

18 December 2009

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/ Madam

IASB ED *Rate-Regulated Activities*

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IASB Exposure Draft *Rate-Regulated Activities* ('the ED'), which was issued in July 2009. This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would have been reached in its capacity of advising the European Commission on endorsement of the definitive IFRS.

The ED sets out proposals on accounting for regulated activities where they involve the provision of goods or services whose prices are subject to cost-of-service regulation. The ED proposes the recognition of regulatory assets (and liabilities) that under existing IFRS requirements would be recognised in profit or loss for the period. The ED goes on to explain that cost-of-service regulation is a form of regulation for setting an entity's prices (rates) in which there is a cause-and-effect relationship between its costs and revenues.

EFRAG agrees that rate-regulation is widespread and that the issue of whether it gives rise to assets and liabilities is not a new one in Europe, and concerns about this topic have previously been raised with the IFRIC. We agree that regulated activities can have a significant impact on an entity's financial position and performance and as such they should be reflected in an appropriate manner in its financial statements. For this reason, we support the IASB's objective and efforts in developing accounting guidance on how to reflect the impact of rate-regulation in the financial statements of an entity that operates in a regulatory environment.

However, we believe that the accounting proposed in the ED is based on an **accounting model** that, in our view, is conceptually flawed and presents proposals that are unclear and difficult to follow. In our view, one of the problems with the model described in the ED is that it draws its conclusions from a very specific set of circumstances that involve only cost-of-service regulation, without considering in sufficient detail other methodologies that have similar economic outcomes. Such an approach is rules-based and is fundamentally flawed, because it fails to consider the underlying concepts that give rise to assets and liabilities under the existing Framework. A second fundamental problem is that the ED does not establish what type of asset (liability) a regulatory asset (liability) is. In the case of a regulatory asset, is its nature that of an intangible asset or of accrued revenue? In case of a regulatory liability is the nature of the liability a financial liability or does it represent deferred revenue? The nature of the asset (or

liability) is critical in understanding what aspects of the accounting literature should be applied. In our view, it is imperative that the IASB further develops its thinking about what the regulatory asset (liability) is before it discusses how it should be recognised and measured in the financial statements of an entity with regulated activities.

Although we accept that assets and liabilities, as defined by the Framework, are created as a result of some regulatory environments, we are not convinced that the arguments presented in the ED are sufficiently persuasive to support the recognition of assets and liabilities under a cost-of-service regime outlined in the ED. We appreciate that there is a complex interaction between market structure, regulation and the relationship between an entity and its customers. Accordingly, the economic impact of regulation on the financial performance and position of an entity is an area that warrants further investigation. Anchoring proposals on long-established practices under US GAAP is not, in our view, a sufficiently robust approach to dealing with such an issue.

We share the concerns raised by the two IASB members in the Alternative Views to the ED, and consider that in some cases, 'regulatory assets' do not represent a 'resource controlled by the entity' nor has a 'past event' occurred to merit recognition under the existing Framework definition of an asset. Furthermore, we are concerned that there is a risk that the proposed requirements could be applied by analogy to activities of an entity for which the IASB did not intend such 'regulatory assets' and 'regulatory liabilities' to be recognised.

In addition, we are concerned with the **interaction with IFRIC 12** and think that the joint application of the two accounting requirements will potentially give rise to significant inconsistencies because it is not always clear when items are covered by IFRIC 12 and when they are covered by the scope of the proposed standard. We consider this to be an important issue, particularly in Europe, where a large number of concessions may fall within the scope of the proposed standard.

We do not support the **scope criteria** proposed in the ED. As previously mentioned, the ED addresses cost-of-service regulation which is common in some jurisdictions outside of Europe but not in other jurisdictions (notably in Europe) where other forms of rate-regulation are far more widespread. In fact, we understand the project was undertaken, in part, to respond to practice issues in Europe. However, it fails to deal with the common types of regulation typically found in the EU. We do not find this very helpful.

