ITC32 sub 6

Submission DP/2014/1: Reporting the financial effects of rate regulation

December 2014

IPA INSTITUTE OF PUBLIC ACCOUNTANTS
Partnership beyond numbers

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The Chairman International Accounting Standards Board 30 Cannon Street London EC4M 6XH United Kingdom	The Chairperson Australian Accounting Standards Board PO Box 204 Collins Street West Victoria 8007 Australia

Dear Sir/Madam

Reporting the financial effects of rate regulation (DP/2014/1)

Introduction

The Institute of Public Accountants (IPA) welcomes the opportunity to comment on the Discussion Paper DP/2014/2 *Reporting the Financial Effects of Rate Regulation.* While the IPA recognises the need to provide guidance in relation to reporting the effects of rate regulation to address a diversity of practice, we believe that any proposals should be consistent with the Framework and the existing body of financial reporting standards.

The IPA is a professional organisation for accountants recognised for their practical, hands-on skills and a broad understanding of the total business environment. Representing more than 35,000 members in Australia and in over 65 countries, the IPA represents members and students working in industry, commerce, government, academia and private practice. Through representation on special interest groups, the IPA ensures the views of its members are voiced with government and key industry sectors and makes representations to Government including the Australian Tax Office (ATO), Australian Securities and Investments Commission (ASIC) and the Australian Prudential Regulation Authority (APRA) on issues affecting our members, the profession and the public interest. The IPA recently merged with the Institute of Financial Accountants of the UK, making the new IPA Group the largest accounting body in the SMP/SME sector in the world.

Executive Summary

We are concerned that the IASB has recently demonstrated a lack of commitment to conceptually consistent standards, for example, the Investment Entities amendment to IFRS 10 “Consolidated Financial Statements” and the impairment amendments to IFRS 9 “Financial Instruments”. Regrettably, a number of the potential methods for accounting options in respect to financial reporting for rate regulated activities continue this trend.

The IPA is of the view any accounting requirements should:

1. Ensure revenue is only recognised when service obligations are discharged. We are concerned there is a pre-disposition to bring forward revenue which may not always be appropriate depending on the method of recovery of under-recoveries from a prior period. The risk of not linking the recognition of revenue to performance obligations will result in profit smoothing.
2. The recognition and measurement criteria of assets and obligations arising from rate regulated activities should be consistent with the Framework.
3. Ensure transparent and separate identification of the rights and obligations arising from rate regulated activities rather than subsume them with a licence intangible or goodwill, particularly in the case of business combinations and privatisations.

We also note that many service concession arrangements exhibit several of the characteristics of rate regulated activities. As such, the impact on IFRIC 12 ‘Service Concession Arrangements’ needs to be considered, particularly, in relation to the recognition and measurement of assets and liabilities impacted by rate regulation. In addition, the IASB should consider IPSAS 32 “Service Concession Arrangements: Grantor’.

Our detailed comments and responses to the questions in the Discussion Paper are set out in Appendix A.

If you would like to discuss our comments, please contact me or our technical advisers Mr Stephen LaGreca (stephenlagreca@aol.com.) or Mr Colin Parker (colin@gaap.com.au) (a former member of the AASB), GAAP Consulting.

Yours faithfully

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APPENDIX A

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?*

IPA response

The IPA believes the financial report should provide information to assess an entity's performance. Information affecting current and future performance arising from the regulatory framework an entity operates in, must be considered relevant information.

For obligations and rights arising from the regulatory framework, assets and liabilities should be recognised on a basis consistent with the Framework and existing accounting standards relating to the recognition of assets (e.g. IFRS 9, IAS 38) and liabilities (e.g. IAS 36, IFRS 9). Guidance should also be provided when a licence is to be recognised and the basis of recognition.

Similarly, the right to charge customers for prior period under-recoveries should be recognised in accordance with the Framework and IFRS 15. Any guidance should ensure revenue should be recognised when the service obligation has been discharged and revenue smoothing should not be possible.

In terms of disclosure, the requirements set out in IFRS 14.30-34 represent a robust starting point. In addition, we recommend the following be disclosed:

- The regulatory asset base, including movements
- A reconciliation between the accounting asset base and the regulatory asset base
- The allowed return on the regulatory asset base, how it is determined, and the reset dates
- All rights and obligations under the regulatory framework, including:
    - Allowable capital expenditure limits
    - Prescribed service level conditions including any related commitments in current and future periods
    - Minimum maintenance requirements
    - If the rate regulated activity is for a service concession any obligation relating to the condition of the asset to be returned to the grantor at the end of the period, including the extent to which such obligations have been recognised in the financial statements
- Other regulatory requirements that may impact the return of invested capital, such as, a commitment to use a minimum level of renewable energy
- Other licence conditions including licence fees payable and the basis of determination of such fees
- The existence of excess return "dividends" – we are aware in the case of some privatisations the government vendor is due any "excess profits" over a period, and
- The impact of rate regulation on the capital structure of the entity including any structuring decisions to ensure an appropriate level of return to equity investors.

