Australian Government

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Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
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UNITED KINGDOM

Dear Hans,

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

The Australian Accounting Standards Board is pleased to submit its comments on the Discussion Paper to the International Accounting Standards Board. In formulating its comments, the AASB sought and considered the views of its Australian constituents through comment letters and other consultation. The comment letters received from constituents in respect of AASB Invitation to Comment ITC 32 *Reporting the Financial Effects of Rate Regulation* (which incorporated IASB DP/2014/2) are published on the AASB's website.

The AASB supports the work of the IASB in addressing whether specific financial reporting requirements are needed for rate regulation, particularly given the issuance of IFRS 14 *Regulatory Deferral Accounts* (January 2014) for optional application by first-time adopters of IFRSs that recognised regulatory deferral account balances under their previous GAAP. The AASB's most significant comments on the more substantive specific questions raised in the Discussion Paper are noted in this letter for your consideration, and expanded on further in the attached pages, together with responses to the other specific questions.

Overall, the AASB does not support the promulgation of financial reporting requirements that would require the recognition of regulatory deferral account balances in general purpose financial statements. The AASB considers that, in most cases, regulatory deferral account balances do not meet the definitions of assets and liabilities in the *Conceptual Framework*, and that an exception should not be introduced into IFRSs to allow their recognition. However, some specific disclosures in the financial statements regarding rate regulation could be useful to identify the financial effects of rate regulation. The disclosures set out in IFRS 14 are a useful starting point, although general disclosure requirements might be sufficient.

Should the IASB decide to develop recognition and measurement requirements for rate regulation, then the AASB would prefer the IASB to address rate regulation from a broad perspective, such as the accounting for licences and intangible assets more generally. If the IASB chooses to develop an IFRS just for rate regulation, then the scope of the IFRS

should be as narrow as possible, with application by analogy prohibited. This would limit any unintended consequences.

Conceptual Framework Concerns

The AASB considers that, in most cases, regulatory deferral account balances do not meet the definitions of assets and liabilities in the existing *Conceptual Framework*. Recognising regulatory deferral account balances as assets and liabilities would require adjusting revenue for the under-billings and over-billings. However, under-billing or over-billing the revenue requirement in any particular period typically does not give the regulated entity present claims against customers (or the regulator) to receive the adjusted price from future sales of the regulated goods or services, or as adjustments to sales of the current period. Therefore, in these circumstances, under-billings and over-billings do not represent financial assets and financial liabilities, and revenue should be recognised at the regulated rate applicable to the sales that have occurred during the period, as set out in paragraph 5.5 of the Discussion Paper.

The recovery or settlement of regulatory deferral account balances depends on future transactions with customers, rather than the existence of a rate-setting mechanism that affects the future prices applying to those transactions. A regulated entity does not control the occurrence of future sales, which depend on future actions of both the entity and customers. A high probability of occurrence of those future transactions should not override the definitions of assets and liabilities.

While an entity's right to recover under-billings through higher regulated prices in the future might add to the level of assurance about the recoverability of an entity's costs, recoverable costs are not of themselves assets. Similarly, although the entity's obligation to reverse over-billings through lower regulated prices in the future might add to the level of assurance that over-recovered costs will result in reduced future cash inflows than otherwise might be expected from future customers, over-recovered costs are not of themselves liabilities. An obligation to reduce future prices does not represent an obligation to transfer economic resources to other parties. The reduction in future prices would reduce the rate of return that the entity might otherwise have expected, but the opportunity loss is not an obligation to transfer economic resources.

The AASB notes that the IASB is continuing to develop the definitions of assets and liabilities for a revised *Conceptual Framework*. As set out in agenda paper 10A for the IASB's November 2014 meeting, the definition of a liability could be extended to encompass future transfers of economic resources that an entity has no practical ability to avoid when the amount of the transfer is determined by reference to past events. The IASB's tentative guidance concerning the 'no practical ability to avoid a transfer' criterion implies that a rate-regulated entity would have a present obligation for all of its future transfers of goods or services under the regulatory arrangements. Only the criterion of the amount of the transfer being determined by reference to past events would appear to limit the present obligation to the amount of a regulatory deferral account credit balance. However, that is a measurement issue, and the tentative decisions therefore raise questions of accounting for executory contracts that have not yet been adequately addressed.