In our view, the approach taken by the IASB in the proposed standard is based on a specific methodology without any overarching principle being applied to clearly articulate why regulatory assets and liabilities exist only under that regulatory regime. Given the narrow scope of the proposed standard, a large number of rate-regulated activities are excluded without any guidance provided – even though the title suggests that it applies to rate-regulated activities in general. This is likely to result in different accounting being applied to methodologies for which the economic outcome is similar and thus significantly impair the comparability of information reported about such activities. We believe that it would be more appropriate to develop principles-based guidance that addresses the scope of rate-regulated activities after having considered the overall rate-regulation issue and its economic implications. Failure to do so is likely to compromise the comparability of financial statements between entities both within and across jurisdictions and will reduce the quality of financial reporting.

For the reasons described above, we do not support the accounting model that forms the basis of the ED and do not favour the issuance of a standard that is based on it. In order to develop a

more robust model for the accounting for rate-regulation, we strongly urge the IASB to undertake further research on the subject and develop an outreach strategy to explore whether there are sufficient grounds to justify the existence of assets and liabilities under the existing Framework and consistent with existing IFRSs. In doing so, the IASB will need to consider all rate-regulated methodologies which have a similar economic outcome.

We also have fundamental concerns with the proposals in the ED in relation to the recognition and measurement of regulatory assets and liabilities as described in the ED. Although we do not support the issuance of a standard based on the accounting model proposed in the ED, the Appendix to this letter contains our responses to the specific questions asked by the IASB, but to summarise:

- We disagree with the proposal to eliminate the recognition criteria as it deviates from the existing Framework.
- We do not support the expected present value approach to measurement proposed in the ED. We believe that a case has not been made to justify why such an approach produces more relevant information to justify the degree of detailed work required to produce it. In our view, an entity should base the measurement of regulatory assets and liabilities on management's best estimate ('most likely' approach) of the cash flows that are expected to occur.
- We do not support the proposal to mix regulatory assets and liabilities with those recognised in accordance with other IFRSs as we think it reduces the transparency of the financial statements because users cannot clearly identify how the accounting for rate-regulation has affected an entity's financial position and performance. In addition, recognising items as assets and liabilities that would otherwise not be recognised in accordance with IFRS reduces comparability of information. As such, we think that the cost of this proposal to users of financial statements exceeds any benefits that may flow to preparers.
- We question why impairment testing of the regulatory asset is necessary given that the asset is measured at its expected present value at each reporting period. In particular, we do not fully understand why the ED considers that a decrease in demand is an indication that a regulatory asset is impaired. In our view, a decline in demand should be reflected in the measurement of the asset based on the approach outlined in the ED. Furthermore, we think the ED fails to clearly articulate how uncertainty/decline in demand impact whether an entity's activities remain within the scope of the ED.

If you would like to discuss our comments further, please do not hesitate to contact Isabel Batista or myself.

Yours sincerely

Stig Enevoldsen

EFRAG, Chairman

Appendix

EFRAG's response to the questions asked in the ED

- 1 This Appendix contains EFRAG's response to the specific questions asked in the ED. However, as explained in our covering letter, we would like to note that this does not imply that we support the issuance of a standard based on the proposals set out in the ED. Answers to the questions are provided as a constructive contribution to the IASB's due process.

Question 1 - Scope

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?

Summary of EFRAG's view:

First Criterion

- We think that an 'authorised body' should be defined in more specific terms.
- EFRAG thinks that the ED is not clear about whether differential pricing arrangements or discounting would breach the scope criteria, and, if it does, under what circumstances that would be the case.
- We are concerned that the first criterion places too much weight on the 'rate' set by the regulator to the detriment of other relevant facts and circumstances.

Second Criterion

- We disagree with the ED's very narrow scope. We do not think that the scope of the proposed standard should be limited to a specific form of regulation ('cost-of-service') that can be observed under a very narrow set of circumstances. Because of the narrow scope of the ED, a large number of rate-regulated activities will be left out without principles-based guidance even though the title of the proposed standard suggests that it applies to rate-regulated activities in general.
- We disagree with such a rules-based approach and support a more principles-based approach that considers the underlying concepts that give rise to assets and liabilities under the existing Framework.
- We are concerned that the proposed standard might be applied by analogy to situations other than those described in the scope of the ED which may be similar in form but not in substance.
- We believe that there is a significant interaction between the ED and concession arrangements covered by IFRIC 12. However, its consequences are not made sufficiently clear in the ED.

