EFRAG

European Financial Reporting Advisory Group

DP/2014/2 Reporting the Financial Effects of Rate Regulation

Feedback to respondents – EFRAG Final Comment Letter

April 2015

Contents

Introduction

Objective of this feedback statement

EFRAG published its final comment letter on the Discussion Paper DP/2014/2 *Reporting the Financial Effects of Rate Regulation* ('the DP') on 16 January 2015. This feedback statement summarises the main comments received in response to EFRAG's draft comment letter on the DP and explains how those comments were considered by EFRAG Board in finalising EFRAG's comment letter.

Background to the Discussion Paper

Rate regulation applies to industries where a regulator is appointed to set prices that a company can bill to customers. Companies affected by rate regulation usually provide essential services such as utilities where the level of competition is low. It is argued by many that the special circumstances around rate-regulated activities should be the subject of specific financial reporting requirements.

Rate regulation may affect not only the amount of revenue and profit that a rate-regulated entity can earn, but also the timing of the cash flows associated with the entity's rate-regulated activities. The timing may be affected because, when establishing the rate to be charged to customers, the rate regulator attributes some costs (or income) to a period other than the period in which those costs (or income) would normally be recognised in profit or loss for financial reporting purposes, creating differences between the regulatory accounts and the IFRS numbers commonly called 'regulatory deferral account balances'.

The IASB published the DP on 17 September 2014 and requested comments by 15 January 2015. The DP addresses:

a) the common features of a defined type of rate regulation, described in the DP as defined rate regulation;

b) which features, if any, create a combination of rights and obligations that is distinguishable from the rights and obligations arising from activities that are not rate-regulated; and

c) what information about the financial effects of rate regulation is most relevant to users of financial statements and how best to reflect that information in the IFRS financial statements.

Further details are available on the EFRAG's website and the IASB's website.

EFRAG's draft comment letter

EFRAG published a draft comment letter on the DP on 27 October 2014.

In its letter, EFRAG welcomed the IASB's comprehensive project on rate-regulated activities and the publication of the DP. IFRS financial statements do not necessarily provide the information users consider useful for understanding the effects of rate regulation on a rate-regulated entity's revenue and related costs, cash flows and financial position associated with the entity's rate-regulated activities.

Based on preliminary outreach, EFRAG had learnt that some of the users that specialised in entities with rate-regulated activities preferred that the economic effects of rate regulation to be recognised in the financial statements.

EFRAG supported the IASB's decision to focus the debate initially on the accounting for a particular type of rate regulation described in the DP as defined rate regulation.

Whilst EFRAG broadly supported the description of defined rate regulation, EFRAG believed that any enforceable rights and obligations that stem from the rate-setting mechanism were the most important elements for distinguishing the types of rate regulation that require recognition in the IFRS financial statements. In EFRAG's view, the other features listed in the DP should be used as indicators to assess whether an entity operated within defined rate regulation.

EFRAG generally supported the accounting approach in the DP that considered deferring or accelerating the recognition of a combination of costs and revenue. EFRAG believed that the revenue approach had an important role to play when an entity had 'performed' to its customers. While it remained open to the cost deferral approach described in the DP, EFRAG recommended the IASB to explore in more detail, cases where it might produce relevant information.

Comments received from respondents

EFRAG received comment letters from nine respondents that included National Standard Setters, preparers, one regulator and one business organisation. The comment letters are available on EFRAG's website.

The views from the EFRAG's Rate-regulated Activities Working Group (RRAWG), and feedback from various user outreach that EFRAG performed were also considered in finalising EFRAG's comment letter.

Overall, most respondents broadly supported EFRAG's tentative positions on most of the issues. All of the respondents agreed with EFRAG that the existence of enforceable rights and obligations were the most important elements of defined rate regulation as described in the DP. However, many respondents highlighted that the rate-setting mechanism, which created enforceable rights and obligations would include an adjusting mechanism based on the revenue requirement (as defined in the DP). These elements had a pivotal role to play in the scoping of the IASB's project.

A description of the main comments received and changes made to the EFRAG final comment letter is provided in the section 'Detailed analysis of issues, comments received and changes made to EFRAG final comment letter' of this document.