Disclosure Requirements

Although the AASB does not support the recognition of regulatory deferral account balances in the financial statements, it considers that general disclosure requirements could

be established that would require entities to disclose in their general purpose financial statements the nature of the rate regulation affecting the entity and its financial effects on the entity. Such requirements could be based on those set out in IFRS 14 (paragraphs 27 and 29) for first-time adopters that recognise regulatory deferral account balances.

Alternatively, more specific disclosure requirements could be established in addition to the general requirements noted above, such as an explanation of activities subject to rate regulation (based on paragraph 30 of IFRS 14) and an explanation of (unrecognised) regulatory deferral account balances (based on paragraphs 32-36 of IFRS 14). Principles established through the Disclosure Initiative project should help to determine appropriate disclosure requirements.

The Scope of New Recognition Requirements

If the IASB proceeds with developing recognition and measurement requirements for rate regulation, then the AASB would prefer the IASB to address the rate-regulation issues from a broad perspective, rather than considering the treatment of regulatory deferral account balances in isolation. For example, rate regulation may be regarded as a subset of licences, or of intangible assets more generally. Under this view, it would be better to address rate regulation in the context of the accounting for licences or for intangible assets, potentially avoiding the need for exceptions in relation to the accounting for regulatory deferral account balances. Such a broader project scope should involve consideration of the revaluation requirements for intangible assets.

However, if the IASB decides instead to develop recognition and measurement requirements specifically in respect of rate regulation, then the AASB would prefer the scope of the new requirements to be as narrow as possible. In this respect, the ‘defined rate regulation’ described in the Discussion Paper could provide the suitably narrow scope for any new recognition requirements. In addition, prohibiting the application of such requirements by analogy (even to other forms of rate regulation) would limit the scope of any unintended consequences, such as the deferral of other costs by an entity on the grounds that highly probable or expected future transactions would result in the recovery of those costs.

Further Comments

The attached comments provide further detail on these views as well as the AASB’s responses to the other specific questions raised in the Discussion Paper.

If you have queries regarding any matters in this submission, please contact Clark Anstis (canstis@aasb.gov.au).

Yours sincerely,

Kris Peach
Chair and CEO

Specific AASB comments on IASB Discussion Paper DP/2014/2
Reporting the Financial Effects of Rate Regulation

Specific Questions for Comment

The AASB provides the following comments on the IASB's specific questions set out in the Discussion Paper (DP).

Question 1 General question about information on rate regulated activities

(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?

1.1 The AASB does not support special recognition and measurement requirements to address issues relating to rate regulation. Therefore, the AASB does not support the recognition of regulatory deferral account balances and changes therein in the statement of financial position and the statement(s) of profit or loss and other comprehensive income. Cash flows arising from regulated transactions should be classified on the usual basis for incorporation in the statement of cash flows.

1.2 In broad terms, a regulatory regime in which an entity might operate can be regarded as an aspect of its business environment. This view would tend to imply that, if information about the entity's rate-regulated activities and the rate-regulatory environment is to be addressed in or with financial statements, it would be as note disclosure or as part of management commentary. However, in many cases, this information might be so widely known that users would not be relying on the financial statements as a source of that information.

1.3 Investors, lenders and other users of general purpose financial statements would regard knowledge of the rate regulation of a material aspect of an entity's operations to be important in any analysis of an entity's financial position and performance. Broader disclosure requirements about the key elements of the business environment in which an entity operates might achieve that outcome without the need for specific disclosure requirements about rate-regulated activities. Where rate-regulated activities form an operating segment (or segments) of an entity, the

requirements of IFRS 8 *Operating Segments* would apply, if the entity is subject to that Standard. Those requirements include general disclosure requirements about the nature and financial effects of the business activities and the economic environment (paragraph 20), as well as more particular requirements. Such general disclosures would also be relevant for any entity with material rate-regulated activities.

Question 2 Familiarity with regulatory deferral accounting

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 generally accepted accounting principles (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?

2.1 Regulatory deferral account balances historically have not been recognised under Australian Accounting Standards, both before and after adopting IFRSs in 2005. Since 2005, Australian Accounting Standards have incorporated IFRSs. For-profit entities (including those in the public sector) with public accountability that are required to comply with Tier 1 requirements under Australian Accounting Standards, and other entities electing to apply those Tier 1 requirements, would simultaneously comply with IFRSs.