- 2 EFRAG notes that the scope criteria set out in the ED are based on features that are common to a cost-of-service regulatory regime. Our detailed comments follow.

First Criterion – authorised body and a binding price (rate)

- 3 EFRAG thinks that the first criterion is a relevant consideration in identifying regulatory activities. However, we have significant concerns.

Authorised body

- 4 The ED defines a regulator as an authorised body empowered by statute or contract to set rates that bind an entity's customers. The ED goes on to say that the regulator may be a third-party body or may be the entity's own governing board if the board is required by statute or contract to set rates. We are concerned that such a definition may be too broad and could be interpreted to encompass the activities of an entity where, for instance, the board of directors have agreed (e.g. in the articles of association of the entity) on a strategic policy to set rates designed to recover costs plus a return, particularly under monopolistic market structures.
- 5 We think that such an interpretation might not always be the intention of the ED and that the reference to an entity's own 'governing body' is made in those cases where an entity is set up to carry on previously state-run monopolistic activities and would be delegated regulatory powers by the Government. Having said this, we do not think the intended meaning of an 'authorised body' is clearly articulated in the ED and recommend the IASB clarify this issue.

Binding price

- 6 We generally agree with the proposal that all the customers of rate-regulated activities must be bound by the price established by the regulator. However, we have concerns about the application of this premise.
- 7 First, we understand that the practice of setting different prices for different customer groups or categories of customers is common practice in rate-regulated industries. For example, wholesale customers may be charged a different price to retail customers. In other circumstances, customers within the same category (for instance retail customers) may also be charged different prices. We think that even rate-regulated entities might have some level of freedom to lower the prices in the form of discounts within categories of customers (e.g. giving preferential rates to blue-chip type customers) or across the entire customer base. In such situations we think it is the 'discounted' price set by the entity that binds its customers and not the price established by the regulator, thus the activities of such entities would in our view be outside the scope of the ED as suggested in BC31-32. However, we think that paragraph 4 of the ED is not clear on this point, and recommend the IASB to clarify whether differential pricing arrangements or discounting would breach the scope criteria, if so under which circumstances that would be the case.
- 8 In addition, we are concerned that the first criterion places too much weight on the 'rate' set by the regulator. In some jurisdictions the regulator does not specifically set 'rates' but sets regulation (intended for actual cost-recovery) that could be revenue-based. For example, a regulator could define the regulation based on the total allowable revenue an entity can charge not the individual rate which generates such revenue. It seems to us

that entities regulated in this way are currently scoped out of the proposed standard. We believe that excluding entities where revenue is regulated rather than 'rates' per se would result in different accounting treatments for similar economic activities reducing comparability between entities in different jurisdictions.

Second criterion – recovery of specific costs and specific return

- 9 We do not support the proposed second scope criterion and support the Alternative Views in the ED. Our concerns are discussed below.

Narrow and arbitrary defined scope

- 10 First, we disagree with the ED's very narrow scope. We do not think that the scope of the proposed standard should be limited to a specific form of regulation ('cost-of-service') that can be observed under a very narrow set of circumstances which is common in some jurisdictions but in many (such as Europe) other forms of rate-regulation are far more widespread. We disagree with such a rules-based approach and would favour a more principles-based approach which considers the underlying economic concepts that give rise to assets and liabilities. Developing a clear and robust set of principles will help constituents more easily evaluate the wide range of regulatory frameworks that exist around the world while alleviating the need for a list of rules or exceptions that accommodates every possible example. The principles and guidance in the final standard should be sufficiently robust, such that an entity could easily determine whether there is a regulatory asset or liability that needs to be recognised.
- 11 We question why the ED does not scope in more modern rate-regulatory techniques like incentive-based and hybrid regulation when the effect of these techniques is economically similar to cost-of-service regulation. We consider that by focusing only on cost-of-service regulation, a number of entities' activities in Europe (and perhaps elsewhere), would be left without principles-based guidance even though the title of the ED suggests that the proposed standard would apply to rate-regulated activities in general. This is likely to result in different accounting being applied to methodologies for which the economic outcome is similar and thus diminish significantly comparability of information. We believe that it would be more appropriate to develop principles-based guidance that addresses the scope of rate-regulated activities after having considered the overall rate-regulation issue and its economic implications. Failure to do so is likely to impair the comparability of financial statements between entities both within and across jurisdictions and will reduce the quality of financial reporting.