EFRAG's final comment letter

In its final comment letter, EFRAG confirmed its original positions with the following main changes:

- EFRAG noted that it had learnt that many users that cover entities that operate in rate-regulated industries support recognition of the effects of rate regulation in the primary financial statements;

- EFRAG emphasised that the existence of a rate-setting framework that creates enforceable rights and obligations and includes an adjusting mechanism based on the revenue requirement (as defined in the DP) had a pivotal role to play in the scoping of the IASB's project on Rate-regulated Activities; and

- EFRAG highlighted that a revenue approach had an important role to play in any future accounting guidance. In addition, EFRAG believed that the IASB should explore whether the fulfilment of indirect obligations may trigger the use of a cost deferral approach.

Detailed analysis of issues, comments received and changes made to EFRAG final comment letter

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Information that users need to be included in the financial statements or accompanying documents

Proposals in the DP

The DP outlined the main messages that the IASB had learnt about the types of information that users of general purpose financial statements found helpful in making investment and lending decisions about an entity that was subject to rate regulation.

The IASB also sought input from stakeholders, particularly investors and lenders, on what information about an entity's rate-regulated activities and the rate-regulatory environment should be included in the primary financial statements or accompanying disclosure.

EFRAG's tentative position

EFRAG learned from some users that cover rate-regulated entities that they prefer the effects of rate regulation to be recognised in the primary financial statements, rather than communicated through disclosure-only requirements.

Respondents' comments

All respondents considered that reflecting the financial effects of defined rate regulation in IFRS financial statements would improve their relevance and information-usefulness for users. Having such effects in financial statements would enhance the understanding of how rate regulation affects rate-regulated activities of the entity and thus increase the usefulness of the information provided in financial statements.

EFRAG's response to respondents' comments

EFRAG's final position

Based on the support from respondents, including users' views provided during outreach activities, EFRAG reinforced the message in its comment letter that users would prefer the effects of rate regulation to be recognised in the primary financial statements supplemented by sufficiently detailed disclosures.

However, EFRAG agreed with respondents' comments that any specific disclosure requirements were carefully targeted to meet the needs of users without imposing excessive costs on preparers. Furthermore, EFRAG noted that some preparers had advised that they found it impracticable in many cases to present a reconciliation of the Regulatory Asset Base as it exists in the regulatory accounting, with the IFRS numbers. The Regulatory Asset Base is often based on other frameworks of accounting (such as local GAAP or specific regulatory reporting).

EFRAG also agreed that one of the factors to consider is the stewardship function of financial statements and whether it is considered relevant to recognise the impacts of regulation in the financial statements.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments	**EFRAG's response to respondents' comments**

Information that users need to be included in the financial statements or accompanying documents (continued)

Respondents' comments (continued)

Outreach undertaken by the EFRAG secretariat with European users confirmed that users that cover entities that operate in rate-regulated industries support recognition of the effects of rate regulation in the financial statements where enforceable rights and obligations exist and a certain level of reliability is ensured.

Other comments made by respondents were:

- Some respondents indicated that a balance needed to be achieved between users' needs for information about the financial effects of rate regulation and high preparer costs, as well as cautioning against obscuring the understandability of financial statements because of excessive disclosures.
- Some preparer respondents believed that the reconciliation between the Regulatory Asset Base, where regulations consider it, and IFRS figures was impracticable in many cases.
- One respondent believed that one of the factors to consider in the discussion on rate-regulated activities was the stewardship function of the financial statements. This was particularly important in the context of the provision of relevant information on performance and management responsibilities towards the shareholders and other stakeholders.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Focus on a defined type of rate regulation

Proposals in the DP

The DP focussed on a defined type of rate regulation, described as defined rate regulation, in order to provide a common starting point for a focussed discussion about whether rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed.

EFRAG's tentative position

EFRAG agreed that defined rate regulation formed a good basis to identify which features of rate-regulatory schemes distinguish rate-regulated activities from other commercial activities and created a combination of enforceable rights and obligations for which specific accounting guidance or requirements might need to be developed.

Respondents' comments

Almost all respondents agreed that the IASB should initially focus on defined rate regulation as described in the DP.