2.2 However, a few for-profit public sector entities in Australia do currently recognise regulatory deferral account balances in their financial statements in relation to regulatory circumstances that appear to be consistent with or similar to the 'defined rate regulation' set out in the DP. This accounting policy is not applied by all rate-regulated entities, as there are differing views on whether the recognition of such balances is consistent with and permitted by Australian Accounting Standards and IFRSs. IFRS 14/AASB 14 *Regulatory Deferral Accounts*, which might change those views, applies only to reporting periods beginning on or after 1 January 2016. For Australian reporting entities, this would typically be the financial year ending 30 June 2017.

2.3 The present lack of comparable reporting by public sector entities subject to the same or similar rate-regulation arrangements makes it difficult for users of general purpose financial statements to fully compare the financial position and performance of those entities.

Question 3 Focus on a defined type of rate regulation

Do you agree that, to progress this project, the IASB should focus on a defined type of rate regulation (see Section 4) 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)? If not, how do you suggest that the IASB should address the diversity in the types of rate regulation summarised in Section 3?

3.1 It is difficult to address the issues on a project that has a wide and potentially indeterminate scope. Thus, the scoping of the project is a major problem. However, identifying a particular type of rate regulation as the starting point for the analysis of the issues is reasonable if the type defined represents a good case for identifying rights and obligations that might be appropriate for recognition in the financial statements. If that case does not in fact justify the recognition of regulatory deferral account balances, then there should be no need to consider weaker regulatory mechanisms, which are less likely to give rise to rights and obligations that should be recognised. Stronger regulatory mechanisms, however, would need to be considered, if they are realistic cases.

3.2 In this way, a range of regulatory mechanisms for which recognition might be appropriate potentially could be established, instead of concentrating only on defined rate regulation. Concentrating on only one regulatory arrangement may result in economically comparable arrangements being accounted for differently, which would not be the best outcome.

Question 4 Limited or market rate regulation

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).

(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?

4.1 The market or incentive-based regulation noted by the IASB (for example, regulatory price caps) does not require specific accounting or disclosure requirements. Entities affected by such regulation can choose to explain the nature of the regulation and its effects in the notes to the financial statements or in management commentary.

Question 5 Key features of defined rate regulation

Paragraphs 4.4–4.6 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.

5.1 The description of ‘defined rate regulation’ presents a reasonably narrow regulatory mechanism, since it requires customers to have little or no choice to purchase essential goods or services from an entity not subject to effective competition, establishes parameters for the availability and quality of the supply and the rates or pricing of the supply, and is enforceable on the rate-regulated entity and the regulator. However, interpreting some of the features of defined rate regulation could be problematic. For example, the notion of a good or service being ‘essential’ is considered a pre-condition for customers having little or no choice. Yet the DP acknowledges that ‘essential’ is hard to define and could be jurisdiction-specific (see paragraph 3.10). For example, in some societies, public liability insurance might be considered essential while in other societies it would not. The meaning of ‘essential’ could also change over time, e.g. with changes in technology and alternative energy sources. Nevertheless, the objective should be to ensure that the principles of identifying defined rate regulation are applied consistently within a jurisdiction, and across jurisdictions to the extent feasible.

5.2 One of the features of defined rate regulation is that there is no effective competition to the rate-regulated entity supplying the essential goods or services. However, the DP sets out cogent reasons in paragraphs 4.40–4.42 for relaxing this feature to refer instead to essential (but not exclusive) suppliers. A monopolistic case would appear to be too limiting, potentially resulting in economically comparable arrangements being accounted for differently.

5.3 The description of defined rate regulation might be too broad in that it is possible that the description scopes in activities that are already the subject of existing IFRSs. For example, the features outlined in paragraph 4.4 of the DP would appear to apply to various types of insurance services in some Australian States, such as workers’ compensation insurance and compulsory third party (road vehicle) insurance. Although those contracts are currently accounted for as insurance contracts under IFRS 4/AASB 4 *Insurance Contracts* and AASB 1023 *General Insurance Contracts*, if a rate-regulation IFRS were promulgated based on defined rate regulation, there could be an issue concerning which IFRS, in principle, should apply in the first instance. This conflict could be resolved by excluding from the scope of a rate-regulation IFRS any transactions or arrangements that are addressed by other IFRSs.

Question 6 Rights and obligations relating to rate regulation

Paragraphs 4.62–4.72 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?

6.1 Overall, the AASB does not support the promulgation of financial reporting requirements that would require the recognition of regulatory deferral account balances in general purpose financial statements. The AASB considers that, in most cases, regulatory deferral account balances do not meet the definitions of assets and liabilities in the *Conceptual Framework*, and that an exception should not be introduced into IFRSs to allow their recognition.