Application by analogy

- 12 We think that an unintended consequence of the proposals is that they might be applied by analogy by entities to activities for which the IASB did not intend such assets and liabilities to be recognised. This is a major concern because we believe the ED's current scope criteria, as currently worded, would create confusion for entities proposed to be outside the scope of the final standard. In our view, this may result in entities asserting they are within the scope and applying the accounting treatment contained in the proposed standard by merely analogising to their particular situation even though technically they do not meet the established criteria.

Interaction with IFRIC 12

- 13 We believe that there are significant interactions between the ED and concession arrangements covered by IFRIC 12. On the basis of the ED's current wording in BC39 and Appendix C7, the fact that an entity applies the intangible asset model for a concession arrangement in accordance with IFRIC 12 does not prevent the application of the proposed standard to that arrangement. We consider that, in practice, a large number of concessions in Europe would meet the scope criteria in the ED. This could be the case, for example, of a concession arrangements included in the IFRIC 12 intangible asset model in which the rates are set by the regulator. Although there is no unconditional right to receive a financial asset, the public rates are calculated to recover the costs incurred by the entity and there is sufficient evidence that these rates will enable the entity to recover its costs, thereby creating a direct cause-and-effect relationship between the costs incurred for the provision of the service and the revenue to be received.
- 14 We think that the joint application of IFRIC 12 and the ED gives rise to some inconsistencies. One of the key inconsistencies is the treatment of the costs incurred at the commencement of the life of the concessions. As regulated by the current IFRIC 12, these costs (including most notably finance costs) are recognised as expenses in the income statement for the period in which they are incurred. However, in a number of concession arrangements, these costs meet the basic requirements established in the ED to be recognised as regulatory assets.
- 15 In addition, we think that the interaction between proposed requirements for the recognition and measurement of regulated assets and liabilities and an intangible asset recognised as a result of the application of IFRIC 12 should be clarified. In particular, we would question how does this affect the intangible asset recognised in accordance with IFRIC 12, when demand is not as expected. As a more general point, we find it difficult to understand whether some priority should be given to one or the other requirement (ED versus IFRIC 12) in considering the accounting for uncertainty/decline in demand.

Clarity about the application of the second criterion

- 16 In some respects we think that the ED is not sufficiently clear on the application of the second criterion.
 - (a) Our first concern relates to situations involving hybrid cost-of-service regulatory schemes (combination of cost-of-service and price-cap regulations). Although these are mentioned in the Basis for Conclusions (BC12), the ED does not provide specific guidance on whether hybrid schemes are within the scope of the ED. If they are excluded, then does it mean that the entire operating activities of the entity subject to the hybrid cost-of-service regulation should be excluded? Or does it mean that the operating activities should be bifurcated so that the ones that are regulated by cost-of-service (and are based on the recovery of actual costs incurred) are within its scope and the ones that are not are outside the scope? We recommend that the IASB clarifies this issue.
 - (b) We also have some concerns in relation to the list of indicators in Appendix B4 of the ED. As pointed out by the IASB in the ED, in some cases entities will be using targeted or assumed costs to establish rates, which are then 'trued-up' to the actual costs incurred. B4 suggests that such rates could arise under cost-of-service

regulation. However, paragraph 6 of the ED leads us to believe that activities using 'targeted rates' would be outside the scope of the ED. We recommend the IASB clarify this issue.