EFRAG's response to respondents' comments

EFRAG's final position

Based on input from respondents, EFRAG confirmed its support that defined rate regulation formed a good basis for a common starting point in the discussion on rate-regulated activities.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Key features of defined rate regulation

Proposals in the DP

The DP provided a detailed description of the features of defined rate regulation and considered whether these features created a combination of rights and obligations for which specific accounting requirements should be developed.

EFRAG's tentative position

EFRAG broadly agreed with the description of defined rate regulation. However, EFRAG believed that any enforceable rights and obligations that stemmed from the rate-regulation mechanism were the most important elements for distinguishing the types of rate regulation that required recognition in the financial statements. In EFRAG's view, the other features in the DP should be used as indicators to assess whether those enforceable rights and obligations existed for those activities that operated in defined rate regulation.

Respondents' comments

All respondents agreed that enforceable rights and obligations that stemmed from the rate-setting mechanism were essential elements for distinguishing the types of rate regulation that required recognition in the financial statements.

Many respondents agreed that the other features listed in paragraph 4.4(a) – (c) of the DP could be used as indicators to access whether enforceable rights and obligations exist.

EFRAG's response to respondents' comments

EFRAG's final position

Based on the feedback from respondents, EFRAG maintained its original position.

EFRAG agreed that the authorised revenue that results from a rate-setting mechanism is a key feature. Therefore, EFRAG added that the rate-setting framework that creates enforceable rights and obligations and includes an adjusting mechanism based on the revenue requirement (as defined in the DP) has a pivotal role to play in the scoping of the IASB's Rate-regulated Activities project.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments	EFRAG's response to respondents' comments
Key features of defined rate regulation (continued)	
Respondents' comments (continued) Many respondents indicated that the authorised revenue that results from a rate-setting mechanism, was also a key feature and needed to be further analysed, especially in the context of IFRS 15. One respondent believed that all the features were essential pre-conditions rather than indicators.	

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Possible financial reporting approaches

Proposals in the DP

The DP presents different views about whether regulatory deferral account balances meet the definitions of an asset and a liability in the *Conceptual Framework*. It also discusses four possible accounting approaches that explore how the financial effects of defined rate regulation could best be reported in IFRS financial statements, i.e.:

- Recognising the package of rights and obligations as an intangible asset (i.e. a licence);
- Adopting the regulatory accounting requirements;
- Developing specific IFRS requirements; and
- Prohibiting the recognition of regulatory deferral account balances.

EFRAG's tentative position

EFRAG generally supported the reporting approach that considered deferring or accelerating the recognition of a combination of costs and revenue. EFRAG believed that the revenue approach discussed in the DP had an important role to play when an entity had 'performed' to its customers.

EFRAG remained open to a cost deferral approach and recommended that the IASB identify when such an approach would produce relevant information.

Respondents' comments

Many respondents said that they supported a principle-based approach to developing accounting requirements based on current IFRS and the

EFRAG's response to respondents' comments

EFRAG's final position

EFRAG agreed with respondents that a reporting approach should be principle-based, be faithful to the Conceptual Framework and should be consistent with existing IFRSs. Accordingly, EFRAG added these points to its final position.

EFRAG agreed that the existence of a rate-setting framework, that creates enforceable rights and obligations and includes an adjusting mechanism based on the revenue requirement (as defined in the DP), has a pivotal role to play in the scoping of the IASB's project on Rate-regulated Activities, and modified its final position to reflect this. EFRAG reinforced its original view that a revenue approach has an important role to play in any future accounting guidance.

EFRAG did not agree with the respondents that supported recognition of revenue when no goods or services have been provided to the customer. EFRAG continued to believe that revenue should be recognised when an entity had 'performed' to its customers. However, EFRAG added that it was important to identify the performance obligations that stem from the regulatory agreement in the context of revenue recognition.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Possible financial reporting approaches (continued)

Respondents' comments (continued)

Conceptual Framework. Some respondents specifically noted that any deferral accounting balances that are to be recognised in the primary financial statements should meet the definition of an asset and a liability in the [revised] Conceptual Framework.

Only a few respondents supported a reporting approach that considered deferring or accelerating the recognition of a combination of costs and revenue.

