues that the IASB may consider if it continues to progress this project.

Do you have any comments or suggestions on these or any other issues that may or may not have been raised in the Discussion Paper that you think the IASB should consider if it decides to develop proposals for any specific accounting requirements for rate-regulated activities?

We have not responded to this question.