- (c) Finally, EFRAG is concerned about the inconsistency in which the ED describes the concept of 'return'. The scope paragraph 3(b) requires a 'specified' return but the application guidance requires an 'adequate' and 'sufficient' return and the Basis for Conclusions mentions a 'fair' return. EFRAG thinks that this inconsistency is likely to create some confusion in practice, and recommends that the type of return required be clarified through use of a single word.

Question 2 - Recognition criteria

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?

Summary of EFRAG's view:

- We disagree with the proposal. We think that the proposed change, to eliminate recognition criteria, deviates from the requirements in the existing Framework. We do not support conceptual changes that are in conflict with the Framework.

17 EFRAG does not support the proposal. We note that the existing Framework sets out the criteria that must be met before an asset or a liability can be recognised. They are that:

- (a) it is probable that any future economic benefit associated with the item will flow to or from the entity; and
- (b) the item has a cost or value that can be measured reliably.

18 It follows that the proposal to eliminate recognition criteria, deviates from the requirements in the existing Framework. In EFRAG's view, if there is something in the Framework that needs amending, it is the Framework that must be changed and not the other way round. That is, if changes to existing concepts are being considered, they should first be discussed in the context of the Framework debate, because introducing major changes in the way the exposure draft is proposing undermines the authority of the Framework and creates the risk that changes that may be appropriate in particular circumstances will at some future date be extended to other circumstances without proper debate.

19 The IASB also argues that reliable measurement is possible because regulatory assets and regulatory liabilities relate to specifically identifiable amounts previously expended or collected by the entity. On the basis of this rationale, the IASB argues that 'additional' recognition criteria are unnecessary. However, the IASB does not articulate why it thinks this to be so. This is a significant concern for us. In our view, until a proper debate has taken place on whether recognition criteria are necessary, we cannot form a view on whether recognition criteria are necessary or not.

20 Finally, concerning the recognition of regulatory assets, we note that the proposals in the ED are internally inconsistent. As discussed above, the ED proposes to omit recognition

criteria for regulatory assets. However, in accordance with paragraph 16 of the ED, when for rate-setting purposes an entity is required to capitalise costs (that might otherwise be expensed under existing IFRSs), it can only include those 'regulatory costs' as part of other assets (for example property, plant and equipment), if it is 'highly probable' that the regulator will allow those costs to be included in the rate-setting process for the entity. We understand from the ED, that if an entity fails to meet the 'highly probable' recognition threshold, it recognises a separate regulatory asset instead. We find this inconsistency concerning, because we cannot see why there should be a different recognition threshold for similar types of "regulatory costs" which are in both cases recognised as assets under the ED.

Question 3 - Measurement of regulatory assets and liabilities

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?

Summary of EFRAG's view:

- EFRAG does not support the expected present value approach proposed in the ED.
- In EFRAG's view, an entity should base the measurement of regulatory assets and liabilities on management's best estimate ('most likely' approach) of the cash flows that are expected to occur.
- We support the ED's proposal that the expected present value should be determined on an 'asset/liability-specific' discount rate.

Expected present value approach

- 21 EFRAG does not support the proposal. We do not support an approach that requires taking into account the probabilities of all possible outcomes, because we believe that such an approach entails a high degree of detailed work, thus imposing additional burden on preparers without demonstrating how it produces information that is more relevant. Again the IASB does not explain why it thinks the proposed approach produces more useful information. Neither does it give sufficient emphasis on the practical difficulties of applying a probability-weighted approach to measure assets and liabilities.
- 22 In EFRAG's view, an entity should base the measurement of non-financial liabilities, including regulatory liabilities, on management's best estimate of the amount expected to be recovered. The emphasis in relation to measurement should be on expected future cash flows, which are a central focus for users of financial statements. We believe that a 'most likely' approach does that because it will result in an estimation of cash flows that are expected to occur.
- 23 EFRAG agrees however, that in circumstances where a wide variety of divergent possible outcomes and probabilities exists, an entity might need to consider the various outcomes and the probability of occurrence attached to those outcomes. However, that should be a

natural consequence of applying a principles-based measurement attribute, (such as the existing IAS 37 approach).