6.2 The combination of rights and obligations described with reference to defined rate regulation does not give rise to rate-regulation assets and liabilities. Paragraph 4.68 of the DP concludes that features relating to the exclusive right to supply essential goods or services do not appear to create distinguishable rights or obligations for which specific accounting guidance should be developed. Similarly, paragraph 4.71 concludes that features relating to the obligations to achieve the defined service levels (non-discriminatory supply, minimum service levels, regulated prices and regulator approval of an entity ceasing regulated activities) are not exclusive to rate-regulated entities, so that specific accounting requirements again are not required. This does not leave many features of defined rate regulation as the potential basis for specific rate-regulation accounting requirements, since the combination of these individual rights and obligations would not change their character.

6.3 A key focus of defined rate regulation in the DP is an entity's "right to recover the revenue requirement, using the rate-setting mechanism to adjust for under-billings or over-billings over time" (paragraph 4.72). Although the rate-setting mechanism might normally ensure that the rate-regulated entity recovers no more and no less than its revenue requirement, it does not give rise to assets and liabilities. Paragraphs 7.5–7.9 of this submission explain the bases for the AASB's views that the rate-setting mechanism does not give rise to financial assets and financial liabilities, or to assets and liabilities as recoverable costs or over-recovered costs.

6.4 Paragraph 4.75 of the DP identifies various types of sanctions that a regulator might apply to address breaches by a regulated entity: imposing fines, reducing the future rate to be charged to customers, and withdrawing the operating licence and requiring transfer of the business. If an entity has already undertaken an act that obligates it to pay a fine or has an onerous contract as a result of having committed to supply customers at a reduced rate, it would recognise a liability under existing IFRSs, including applying IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. If an entity is to have its licence to operate in a particular business revoked and be forced to transfer the assets relating to that business to another entity, the entity would need to consider the requirements of IFRS 5 *Non-current Assets Held*

for Sale and Discontinued Operations and IAS 36 *Impairment of Assets*. New IFRS requirements would not appear to be needed to address these circumstances.

6.5 The above analysis of the rights and obligations arising from the features of defined rate regulation indicates that specific recognition requirements for rate-regulation accounting (including regulatory deferral account balances) are not needed.

Question 7 Approaches the IASB could adopt

Section 5 outlines a number of possible approaches that the IASB could consider developing further, depending on the feedback received from this 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.

7.1 The AASB's view is that the best approach to presenting the financial effects of rate regulation in general purpose financial statements is to prohibit the recognition of regulatory deferral account balances as they are neither assets nor liabilities[1], but to require suitable disclosures regarding the nature of the rate regulation affecting the entity and its financial effects on the entity. Such requirements could be based on those set out in IFRS 14 (paragraphs 27 and 29) for first-time adopters that recognise regulatory deferral account balances. More specific disclosure requirements could also be established, again based on those in IFRS 14.

7.2 The following comments address the asset/liability debate and the other possible financial reporting approaches set out in Section 5 of the DP.

The Asset and Liability Debate

7.3 The AASB considers that, in most cases, regulatory deferral account balances do not meet the definitions of assets and liabilities in the existing *Conceptual Framework*. In brief, a regulated entity's right under defined rate regulation to charge a higher price on future sales to recover under-billings should not be recognised as an asset

1 With the exception of some special cases – see the end of paragraph 7.6.

because the entity has no claims against past or future customers in relation to the higher price. Similarly, the entity's obligation to charge a lower price on future sales to reverse over-billings should not be recognised as a liability. Reduced margins on contracted sales would not necessarily make the contracts onerous (which would trigger liability recognition under IAS 37 if they were), but in this case the reduced margin applies to future, uncontracted sales. The rate regulation gives rise to agreements between the regulated entity and the regulator, but there are no contracts between the entity and customers that commit a customer to purchase the regulated goods or services from the entity in the future.

7.4 Recognising regulatory deferral account balances as assets and liabilities would require revenue to be adjusted for the under- and over-billings. However, under- or over-billing the revenue requirement in any particular period does not give a regulated entity present claims against customers (or the regulator) to receive the adjusted price from future sales of the regulated goods or services, or as adjustments to sales of the current period. Therefore, revenue should be recognised at the regulated rates applicable to the sales that have occurred during the period, as set out in paragraph 5.5 of the DP.

