Power and Utilities Alert

Accounting for rate-regulated activities under IFRS

pwc

Alert 2014-1
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This Power and Utilities Alert describes recent developments regarding accounting for rate-regulated activities under International Financial Reporting Standards (IFRS).

Background

The IASB continues to advance its rate-regulated activities projects

There are currently two rate-regulated activities projects underway at the International Accounting Standards Board (IASB):

(1) a research project to develop a Discussion Paper to increase the IASB's understanding of users' needs regarding rate regulation, as well as how the rights and obligations of rate-regulated entities differ across jurisdictions, and whether those rights and obligations support recognition of assets and liabilities; and

(2) a project to develop an interim standard (the interim standard) that would permit first-time IFRS adopters that recognize regulatory deferral balances under existing generally accepted accounting principles to continue to do so in IFRS financial statements until the remainder of the research project is completed.

In March 2013, the IASB issued a Request for Information (RFI) related to the Discussion Paper. The primary objective of the RFI was to identify the range of rate-regulatory schemes and the common features of rate regulation to help determine the scope of the research project. The IASB and its recently formed Consultative Group are now in the process of analyzing the responses to develop the Discussion Paper.

This alert provides an update of the latest IASB and Consultative Group discussions on the planned Discussion Paper, as well as an update on the status of the interim standard. Power and Utilities Alert 2013-7 provides additional information on the RFI responses and highlights from the first Consultative Group meeting.

Update on the Discussion Paper

The IASB has tentatively decided that the Discussion Paper should focus on those common features of rate regulation identified by the IASB staff through the RFI process. The IASB also discussed how a combination of the following features and characteristics may distinguish rate-regulated activities from other commercial activities:

Feature	Characteristics
Exclusive or near exclusive right to supply	Competition is restricted and potential competitors would typically need to apply to the rate regulator or other authoritative body to seek permission to compete.
Essential or near-essential goods or services	Whether a particular good or service is considered essential depends on a number of factors, including availability compared to demand, the level of industrial development, and the local environment.
Obligations imposed by rate regulation	The rate-regulated entity generally cannot choose to stop delivering the rate-regulated goods or services and is obliged to serve consumers on a non-discriminatory basis.
An authorized rate regulator	Provision of the service is governed by a rate regulator whose role and authority is established in legislation or other formal regulations.

In addition to these features, the IASB discussed that the most important and unique feature of rate regulation is the existence of a rate-setting mechanism that requires one or both of the following types of true-up adjustments:

a) differences between previously estimated and actual amounts

b) awarding a bonus or imposing a penalty for meeting or failing to meet a performance target

The IASB also discussed the unit of account for analyzing whether rights and obligations associated with rate regulation give rise to assets and liabilities and that it may be set at a level of aggregation that is lower than the entirety of rights and obligations embodied within the rate-regulatory license or other agreement.

The Consultative Group met in November 2013 to consider the IASB's analysis. Although a majority of the members generally supported the distinguishing features, there were concerns regarding the IASB's focus on true-up adjustments. Many were concerned that too much emphasis is being placed on this single aspect of rate-regulation.

The IASB met in November 2013 to consider the Consultative Group's feedback and to continue discussions on the content of the Discussion Paper. The IASB discussed whether a rate-setting mechanism with true-up adjustments that result from past performance may represent a right or an obligation of the entity that is capable of resulting in the transfer of economic benefits to or from the entity. It was agreed, however, that further analysis would be necessary, including additional consideration of the Consultative Group's views.

Update on the interim standard

The comment period for the IASB's interim standard exposure draft, *Regulatory Deferral Accounts*, ended in September 2013. The reactions were mixed in the 114 responses received from 26 countries, representing seven geographical regions. A slight majority of responses support issuing an interim standard applicable to first-time adopters only; while a significant minority of responses (a little over 25 percent) does not support issuing an interim standard. A slightly smaller number of responses (approximately one-fifth of all responses) disagree with providing an interim standard only for first-time adopters and the majority of these would prefer an interim standard that is applicable to a wider range of entities.

The IASB met in November 2013 to discuss the responses and proposed several minor amendments and clarifications to the interim standard. The IASB concluded that these were not sufficiently significant to warrant a re-exposure.

The following summarizes of the key aspects of the original interim exposure draft and highlights the IASB's proposed changes.

Topic	**Original**	**Proposed changes**
Scope	The scope would be restricted to regulatory deferral balances arising from a defined type of rate regulation and only to those balances that are not already covered by other applicable IFRSs. The scope would also be limited to those entities that are within the scope of IFRS 1 *First-time Adoption of International Financial Reporting Standards* in the period when the proposed interim standard is first applied.	• Remove the scope limitation based on a defined type of regulation (except for self regulation as noted below). That is, the scope is no longer limited to balances arising from regulation where the price is designed to recover the entity's allowable costs of providing the regulated goods or services • Exclude self-regulated entities where regulation is not subject to external oversight and/or approval by an authorized rate regulator
Recognition and measurement	Entities would continue to use their existing accounting policies for recognition, measurement, and impairment when the proposed interim standard is first applied and in subsequent reporting periods. Changes to existing policies would be restricted.	• Specify that an entity should also continue to apply its previous accounting policies for the derecognition of regulatory account balances. • Clarify that an entity is not prohibited from recognizing new regulatory balances that are created as a consequence of a change in an accounting policy for other items required by IFRS • Prohibit recognition of an acquired subsidiary's regulatory balances in the consolidated financial statements when the acquirer does not recognize regulatory balances in accordance with this interim standard

Topic	Original	Proposed changes
Presentation and disclosure	Regulatory amounts would be shown as separate line items within the balance sheet, the income statement, and statement of other comprehensive income using subtotals. Entities would also be required to include an analysis of these amounts in the notes to the financial statements (e.g., regulatory assets or liabilities by type, recovery period, and whether balances earn a return).	Emphasize the requirement to separately classify the net movements in regulatory deferral account balances that relate to items recognized in either other comprehensive income or profit and loss
Transition and consequential amendments	Application of the proposed interim standard would be optional with retrospective application required, subject to the deemed cost exemption already contained within IFRS 1. The scope of that exemption would be amended to be consistent with the scope of this proposed interim standard.	Effective January 1, 2016 with earlier application permitted

Next steps

The IASB staff will meet again this month to further consider the points that were recently raised by the Consultative Group and the discussion from the November IASB meeting. The Discussion Paper is expected to be issued in the second quarter of 2014. The IASB indicated that it is satisfied that it has completed all of the necessary due process steps required to date and instructed the staff to prepare a draft of the interim IFRS for ballot. The interim standard is expected to be issued in the first quarter of 2014.

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Questions

Clients of PwC that have questions about this Power and Utilities Alert should contact their engagement partner. Engagement teams that have questions about this Alert should contact Casey Herman, Heather Horn, David Humphreys, or Steve Krump.

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