- 24 In addition, EFRAG notes that the probability-weighted approach (or expected value approach) has been the subject of some criticism when it has been proposed in other EDs issued by the IASB. For example, a number of constituents, including EFRAG, disagreed with a requirement to adopt an expected value approach to measure uncertain tax positions when responding to the IASB's ED *Income Taxes*, and instead argued in support of the existing IAS 37 'best estimate' approach. Similarly, EFRAG has expressed a preference for a measurement approach based on the most likely outcome approach when it commented on the accounting for contingent rentals as set out in the IASB's Discussion Paper on Leases.
- 25 The IASB argues (in paragraph BC44) that regulatory liabilities should be measured consistently with the guidance in IAS 37, that is - at 'the present value of the expected future cash flows'. However, we think the two approaches are not the same. IAS 37 requires the liabilities to be measured based on the best estimate of the expenditure required to settle the obligation, but goes on to claim that that amount would be the amount that an entity would rationally pay to settle the obligation at the end of the reporting period (that is the immediate fulfillment value) or to transfer it to a third party at that time (which would be equal to the probability-weighted average of all possible outcomes). In our view, the ED is in effect proposing a change to the current IAS 37 approach by retaining only the transfer approach (based on expected value), whilst removing the fulfillment approach.
- 26 Regarding the measurement of regulated assets, we have trouble understanding why the measurement model proposed is not a cost accumulation model. We understand from paragraph 8 of the ED that the recognition of an asset is justified as the deferral of incurred costs for which revenues are expected in the future. Such an asset should therefore be measured at its cost, limited to the present value of expected cash flows in accordance with other cases of deferred costs such as costs of inventories, or tangible and intangibles assets. However, the ED proposes measurement of the right to increase rates in future periods at the expected present value of future cash flows i.e. at selling price which includes a profit margin, instead of cost.

Remeasurement

- 27 We agree that remeasurement is necessary under the proposed expected present value measurement approach. We also note that regulatory liabilities measured in accordance with management's best estimate would be remeasured under the current IAS 37. However we note that if the IASB had decided to use an accumulated cost approach in relation to assets, remeasurement would be primarily based on a depreciated cost notion subject to impairment testing under IAS 36 *Impairment*.

Discount rate

- 28 The ED proposes that the expected present value be determined based on an 'asset/liability-specific' discount rate that considers the uncertainties inherent to the respective regulatory asset or liability which is consistent with the discount rate applied in IAS 36 *Impairment of Assets* and IAS 37. As indicated in BC47, this 'asset/liability-specific'

discount rate might not necessarily be the same as the rate of return set by the regulator in the rate-making process.

- 29 EFRAG supports the proposal because we see no conceptual reason to use a different discount rate for regulated assets and liabilities, compared to other assets and liabilities recognised under IFRSs. We agree that the discount rate should reflect the risk associated with the specific asset and liability.

Question 4 - Cost of self constructed property, plant and equipment or internally generated intangible assets

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 regulated activities all the amounts included by the regulator even if those amounts would not be included in 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?

Summary of EFRAG's view:

- EFRAG does not support the proposal and supports the alternative views in the ED.

- 30 EFRAG does not support the proposal because we believe that regulatory assets do not have the same characteristics as other assets recognised in accordance with IFRSs. Therefore, they should be presented separately from those other assets recognised in accordance with IFRSs.
- 31 In this respect, we share many of the views expressed by the IASB Board members that dissented on this issue, which are explained in AV7-AV9. But to summarise:
- (a) There is no conceptual basis for overriding the principles that other IFRSs would require to be applied in such cases as described in the ED.
 - (b) Because of the inconsistent requirements with other IFRSs, this ED will lead to a lack of comparability: economically similar situations will be accounted for differently within a regulatory entity over time, or among different regulated entities, and between regulated and unregulated entities.
 - (c) Mixing regulatory assets and liabilities with those recognised in accordance with other IFRSs reduces the transparency of the financial statements.
- 32 Given the above concerns, we think the cost of this proposal to users of the financial statements is likely to exceed any benefits that may flow to the entity.