Rate-setting adjustments for under- and over-billings

7.5 Under the rate-setting mechanism in defined rate regulation, the right to recover under-billings and the obligation to reverse over-billings are settled through the regulated entity's right to receive economic benefits expected to be generated from the expected future delivery of the regulated goods or services at a higher or lower regulated price respectively. However, because the entity does not control the occurrence of future sales – these depend on future actions of both the entity and customers in the absence of contracts to supply stated quantities – the entity does not have present claims against past or future customers (or the regulator) to receive the adjusted price. Customers are not obligated to purchase the regulated (essential) goods or services and in aggregate might not purchase the quantities forecast when the rate regulation was established or when the rates are reset at periodic intervals or as permitted by the rate regulation.

7.6 Therefore, the entity's right to recover under-billings and obligation to reverse over-billings through potential future transactions that it does not control do not amount to financial assets and financial liabilities. A high probability of occurrence of those future transactions should not override the definitions of assets and liabilities. The entity's right to recover the revenue requirement might be limited to the current regulatory period or alternatively expected to continue beyond that period into the future, but even a perpetual right is not an unconditional right simply because it is expected to remain in place in the future. This is consistent with treating a non-redeemable share with cumulative dividend rights as an equity instrument rather than a liability when the dividends are at the discretion of the issuer. In contrast, as acknowledged in paragraph 4.27 of the DP, the right to recover under-billings and the obligation to reverse over-billings with past customers in relation to their purchase of the regulated goods or services from the entity in the past do represent financial assets and liabilities, which are subject to existing IFRSs. This would also be the case if the regulator guaranteed the settlement of under-billings and over-billings so that the entity received only the revenue requirement over time.

7.7 An alternative argument made by some commentators in support of rate-regulation accounting is that under-billings represent recoverable costs (and over-billings represent over-recovered costs). Although the features of defined rate regulation include enforceable arrangements between rate-regulated entities and the regulator, customers would be subject to the regulated pricing when they purchase the regulated goods or services. However, the AASB considers that, while an entity's right to recover under-billings through higher regulated prices in the future might add to the level of assurance about the recoverability of an entity's costs, recoverable costs are not of themselves assets. The *Conceptual Framework* defines an asset as a resource, and notes (paragraph 4.14) that expenditures are not synonymous with assets.

7.8 Similarly, although the entity's obligation to reverse over-billings through lower regulated prices in the future might add to the level of assurance that over-recovered costs will result in reduced future cash inflows than otherwise might be expected from future customers, over-recovered costs are not of themselves liabilities. Under the *Conceptual Framework*, a liability is defined in terms of a present obligation that is expected to result in an outflow of resources. Paragraph 4.17 of the Framework illustrates numerous ways in which an entity might give up resources in settling a present obligation. Those ways do not include an entity agreeing to accept reduced inflows compared with those it might otherwise have hoped for. As set out in paragraph 5.30 of the DP, an obligation to reduce the price charged for future sales does not involve the transfer of an economic resource. The reduction in future prices would reduce the rate of return that the entity might otherwise have expected, but the opportunity loss is not an obligation to transfer economic resources.

7.9 The AASB therefore holds the view that although the rate-setting mechanism might normally ensure that the regulated entity recovers no more and no less than its revenue requirement over time, the mechanism does not give rise to assets and liabilities. Under this view, rate-regulation accounting for defined rate regulation is not justified, and specific recognition requirements for regulatory deferral account balances would not be needed.

7.10 Treating recoverable costs as assets on the basis of their recoverability could have unintended consequences. For example, if regulator-approved costs that are specifically recoverable were treated as assets because the entity has strong assurance under the rate regulation scheme that it will recover the costs, it would seem logical for entities in dominant market positions to defer all of their costs as assets, regardless of whether they are subject to rate regulation, on the grounds that those costs have a very high probability of being recovered. However, that rationale would be inconsistent with the rationale for the boundaries of the costs included in the costs of acquisition of an item of inventory or property, plant and equipment – IAS 2 *Inventories* (paragraph 11) and IAS 16 *Property, Plant and Equipment* (paragraph 16) stipulate in effect that 'cost' is limited to costs directly attributable to acquisition of the item. Furthermore, the regulatory asset base considered by the regulator in setting the revenue requirement might include indirect costs that would not be recognised as assets under IFRSs.