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 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-regulated entities; and

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

IPA response

The IPA is not aware of the use of US GAAP or IFRS 14 in financial statements of entities undertaking rate regulated activities.

However in the course of the preparation of this submission, we became aware of diversity in practice where some entities are recognising income and financial receivables arising from the right to charge higher prices in forthcoming periods due to under-recoveries in prior periods. We have concerns in relation to such practices as:

- It is unclear how it can be considered that the service obligation has been met as the mechanism for recovery of prior under-recovery is a higher charge for a new service, and
- The quantum recognised as income and receivables must be a function of not only the higher price but also expected volume or output. The quantification may be difficult to support where there is structural decline in volumes due to:
  - Reduced economic activity which may extend over the regulatory reset period
  - Price sensitivity leading to user efficiencies
  - Product substitution e.g. in the energy sector with alternative energy source e.g. gas for electricity and own use generation, and
  - The increases in prices may reinforce the above trends.

Question 3

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 specified 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?

IPA response

The IPA agrees "defined rate regulation" forms an appropriate starting point for the development of guidelines. However, we do not believe all rate regulated activities are necessarily captured by the proposed definition. We are aware of instances where concession arrangements provide rate regulation via concession agreements rather than legislation and no specific regulator is identified.

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).

(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 that the IASB should, alternatively, consider developing specific disclosure requirements? If so, what would you propose and why?

IPA response

At this stage, the IPA agrees no specific accounting requirements should be formulated for limited or "market" rate regulation. However, we do support disclosures consistent with those we have recommended in our response to Question 1.

Question 5

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 at 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.

IPA response

The IPA agrees the factors identified by the IASB represent an appropriate starting point for identifying entities subject to rate regulated activities. We recommend that the scope be expanded to include rate regulation arising from contractual obligations arising from service concession arrangements.

Question 6

Paragraphs 4.62-4.72 contain an analysis on 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?

IPA response

The IPA believes any rights and obligations arising from rate regulated activities should be recognised on a basis consistent with the Framework and existing accounting standards including IFRS 9 & IFRS 15 and IAS 37 & IAS 38. It is possible many of the rights and obligations have netted or embedded into existing intangibles including goodwill (particularly in the event of business combinations or privatisation). The specific identification of rights and obligations would enhance the financial information available in relation to rate regulated activities. Furthermore, specific guidelines on the recognition and measurement of service level requirements, asset maintenance and condition (particularly when assets required to be returned at the end of a service concession period at a specific standard) would reduce the diversity of practice.

Question 7

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.

IPA response

The IPA believes the recognition and measurement principles for rate regulated activities should be consistent with the Framework and existing accounting standards, including IFRS 9 & 15 and IAS 37 & 38. Please also see our responses to Questions 1 & 6.

The IPA also does not support a unit of account based on a single intangible representing "a package of rights and obligations" (paragraphs 5.35-5.46). Unless sufficient detail is provided in relation to the components of such an intangible the information to users will not be transparent. Furthermore, the cash flows relating to the components of such intangibles are unlikely to occur in the same period and by netting the obligations and assets, useful information is likely to be obscured and information not available to users.

In addition (as mentioned in our response to Question 2), the IPA has reservations as to the "acceleration" of revenue recognition when the regulatory adjustment mechanism is an increase in prices charged to customers in future periods. The IPA believes that a service obligation remains to be performed and, therefore, revenue should only be recognised when the service obligation is discharged i.e. the customer has received the service. The IPA is concerned that the proposals relating to acceleration of revenue recognition is nothing more than income smoothing.

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?

IPA response

The IPA is not subject to defined rate regulation and cannot comment on operational issues in relation to any specific guidance or requirements.

Question 9

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.

IPA response

The IPA would support specific disclosure requirements as a method to provide useful information on the impact of rate regulation on an entities financial position and performance.

In relation to specific disclosures we would refer you to our response to Question 1.

Question 10

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.

IPA response

We refer you to our response to Question 1 in which we recommend disclosures in addition to the disclosures of IFRS 14.

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 do you envisage if the separate presentation required by IFRS 14 was to be applied?

IPA response

If regulatory deferral account balances are recognised, the IPA believes the separate presentation would assist users in understanding the impact on the financial position, cash flows and financial performance of an entity operating in a rate regulated environment.

Question 12

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?

IPA response

The IPA cannot envisage, in the absence of regulatory oversight or contractual obligation, that voluntary rate regulation would exhibit the characteristics of rate regulated activities. However, a self-regulation regulatory requirement of the industry may be imposed by regulation and in such circumstances it may be possible for the activities to meet the characteristics of rate regulation required in the discussion paper.

Question 13

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

IPA response

As previously mentioned, the IPA believes any accounting requirements for rate regulated activities should be consistent with existing accounting requirements and the Framework.

We also agree the impact on IFRIC 12 “Service Concession Arrangements” should be considered as activities subject to service concessions may include many of the characteristics of rate regulated activities. As such assets and liabilities required to be measured under IFRIC 12 may be impacted as a result of developments in the accounting for rate regulated activities.

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