Derecognition

- 33 We think the ED is unclear on how this proposal would apply in those cases where an entity fails to continue to meet the scope criteria in paragraph 3 and must derecognise its regulatory assets and liabilities according to paragraph 21. We would think that these

amounts would continue to be regulatory assets (since they are not assets under other IFRS) and should therefore be derecognised, but the ED is not explicit on this point.

Question 5 - Recoverability of regulatory assets and liabilities

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 regulatory 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?

Summary of EFRAG's view:

- It is unclear to EFRAG why an issue about impairment would arise subsequent to measurement.
- We think that the ED is very unclear on how an impairment loss should be allocated to the other assets in the same cash generating unit(s) as the regulatory assets and liabilities.
- We believe that consecutive impairment triggers may indicate that the entity is not earning a fair return on its activities and could fail to meet the scope criterion in paragraph 3(b).

34 EFRAG does not support the proposals. We have three main concerns which we discuss below.

35 First, we are unclear as to the intention of the requirements in paragraph 18 and 19 of the ED, and, in particular, whether the effect on changes in rates and any consequential effect on uncertainty or decline in demand is a question of impairment or a question of remeasurement of the regulatory asset. We question why an impairment loss would arise if regulatory assets are measured at their expected future cash flows at each reporting period. In our view, changes in rates and the effects on demand would be taken into account in the initial measurement and subsequent remeasurement of the regulatory asset.

36 Furthermore, we are very concerned that the ED is not clear on how the occurrence of an impairment trigger might affect the assets in the cash-generating unit(s) in which the regulatory assets and liabilities are included. According to the ED, an indicator of impairment exists when it is not reasonable to assume that the entity will be able to collect sufficient revenues from its customers to recover its costs and earn a fair return, which may trigger impairment testing of the regulatory asset as well as of the carrying amount of the related assets included in the cash-generating unit(s) in accordance with IAS 36. We think that if an impairment loss arises with respect to a cash-generating unit(s) that includes regulatory assets, that loss would be allocated to the assets of the cash-generating unit(s) but that no loss would be allocated to the regulatory assets since they are already measured using a current value methodology. That is, there would be no further impact on the carrying amount of the regulatory asset(s). However we think that

the ED is very unclear on this point and would recommend the IASB to provide clear guidance in this respect.

- 37 Finally, we think that consecutive impairment triggers may raise some doubts as to whether the scope criteria are still met by the regulated activities. That is because we think it might indicate that the entity is not earning a fair return on its regulated activities and therefore that it would fail to meet the scope criterion in paragraph 3(b). In practice this could result in entities required to apply the proposed standard having to frequently recognise and subsequently derecognise regulatory assets and liabilities – this is likely to further impair the comparability of financial statements from one period to the next and across entities engaged in similar activities. Again, we think clarity on this point would be helpful.

Question 6 - Disclosure requirements

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.

Summary of EFRAG's view:

- EFRAG is broadly supportive of the ED's proposals on disclosure.
- We think that accounting for rate-regulation together with mandatory disclosures would place a substantial burden on preparers that might not be justified by the benefits derived by users. We therefore encourage the IASB to reach out to financial statement preparers regarding the cost of disclosure requirements.
- We are concerned that the proposed disclosure requirements seem to be advocating a rules-based approach to disclosures, which may encourage a checklist mentality.
- We are supportive of the proposed reconciliation schedule and think that it will provide useful information. In addition to the proposed disclosure, suggested disclosures from EFRAG's User Panel members include a Disclosure Framework based on the entities' regulatory filings and disaggregation of the gross revenue figure.

- 38 We believe that providing enhanced disclosures alone would be a better way to address the effects of rate-regulated activities. Even though EFRAG is broadly supportive of the ED's proposals on disclosure, we think that accounting for rate-regulation together with mandatory disclosures would place a substantial burden on preparers that might not be justified by the benefits derived by users. We therefore encourage the IASB to reach out to financial statement preparers regarding the cost of disclosure requirements. We also think that the IASB should make an attempt to understand from financial statement users what additional information about regulated activities would be useful, subject to the cost/benefit constraint. We also have some additional concerns, which are discussed below.

