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The Exposure Draft emphasizes that the regulated rate must be charged to all customers (or, if regulation establishes different rates for different categories of customers, the same rate must be charged to all customers within each category).

IASB Proposes Guidance on Rate-Regulated Activities.

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On July 23, 2009, the IASB issued an Exposure Draft, *Rate-regulated Activities*, that would establish how assets and liabilities resulting from rate-regulated activities should be recognized and measured. The IASB added the project to its agenda after receiving ongoing requests for guidance and because of the importance of rate regulation in many jurisdictions that are in the process of adopting IFRSs. The Exposure Draft's comment period ends November 20, 2009, and the IASB plans to issue a final standard in 2010.

Rate regulation is designed to ensure that customers are charged a reasonable rate for services or products while giving entities an opportunity to earn a fair return on their investments. This is generally achieved through price setting by a governmental regulator on the basis of the regulated entity's cost of providing the product or service. Under U.S. GAAP, Statement 71[1] (codified in ASC 980[2]) provides guidance on the recognition of regulatory assets and liabilities that result from the actions of regulatory bodies that direct the rate-making process of the entity.

Scope

An entity would be required to apply the proposal's guidance if its operating activities meet the following two criteria: (1) the price an entity **must** charge its customers is set by an authorized body and that price binds the customers and (2) the rate is set to recover the specific costs the entity incurs to provide the regulated goods or services plus a specified return that need not be fixed or guaranteed. In the absence of these two criteria (which would be evaluated initially and at the end of every reporting period), an entity would not be able to apply the proposed guidance and would be required to derecognize any previously recognized regulatory assets or liabilities.

Editor's Note: The Exposure Draft emphasizes that the regulated rate **must** be charged to all customers (or, if regulation establishes different rates for different categories of customers, the same rate must be charged to all customers within each category). As a result, situations in which negotiated rates are permitted that are less than the maximum rate approved by the regulator would presumably not be within the scope of the final IFRS.

Also, unlike Statement 71, the proposed scope does not include the assessment of the ability of the enterprise to collect regulated rates from its customers. Instead, the proposed standard requires that entities make a similar assessment as of each reporting date to determine whether an impairment has occurred, as discussed below.

[1] FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation.*
[2] FASB Accounting Standards Codification Topic 980, *Regulated Operations.*

Recognition and Measurement

According to the proposal, regulatory assets are recognized for an entity's "right to recover specific previously incurred costs and to earn a specified return," while regulatory liabilities are recognized for the entity's "obligation to refund previously collected amounts and to pay a specified return." Such assets and liabilities would be recognized when the entity "has the right to increase or the obligation to decrease rates in future periods as a result of the actual or expected actions of the regulator." The proposed IFRS does not contain separate recognition criteria other than those mentioned in the Scope section above, but it notes that if an entity's activities are within the scope of the proposal, "the entity shall recognise regulatory assets and regulatory liabilities in addition to the assets and liabilities recognised in accordance with other IFRSs." However, an entity would not apply the proposed IFRS if "items related to regulated operating activities have been recognised as assets or liabilities in accordance with other IFRSs."

In certain situations, a regulator requires capitalization of amounts as a cost of self-constructed property or internally generated intangible assets that would otherwise be recognized as regulatory assets under the proposed IFRS. If including those amounts in the costs for rate-making purposes is "highly probable,"[3] the entity would include them in the cost of the property or intangible asset for financial reporting purposes rather than report them as regulatory assets. Otherwise, the entity would apply the guidance in the proposed IFRS.

The assets and liabilities stemming from regulated operating activities would be measured at their expected present value at initial recognition as well as at each subsequent reporting period.

The assets and liabilities stemming from regulated operating activities would be measured at their expected present value at initial recognition as well as at each subsequent reporting period. The proposal requires the use of a probability-weighted cash flow approach and indicates that the following elements should be considered in the measurement:

> (a) [A]n estimate of the future cash flows that will arise in a range of possible outcomes.
>
> (b) [A]n estimate of the probability of each outcome occurring.
>
> (c) [T]he time value of money, represented by the current market risk-free rate of interest.
>
> (d) [T]he price for bearing the uncertainty inherent in the regulatory asset or regulatory liability.

Editor's Note: The measurement criteria in the proposed standard differ from those in Statement 71. Statement 71 provides for capitalization of a regulatory asset of 100 percent of an incurred cost that would otherwise be charged to expense if future recovery in rates is probable, which is subject to the entity's judgment. Under the proposed IFRS, an entity would instead (1) measure the regulatory asset or liability at a probability-weighted amount, (2) recognize the regulatory asset or liability initially at its expected present value using a discount rate that is likely to be different from the return specified by the regulator, and (3) adjust its expected present value each reporting period.

Recoverability guidance is also included in the proposed IFRS, as entities would be required to assess the effects of rate regulation on existing regulatory assets and liabilities as of each reporting period. According to the proposal, when an "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," that cash-generating unit is to be tested for impairment in accordance with IAS 36.[4] Any impairment loss is then allocated to the assets of the cash-generating unit.

Editor's Note: The proposed standard's impairment test must be performed when it is reasonable to assume that sufficient revenues cannot be collected to recover the entity's costs. The effect on entities will therefore be significantly different than ceasing to recognize rate-regulated accounting and derecognizing the regulatory assets as a result of a failure to meet the scope requirement of Statement 71.

[3] The IASB "regards "highly probable" as implying a significantly higher probability than "more likely than not" [e.g., a significantly higher probability than 50 percent] and as implying the same probability as the FASB's phrase "likely to occur.""

[4] IAS 36, *Impairment of Assets*.

Presentation and Disclosure

The Exposure Draft requires that regulatory assets and liabilities be presented separately from other assets and liabilities (other than costs permitted to be included in property or intangible assets, as noted above). Both current and noncurrent classifications should be used without offsetting. However, the proposal notes that "a net regulatory asset or a net regulatory liability for each category of asset or liability subject to the same regulator" may be presented.

An entity must provide information that allows users to understand the nature and financial effects of rate regulation on its activities and identifies and explains the amounts of regulatory assets and liabilities, and related income and expenses, recognized in its financial statements. The proposal requires disclosures that are much more extensive than those required under U.S. GAAP, including a tabular reconciliation of each category of regulatory asset or liability from the beginning of the period to the end, responding to the Board's observation that information on an entity's rate-regulated activities often appears in various places in the financial statements. According to the proposal's basis for conclusions, "such a table would be useful in helping users to understand how the entity's reported financial results and position have been affected by rate regulation."

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Effective Date and Transition

The effective date (currently expected to be January 1, 2011) will be determined upon issuance of a final standard, with early application permitted. The proposal notes that entities would apply the standard to "regulatory assets and regulatory liabilities that exist at the beginning of the earliest comparative period presented" upon application of the final IFRS. Any adjustments that result from the applying the final standard would be reflected in the opening balance of retained earnings.

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