THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

18 November 2009

Our ref: ICAEW Rep 117/09

Your ref:

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

Dear Sir David

RESPONSE TO EXPOSURE DRAFT, RATE-REGULATED ACTIVITIES

The Institute of Chartered Accountants in England and Wales (the ICAEW) is pleased to respond to your request for comments on the Exposure Draft, Rate-regulated Activities, issued in July 2009.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW REPRESENTATION

ICAEW REP 117/09

Response to Exposure Draft issued by the IASB in July 2009 on Rate-regulated Activities

Contents

INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on the Exposure Draft *Rate-regulated Activities* published by the International Accounting Standards Board.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the Institute provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The Institute is a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The Institute ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

Our overall view

4. We note that there is currently no specific guidance in International Financial Reporting Standards (IFRS) regarding the treatment of rate-regulated activities. We also note that one of the reasons the Board has issued this exposure draft is that some of the countries soon to adopt IFRS, such as Canada, have their own national GAAP guidance addressing rate-regulated activities. In the absence of specific IFRS guidance on rate-regulated activities, reporting entities in such countries may seek to apply their national GAAP guidance which could result in diversity of treatment in practice. Our interpretation of existing general IFRS guidance, however, based on the *Framework for the Preparation and Presentation of Financial Statements* (the Framework), is that regulatory assets and regulatory liabilities, as defined in the exposure draft, would not be permitted to be recognised.

5. Thus, we agree with the Board that specific IFRS guidance is required regarding rate-regulated activities, but we disagree with the Board's proposals that this specific guidance should include the recognition of regulatory assets and liabilities. A far better approach would be to prohibit the recognition of regulatory assets and liabilities but to provide clear guidance on disclosures required. Our key point of disagreement with the Board is thus their conclusion that assets and liabilities consistent with the Framework arise through regulatory activities within the scope of the draft IFRS.

6. We note that, with regard to assets, the Board considers that a present right to receive economic benefits arises from the aggregate customer base, as a consequence of the regulator's 'promise' to permit increased rates in the future to recover certain past costs. We do not agree that the regulator's promise can be viewed as a resource from which future economic benefits are expected to flow. It is not the regulator's promise that generates future economic benefits but the aggregate customer base. There is a significant disconnection between the regulator's promise and the aggregate customer base - the customer base may change its overall demand level according to prices set by the regulator and this is outside the control of the rate-regulated entity. Thus, we do not consider that the regulator's promise satisfies the definition of an asset within the

Framework. We view the regulator's promise as a facilitation mechanism for future rate increases rather than an asset.

7. We note that our view expressed above is consistent with the dissenting view expressed by Stephen Cooper and Wei-Guo Zhang, their stated view being that the regulator's actions do not result in an enforceable right to recover cost plus a rate of return.

8. With regard to liabilities, we note that the Board considers that there is a present obligation to refund previously collected amounts and to pay a specified return. We do not agree that the regulator's requirement to reduce rates in future periods results in an outflow of resources from the entity. We note that in paragraph BC 25 of the Basis for Conclusions the Board concluded that an economic obligation may be something that results in reduced cash inflows as well as something that results in increased cash outflows. In our view, however, a reduction in rates has the impact of reducing future profit margins for the entity rather than comprising an outflow of resources. We do not consider that a reduction in rates comprises a liability, nor that such a reduction in rates is economically very different from a retailer reducing prices when it is necessary in order to maintain sales volume.

9. Thus, we do not agree that assets or liabilities as described in the Exposure Draft arise from rate-regulated activities. As is expressed in the dissenting view referred to above, we consider that the recognition of regulatory assets and liabilities would result in inappropriate profit-smoothing by entities involved in rate-regulated activities, thus producing information that is not transparent.

10. We have a major concern that an unintended consequence of the proposals, if they were to become a standard, is that other industries may draw analogies and reach inappropriate conclusions. For instance, the outsourcing industry may commence the deferral of costs together with recognition of a future return. We are also aware anecdotally that several other industries are actively considering how they could interpret the proposals in the exposure draft to apply them, inappropriately in our view, to their own accounting.

11. There is other guidance within the draft IFRS that we consider to be incomplete or muddled, in particular with regard to measurement after initial recognition including impairment testing. We have addressed this in our responses to the specific questions raised by the Board below.

12. We also note recent G20 comment that financial instrument accounting under IFRS is too complex and consider that it is important that the Board does not follow an approach that would result in overly complex accounting by entities involved in rate-regulated activities.

13. In conclusion, we reiterate our view that a more appropriate approach to rate-regulated activities would be to prohibit the recognition of regulatory assets and liabilities but to provide clear guidance on disclosures required.

RESPONSES TO SPECIFIC QUESTIONS/POINTS

Question 1

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

Is the scope definition appropriate? Why or why not?

14. We question why the scope of the draft IFRS has been set narrowly. There is no explanation in the Basis for Conclusions as to why only cost-of-service regulation is within the scope. It could be that the Board considered other types of regulation to give rise to too many complexities regarding future price changes but this is not elaborated upon.