- 39 First, we are unsure whether the disclosure requirements in the ED are to be applied to regulatory assets and liabilities that have been included in the carrying amount of self-constructed property, plant and equipment or intangible assets (except for financing costs included in the current period), or whether they apply only to separate regulatory assets and liabilities. We recommend the IASB to clarify this point.
- 40 Second, we are concerned that paragraphs 25-29 of the ED seem to be advocating a rules-based approach to disclosures, which may encourage a checklist mentality. EFRAG is also concerned about the apparent conflict between paragraphs 24 and 30. We understand that paragraph 24 requires an entity to disclose information that explains the amounts of regulatory assets and liabilities as well as enables users to understand the effects of rate-regulation. Paragraph 30 then requires an entity to disclose additional information if it deems that the disclosures required by paragraphs 25-29 do not meet the objectives in paragraph 24. To us it seems that these are conflicting requirements because paragraph 30 could be interpreted in a way so as to limit the information provided on the basis that the objectives in paragraph 24 would have been met.
- 41 Furthermore, we note that members of EFRAG's User Panel have also told us that, assuming the ED results in a final IFRS, one of their main concerns would be to determine the expected future cash flows for the regulated entity. These expected future cash flows would not comprise any cash flows from the recovery of regulatory assets and similarly would exclude any over-billings in the current year, which would eventually result in a regulatory liability. Expected future cash flows would hence only comprise recurring cash flows from the entity's ordinary revenue generating activities.
- 42 These users have told us that one way to overcome their concern is to report a revenue figure that clearly reflects the effects of rate-regulation, which could be done by disaggregating the annual gross revenue figure into three components, being: total amortisation of regulatory assets, total revenue from supplies in the period and over-billings in the current period (regulatory liabilities). In addition, further disaggregation of the total amortisation of regulatory assets figure into amortisation of deferred allowable costs and allowed return on these costs would be very useful information.

Question 7 - Transition requirements

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?

Summary of EFRAG's view:

- EFRAG agrees with the IASB's proposal to require a "modified" retrospective application approach.
- We think that transition provisions in the new standard should also consider entities that have acquired in the past a subsidiary operating under a rate-regulated system and for which any rate-regulated asset or liability was not recognised separately but as part of goodwill.

- 43 EFRAG's general view is that full retrospective application of IFRS is preferable to other transition arrangements, because it ensures comparability and enhances understandability. Furthermore, if the choice is between prospective application now or retrospective application with a longer lead time, EFRAG's general policy would still be to support retrospective application.
- 44 However, we accept that there might be circumstances in which full retrospective application is not possible (because the information needed is not available) or is undesirable (because it would be necessary to apply hindsight in a way that could significantly benefit the entity). We agree that this is will be the case for some of the proposals. For these entities, relief from retrospective application is granted. Therefore, on cost and benefit grounds we support the proposal to require a "modified" retrospective application approach.
- 45 We also believe that transition provisions in the new standard should consider the situations in which entities have acquired in the past a subsidiary operating under a rate-regulated system and for which any rate-regulated asset or liability was not recognised separately but as part of goodwill, since at such time there was no standard that supported the recognition of such assets and liabilities apart from goodwill. When those rate-regulated assets and liabilities will be recognised under the new standard, it may have consequential effect on the carrying amount of goodwill (possibly an impairment loss to be recognised). We would recommend the IASB to clarify where that consequential effect should be recognised.

Question 8 - Other comments

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

- 46 We are not sure how the proposed derecognition criterion in paragraph 21 of the ED would work in cases where an entity fails to meet the scope criteria in paragraph 3 of the ED because of a change in the rate-setting methodology. If that is the case, paragraph 21 requires an entity to derecognise all previously recognised regulatory assets. We do not think that this is entirely appropriate because we believe that if a regulatory asset is still recoverable (or partly recoverable) based on the new rate-setting methodology, an entity should not be required to derecognise those assets in the financial statements in addition to being prevented from recognising new regulatory assets but should be retained subject to impairment. We think there is something illogical in this thinking. In our view, the IASB give further consideration to this issue.