Reconsidering the definition of liabilities

7.11 Paragraph 5.27 of the DP sets out the IASB's tentative decision in its current Conceptual Framework project that an entity would have a present obligation to transfer an economic resource as a result of past events if both:

(a) the entity has no practical ability to avoid the transfer; and

(b) the amount of the transfer is determined by reference to the benefits that the entity has received, or activities that it has conducted, in the past.

7.12 As set out in agenda paper 10A for the IASB's November 2014 meeting, the IASB has also tentatively decided that an entity would have no practical ability to avoid a particular course of action that requires it to transfer an economic resource if all courses of action that would avoid the transfer would cause significant business disruption or have economic consequences significantly more adverse than the transfer itself.

7.13 In rate-regulated industries, the consequence of ceasing to sell a rate-regulated good or service might be that the entity relinquishes its operating licence or otherwise is required to dispose of its business through which that good or service is provided. In either case, the consequence of avoiding transfers of goods or services to customers at reduced prices in the future (to reverse existing over-billings) might be significant business disruption or economic consequences significantly more adverse than selling the goods or services at reduced prices. Therefore, adopting the IASB's tentative decisions would suggest to some that the regulated entity would incur a present obligation under defined rate regulation, as indicated in paragraphs 5.27-5.29 of the DP. Such a present obligation would seem not confined to onerous contracts, since reduced-price sales can still be profitable for the entity. Furthermore, extending the definition of a liability could result in the recognition of regulatory deferral account credit balances as liabilities without a corresponding basis for recognising regulatory deferral account debit balances as assets. Such an outcome would not be desirable.

7.14 If the IASB's tentative decisions are taken to mean that an entity would have a present obligation for all of its future transfers of goods or services under the regulatory arrangements, only the criterion referred to in paragraph 5.27(b) of the DP would appear to limit the present obligation to the amount of a regulatory deferral account credit balance. Whilst criterion (b) would appear to avoid triggering accounting on a gross basis for obligations under executory contracts, it seems an inappropriate basis for determining whether an entity has a present obligation. Determining the amount of the transfer by reference to the benefits that the entity has received, or activities that it has conducted, in the past is an issue of measurement that seems irrelevant to determining whether an economic phenomenon that represents a present obligation exists. The tentative decisions, therefore, raise questions of accounting for executory contracts that have not been adequately addressed in the IASB's Conceptual Framework project (see, for example, the comments on executory contracts in paragraphs S61–S64 of the AASB's Supplementary Paper, dated 6 June 2014, to its submission on the IASB's Conceptual Framework DP).

7.15 A rate-regulated entity's practical inability to avoid a transfer of economic resources would appear to stem from the regulator's powers to compel the entity to continue operating in the market or else suffer adverse economic consequences, and not from the essential nature of the goods or services to be provided. This contrasts with the suggestion in paragraph 5.28 of the DP that the entity has no practical ability to avoid reversing a regulatory deferral account credit balance because customers have little or no choice but to purchase the rate-regulated goods or services from the entity. Until customers contract with the entity to provide particular goods or services, the entity does not promise to deliver goods or services to them, and those future customers are not required to pay for those goods or services until they are delivered. For the same reason, the AASB disagrees with the argument in paragraph 5.31 of the DP that a regulatory deferral account credit balance is similar to the liability arising from a customer's prepayment for goods or services to be delivered in the future.

Intangible Asset Approaches

Regulatory licences

7.16 If the IASB proceeds with developing recognition and measurement requirements for rate regulation, then the AASB would prefer the IASB to address the rate regulation issues from a broad perspective, rather than considering the treatment of regulatory deferral account balances in isolation. For example, rate regulation may be regarded as a subset of licences, or of intangible assets more generally. Under this view, it would be better to address rate regulation in the context of the accounting for licences or for intangible assets, potentially avoiding the need for exceptions in relation to the accounting for regulatory deferral account balances.

7.17 Such a broader project scope could involve consideration of the revaluation requirements for intangible assets, since regulatory licences are unlikely to have an active market. The AASB has previously put to the IASB the view that the difference between the revaluation accounting policy choice in IAS 16 *Property, Plant and Equipment* (no need for an active market price to be available) and IAS 38 *Intangible Assets* (an active market price is needed) is inappropriate, particularly since the release of IFRS 13 *Fair Value Measurement*.