15. We note that a consequence of this narrow definition of scope is likely to result in all current UK rate-regulated activities being outside the scope of the draft IFRS. Most UK regulated activities are more complex than the cost-of-service regulation described in the exposure draft and are based, instead, on incentive-based regulation, such as price cap mechanisms.

16. Paragraphs B3- B6 of Appendix B highlight the complexity in certain cases of determining whether an activity is within the scope of the proposed IFRS. Five indicators are set out in paragraph B4 of whether activities are within the scope. Paragraph B4 also states that significant judgement will be required in certain circumstances to identify whether activities are within the scope. We consider that a standard which creates such difficulty in the determination of whether activities fall within its scope is likely to cause unnecessary difficulties and inconsistencies in practice.

Question 2

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

Is this approach appropriate? Why or why not?

17. As noted earlier, we do not agree with the recognition of regulatory assets or liabilities, principally because of the disconnection between the regulator's promise and the aggregate customer base. If the Board were to proceed with the approach proposed in the draft IFRS, however, we consider that there should be greater clarity surrounding the nature of the asset. As currently proposed, a regulatory asset would be a different type of asset from a tangible asset, an intangible asset and a financial asset, thus not falling into any of these categories. This should be clearly stated together with an explanation of why regulatory assets are not considered by the Board to be either financial assets or intangible assets.

18. If the Board wishes to proceed with an approach involving the recognition of regulatory assets as set out in the exposure draft, it may also be helpful to clarify whether other factors such as the nature of the cost involved and the time horizon for recovery of costs should be known and fixed in order for recognition to be permitted. Similarly, in the case of recognition of regulatory liabilities, it may be helpful if the nature of the overcharge and a time horizon for reducing rates is required to be known and fixed prior to a liability being recognised.

Question 3

The exposure draft proposes that an entity should measure regulatory assets and regulatory liabilities on initial recognition and subsequently at their expected present value, which is the estimated probability-weighted average of the present

value of the expected cash flows (see paragraphs 12-16 of the draft IFRS and paragraphs BC44-BC46 of the Basis for Conclusions).

Is this measurement approach appropriate? Why or why not?

19. We note that present value is one of four possible measurement bases explicitly referred to in the Framework. Its proposed application in the manner described in the exposure draft would result in the recognition as assets not only of certain previously-incurred costs but also of a return on such costs. There is no discussion in the exposure draft of whether or why the Board considers it appropriate to recognise a return on the costs in addition to the costs themselves. An alternative approach if regulatory assets are to be recognised would be to recognise them at historical cost. A logical extension of an historical cost approach would be to amortise the cost in step with the periods in which it is recovered and subject the carrying value to annual impairment testing under IAS 36 *Impairment of Assets*. We are surprised that the Board has not discussed an historical cost approach. We note, however, that an historical cost approach might give rise to some difficulties in symmetry with liabilities where, if a liability is deemed to exist, it would relate to the corresponding return as well as the underlying cost.

20. Whilst expected present value is a possible measurement basis, we consider that the Board should provide a clear explanation of why this approach has been adopted. As noted earlier, we consider that the Board should clarify the nature of a regulatory asset and how it differs from a financial asset or intangible asset.

21. Substantial judgements would be required in practice to measure regulatory assets at expected present value and we agree with the difficulties described by Messrs Cooper and Zhang in their dissenting view. They identify, in paragraph AV 6 of the Basis for Conclusions, specific complications in measurements including differences between expected and actual transaction volumes and different classes of customers being subject to different rates.

22. We also note that if an expected present value basis of measurement is to be used, the approach to remeasurement and impairment described in the exposure draft is fundamentally flawed. The exposure draft proposes that regulatory assets and liabilities should be remeasured to expected present value at each period end. However, paragraph 19 of the exposure draft sets out how the regulatory assets should be assessed for impairment. But by definition there cannot be any need for impairment testing as the remeasurement process will render this unnecessary. This is analogous to the absence of a requirement for impairment testing of financial assets carried at fair value through profit under IAS 39 *Financial Instruments: Recognition and Measurement*.

23. However the change in carrying value is assessed, the proposals should state where any change in the carrying value of the asset or liability should be recognised - presumably in profit or loss rather than other comprehensive income?

24. The approach described in the exposure draft is further confused by Number 8 of the Illustrative Examples. This shows a computation involving a change in the balance for the regulatory asset from one year to the next that includes straight-line amortisation of previous period amounts, with no reference to a revised expected present value calculation, nor to any unwinding of a discount rate that would arise as present value calculations are updated from one year to the next. This is inconsistent with the approach proposed in paragraph 12 of the exposure draft that regulatory assets and liabilities are to be measured at each reporting period end at their expected present value.

25. If regulatory assets or liabilities are to be recognised, a clear and consistent measurement basis needs to be established. Guidance and illustrative examples should be consistent with the basis adopted.

Question 4

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

Is this exception justified? Why or why not?