Many respondents supported a reporting approach that was based on the principles in IFRS 15 *Revenue from Contracts with Customers.* These respondents disagreed that recognition of the effects of rate regulation was the result of an acceleration or deferral of cost or revenue. In their view:

- It was important to understand how the rights and obligations that stem from the regulatory agreement (between the regulator and the entity) related to the customer as a whole (a customer-base notion), and to clearly identify the performance obligations arising from regulatory agreement. Such an analysis was necessary in the context of IFRS 15.

EFRAG's response to respondents' comments

EFRAG's final position (continued)

Furthermore, to address the concerns raised by respondents in respect to the entitlement of the revenue requirement upon satisfying indirect performance obligations (for example, satisfying government/rate regulator objectives such as changes in the infrastructure network) related to rate-regulated activities, EFRAG added that the IASB should explore whether the fulfilment of these indirect obligations may trigger the use of a cost deferral approach.

In line with its tentative position view, EFRAG remained open to a cost deferral approach and recommended the IASB to explore in more detail cases where such an approach might produce relevant information.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments	EFRAG's response to respondents' comments

Possible financial reporting approaches (continued)

Respondents' comments (continued)

- Some of these respondents believed that the revenue requirement (revenue) should also be allocated to indirect performance obligations of entities with rate-regulated activities (e.g., maintaining rate-regulated assets) as they provided direct benefit to customers even if not through the transfer of goods and services. These respondents did not agree with EFRAG's tentative view that revenue should not be recorded when no goods or services have been provided to a customer. In their view, the rate-setting mechanism and adjustments to the revenue requirement focus on determining the amount of revenue to which an entity is entitled in exchange for performing its rate-regulated activities, which could include indirect obligations to enable an entity to provide goods or services to its customers.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments

Presentation and disclosure requirements in IFRS 14 *Regulatory Deferral Accounts*

Proposals in the DP

The DP provided a summary of the presentation and disclosure requirements in IFRS 14 *Regulatory Deferral Accounts*. The IASB sought feedback about the usefulness of these requirements to users of IFRS financial statements.

EFRAG's tentative position

EFRAG believed that the disclosures required in IFRS 14 provided a good starting point for the development of comprehensive disclosures.

Also, in EFRAG's view, separate presentation of regulatory deferral account balances would permit users to understand better how the effects of rate regulation modified both the revenue and expenses that an entity has reported and associated impacts on cash flows and financial position, and therefore would enhance the relevance of the information provided.

Respondents' comments

Many respondents agreed that IFRS 14 provided a good starting point for comprehensive disclosures.

EFRAG's response to respondents' comments

EFRAG's final position

Based on comments from respondents, EFRAG confirmed its original position that IFRS 14 provided a good starting point for the development of disclosure requirements, and continued to support separate presentation of regulatory deferral account balances.

To address comments from respondents that did not agree with separate presentation, EFRAG encouraged the IASB to draw on the experience of the implementation of IFRS 14 before finalising any requirements.

EFRAG's tentative views expressed in the draft comment letter and respondents' comments	**EFRAG's response to respondents' comments**

Presentation and disclosure requirements in IFRS 14 *Regulatory Deferral Accounts* (continued)

Respondents' comments (continued)

However, there were mixed views regarding separate presentation of regulatory deferral account balances in the financial statements. Some respondents agreed with separate presentation as that permitted users to better understand the effects of defined rate regulation on the financial position, performance and cash flows of an entity with rate-regulated activities. However, other respondents believed that separate presentation created an artificial distinction in the nature of the transactions, which was less helpful to users.

Outreach with users confirmed that separate presentation would assist them when comparing information (revenue, costs and balance sheet items) of entities that undertook both rate-regulated and non-rate-regulated activities as well as comparing information for those entities that operated mostly in rate-regulated activities.

List of respondents

Respondents whose comment letters were considered by EFRAG TEG and EFRAG Board before finalisation of EFRAG's comment letter	*Country*
National Standard Setters	
Autorité des normes comptables (ANC)	France
Danske Revisorer (FSR)	Denmark
Organismo Italiano di Contabilità (OIC)	Italy
The Dutch Accounting Standards Board (DASB)	The Netherlands
Business Organisation	
International Energy Accounting Forum (IEAF)	Europe
Preparers	
50Hertz Transmission GmbH	Germany
Iberdrola	Spain
National Grid plc	UK
Regulator	
European Securities and Markets Authority (ESMA)	France