7.18 Fair value measurement of an asset covers many aspects of the asset. In this respect, revaluing regulatory licences would not be any different. Paragraph 5.44 of the DP suggests that recognising overall changes in the value of regulatory licences could obscure those changes that arise from the elements of the licence that create the regulatory deferral account balances. However, without expressing a view on whether revaluing regulatory licences would effectively account for the effects of defined rate regulation, the AASB questions whether such revaluations would necessarily obscure the amounts of regulatory deferral account balances (and changes therein). Recognition of changes in values is compatible with disclosure of other movements, such as changes in regulatory deferral account balances.

Customer relationship intangible assets

7.19 The IASB should also consider another view of the rights and obligations of a regulated entity under defined rate regulation. One of the features of defined rate regulation is that customers have little or no choice but to purchase the essential goods or services from the rate-regulated entity, which has no effective competition against its right to supply those goods or services (paragraph 4.62 of the DP). This circumstance would seem highly likely to give rise to the entity having a 'customer relationship' intangible asset. Such intangible assets do not arise only in rate-regulated markets. Recognising regulatory deferral account balances or operating licences as assets is not a substitute for recognising customer relationship intangible assets. As paragraph 5.105 of the DP notes, licences to supply rate-regulated goods or services are often acquired for little or no cost, which may bear little relationship to the value of the 'customer relationship' intangible asset. The total of regulatory deferral account balances is also likely to bear little relationship to the value of the intangible asset. The recognition of such intangible assets should be reconsidered within a broader project on intangible assets.

Rate-Regulation Accounting Exception

7.20 The AASB opposes the possible approach of requiring or permitting entities to adopt the accounting prescribed by the rate regulator as an exception to IFRSs. This would give rise to inconsistencies across jurisdictions and industries, impairing the comparability of financial reporting between entities applying rate-regulation accounting on one hand and those choosing not to apply (or unable to apply) such accounting on the other. Even requiring entities to isolate the impact of recognising regulatory deferral account balances by presenting them separately would not fully mitigate the effects of inconsistency in application of IFRSs and the lack of comparability between entities.

7.21 It would be better for a regulated entity to report revenue and asset amounts that show a 5% return on assets based on the normal IFRS requirements than to report a 6% return on assets based on the regulated revenue requirement and the regulated asset base. The 5% return would be able to be compared directly with the return on assets earned by unregulated entities, whereas the 6% return would not be comparable with unregulated entities, and additional disclosures would be necessary to enable users of the financial statements to adjust the primary figures to a comparable basis. The need to understand the significance of such additional disclosures means that the analysis of the financial statements is likely to be more difficult for some users.

Changing the Recognition of Costs and/or Revenue

7.22 The AASB opposes the possible approaches of deferring or accelerating the timing of the recognition of costs and/or revenues, as the deferral or acceleration would reflect the particular regulatory mechanism facing an entity and result in financial reporting that is not comparable with other entities. In the AASB's view, the deferral or acceleration would require the recognition of balances that would not meet the definitions of assets and/or liabilities. These approaches are essentially

variations on the recognition of regulatory deferral account balances under rate-regulation accounting, to which the AASB maintains its conceptual objections.

7.23 Cost deferral is an issue that arises in a number of contexts – for example, it is being considered in the Insurance Contracts project in relation to acquisition costs. An argument for specifically addressing cost deferral as part of rate-regulation accounting might be that the deferral represents a kind of acquisition cost for future business. However, the fundamental difference from the contractual arrangements under which acquisition costs might typically be deferred is that, under defined rate regulation, the 'contract' is between the entity and the regulator, not the customer.

Prohibiting the Recognition of Regulatory Deferrals

7.24 Prohibiting the recognition of regulatory deferral account balances (including deferring or accelerating the recognition of costs and/or revenue to reflect regulatory rate-setting requirements) is the AASB's preferred approach. The AASB supports the arguments against specific accounting requirements for rate regulation set out in paragraphs 5.94–5.102 of the DP. Specific disclosure requirements would assist entities to explain the financial effects of rate regulation on the entity.

Question 8 Information on your organisation

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?

8.1 The activities of the AASB are not subject to rate regulation. The AASB establishes accounting standards in Australia for both private sector entities and public sector entities through a due process that includes consultation with preparers, auditors and users of financial statements.

Question 9 Disclosure-only approach

If, after considering the feedback from this 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.