26. Consistently with the dissenting view held by Messrs Cooper and Zhang, we do not agree with this proposal. Similarly to our views on the recognition of regulatory assets and regulatory liabilities, we do not consider that there should be any deviation from the Framework when it comes to the recognition of assets and liabilities in rate-regulated activities. Especially given the difficulty that may arise in determining whether an entity's activities are within the scope of the draft IFRS, the inclusion in IFRS financial statements of costs that are treated as capital by the regulator but as expenses under IFRS would be likely to confuse the reader and decrease comparability between similar entities. IFRSs prescribe the preparation of general purpose financial statements. If a particular regulator requires a specified different treatment for regulatory purposes, such different treatment could be included in financial statements prepared for that regulator, not the general purpose financial statements.

27. The Board could consider requiring disclosure, including nature and quantification, of amounts that are treated differently by the regulator if it thinks this would be helpful.

Question 5

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

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

28. As with our response to question 3, we consider that there is inconsistent guidance regarding measurement of regulatory assets and liabilities in the draft IFRS after initial recognition. As stated in our response to question 3, if regulatory assets and liabilities are to be measured at their expected present value at each reporting period end, the question of impairment with regard to them will not arise as they will always be carried at their expected present value.

29. Regarding impairment of other assets in the same cash generating units as the regulatory assets and liabilities, it should be clarified that the first step in the impairment test for a cash-generating unit containing a regulatory asset should be to re-measure the regulatory asset to its expected present value at the period end. If this includes a reduction in the carrying value of the regulatory asset from the previous period end, that should serve as an indicator of impairment for the cash-generating unit involved, which would then be tested for impairment. There would, however, be no further impact on the carrying value of the regulatory asset (as such assets are outside the impairment testing requirements being carried at expected present value at each period end).

30. Guidance is also currently lacking with regard to the impairment testing of self-constructed property, plant and equipment or internally generated intangible assets that include amounts that the regulator has required are included, even though that would not be consistent with the otherwise relevant IFRS, e.g. IAS 16, *Property, Plant and Equipment*, IAS 23, *Borrowing Costs*, or IAS 38, *Intangible Assets*. It would appear, prima facie, that an appropriate treatment on identification of an impairment loss might be to write down the part of the capitalised cost relating to the recovery of regulated costs. The exposure draft is, however, silent on this. An appropriate amendment would also be required to IAS 36 *Impairment of Assets*.

Question 6

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

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

31. We consider that the proposed disclosures would be extremely useful and it would be helpful to codify existing disclosure practice. The disclosures should be made as notes to the financial statements without recognising assets or liabilities in relation to rate-regulated activities (because as already noted these fail to meet the definitions in the Framework). We suggest that the best way forward would thus be to provide a standard mandating disclosure only in relation to rate-regulated activities. Recognition of assets and liabilities relating to rate-regulated activities should only be revisited as and when the definitions of assets and liabilities, and their recognition criteria, are changed in the new conceptual framework project.

32. With regard to specific proposed disclosures, we have the following comments.

    1. There should be specific disclosure requirements applicable to self-developed intangible assets and property plant or equipment that clearly identifies the nature and amount of any costs that are included because the regulator requires this, but which are not permitted to be recognised under other IFRS.

    2. Gross revenue should be analysed into the following three components:

a. total change in carrying value of regulatory assets, split into change in carrying value of deferred allowable costs and change in carrying value of the allowed return on these costs;
b. total revenue from supplies in the period; and
c. overbillings in the current period.

3. The discount rate applied in measuring expected present value should be disclosed together with the regulator's required rate of return. Differences between the discount rate applied and the regulator's required rate of return should be explained.

4. Whilst the proposal in the exposure draft is to measure regulatory assets and liabilities at expected present value rather than fair value, the Board should review the disclosures proposed in the Fair Value Measurement Exposure Draft, issued in May 2009, and consider which of those would also provide useful information in respect of the measurement of regulatory assets and liabilities.

Question 7

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

Is this approach appropriate? Why or why not?

33. If the approach in the exposure draft were to be adopted, we would agree with this approach to the initial application of the IFRS.

Question 8

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

34. We note that paragraph BC 37 of the Basis for Conclusions considers similarities between regulatory assets and intangible assets arising under IFRIC 12 *Service Concession Arrangements*. Paragraph BC 37 states 'Thus, IFRIC 12 requires an entity to recognise an asset for a right to charge customers for use of a public service at a price controlled or regulated by the grantor even though the entity bears the demand risk. The Board concluded that it would be inconsistent not to recognise regulatory assets when an entity has a similar right as a result of regulation rather than a contract.'

35. We do not consider that it is appropriate to make this comparison. There are many situations in IFRS such that similar items are accounted for differently according to how they arose – for instance, brands arising from a business combination are recognised whereas internally generated brands are not recognised. However, this comparison by the Board between intangible assets arising under IFRIC 12 and regulatory assets draws attention to our concern expressed earlier that we would have expected the Board to have clarified why regulatory assets are not considered to be intangible assets under IAS 38.

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