9.1 Investors, lenders and other users of general purpose financial statements would regard knowledge of the rate regulation of a material aspect of an entity's operations to be important in any analysis of an entity's financial position and performance. Broader disclosure requirements about the key elements of the business environment in which an entity operates might achieve that outcome without the need for specific disclosure requirements about rate-regulated activities. For example, IAS 1 *Presentation of Financial Statements* (paragraph 138(b)) already requires the disclosure of a description of the nature of the entity's operations and its

principal activities (if not disclosed elsewhere in information published with the financial statements). A rate-regulated entity could make disclosures about the nature of the rate regulation in response to this paragraph and could elect to also disclose information about the financial effects of the regulation in the absence of more detailed disclosure requirements.

9.2 More detailed requirements apply to entities with publicly traded debt or equity instruments in IFRS 8 *Operating Segments*: paragraph 20 requires such an entity to disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environment in which it operates. These requirements apply to a rate-regulated entity that is subject to IFRS 8, but the requirements could be extended to all entities through IAS 1 if the existing general IAS 1 requirements were considered insufficient.

9.3 Disclosure requirements addressing rate regulation more particularly could be based on those set out in IFRS 14 *Regulatory Deferral Accounts* (paragraphs 27 and 29) for first-time adopters that recognise regulatory deferral account balances. These paragraphs set out the objective for disclosures about rate regulation and identify a range of factors to consider, such as the level of detail, degree of emphasis on various regulatory requirements, and the need for qualitative and quantitative information. Alternatively, more specific disclosure requirements could be established in addition to these general requirements, such as an explanation of activities subject to rate regulation (based on paragraph 30 of IFRS 14) and an explanation of (unrecognised) regulatory deferral account balances (based on paragraphs 32-36 of IFRS 14). Such disclosures would be relevant to users of the financial statements of entities with material activities subject to rate regulation. The IASB should apply the lessons from and principles established through its Disclosure Initiative project to help determine appropriate disclosure requirements.

Question 10 Information needs of users re rate regulation

Sections 2 and 6 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).

(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.

10.1 The AASB does not have a view on the effectiveness of the disclosure requirements set out in IFRS 14 and whether they should be modified in some way to support recognition requirements for regulatory deferral account balances applicable to all entities.

Question 11 Separate presentation of regulatory amounts

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?

11.1 If the form of accounting that the IASB were to require resulted in the recognition of regulatory deferral account balances that are not assets or liabilities, the AASB considers separate presentation would be essential to distinguish them from balances that do represent assets and/or liabilities. Separate presentation of net movements in regulatory deferral account balances would also be necessary.

Question 12 Self-imposed regulation

Section 4 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 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), 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?

12.1 The AASB considers that regulatory deferral account balances should only be recognised when they meet the definition and recognition criteria for assets and/or liabilities. There would need to be enforceable rights and/or obligations between the entity and the customers. This could occur when there are long-term supply contracts between the entity and its customers. In the case of co-operatives, the members may play a dual role. If a co-operative's 'self-imposed regulation' gives

rise to enforceable rights and/or obligations between the entity and the members as customers, at a conceptual level they would give rise to assets and/or liabilities.

12.2 In the absence of enforceable arrangements between entities and customers, the existence of a third-party rate regulator, or of self-imposed regulation, should not lead to asset or liability recognition. Paragraph 7.8 of the DP refers to regulatory oversight that is designed to “encourage or ensure” that a co-operative provides goods or services on a non-discriminatory basis and at a price that prevents excessive profit-making. Regulatory oversight that merely encourages outcomes is not considered to be within the scope of defined rate regulation.

Question 13 Other issues and comments

Paragraphs 7.11–7.22 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 this Discussion Paper that you think the IASB should consider if it decides to develop proposals for any specific accounting requirements for rate-regulated activities?

13.1 The AASB commented in paragraph 5.3 that the scope of a rate-regulation IFRS should exclude any transactions or arrangements that are addressed by other IFRSs. That is, any rate-regulation IFRS should apply only after an entity has exhausted all other avenues in IFRSs in determining an accounting treatment for the relevant transactions.

13.2 If the IASB decides to develop recognition and measurement requirements specifically in respect of rate regulation, then the AASB would prefer the applicability of the new requirements to be as narrow as possible. In this respect, the defined rate regulation described in the DP could provide the suitably narrow scope for any new recognition requirements. In addition, prohibiting the application of such requirements by analogy (even to other forms of rate regulation) would limit the application of any unintended consequences, such as the deferral of other costs by an entity on the grounds that highly probable or expected future transactions would result in the recovery of those costs.