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27 January 2015

Dear Sir

**Discussion Paper DP/2014/2: Reporting the Financial Effects of Rate Regulation**

We are pleased to comment on the above Discussion Paper (the DP). Following consultation with the BDO network[1], this letter summarises views of member firms that provided comments on the DP.

In responding to the questions in the DP we have focussed primarily on whether it would be appropriate to include adjustments, to IFRS amounts that are included in financial statements, to reflect the economic effects of defined rate regulation (as described in section 4 of the DP). We believe that it would be appropriate to make those adjustments, as they would provide enhanced predictive information to users of financial statements. Those adjustments would also reduce the risk, for example, of an entity that is subject to rate regulation, which has made excessive profits in the current period which will be 'clawed back' in future periods, from distributing those current period profits to shareholders.

We remain sceptical that adjustments arising from defined rate regulation meet the definitions of assets and liabilities in the current Conceptual Framework, or the definitions in the July 2013 Discussion Paper *A Review of the Conceptual Framework for Financial Reporting*. However, we believe that this could be overcome by viewing the customer base, for those activities of an entity that are subject to defined rate regulation, as being a single unit of account. This approach would be likely to enable the accrual and deferral of revenue under the definitions in both the existing Conceptual Framework and the July 2013 Discussion Paper.

Our responses to the questions in the DP are set out in the attached Appendix.

[1] Service provision within the international BDO network of independent member firms ('the BDO network') in connection with IFRS (comprising International Financial Reporting Standards, International Accounting Standards, and Interpretations developed by the IFRS Interpretations Committee and the former Standing Interpretations Committee), and other documents, as issued by the International Accounting Standards Board is provided by BDO IFR Advisory Limited, a UK registered company limited by guarantee. Service provision within the BDO network is coordinated by Brussels Worldwide Services BVBA, a limited liability company incorporated in Belgium with its statutory seat in Brussels. Each of BDO International Limited (the governing entity of the BDO network), Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and the member firms is a separate legal entity and has no liability for another such entity's acts or omissions. Nothing in the arrangements or rules of the BDO network shall constitute or imply an agency relationship or a partnership between BDO International Limited, Brussels Worldwide Services BVBA, BDO IFR Advisory Limited and/or the member firms of the BDO network.
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We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)20 7893 3300 or by email at abuchanan@bdoifra.com.

Yours faithfully

Andrew Buchanan

Andrew Buchanan

*Global Head of IFRS*

# Appendix

*Question 1*

*a) **What information about the entity's rate-regulated activities and the rate-regulatory environment do you think preparers of financial statements need to include in their financial statements or accompanying documents such as management commentary?***

***Please specify what information should be provided in:***

*i. **The statement of financial position***

*ii. **The statement(s) of profit or loss and other comprehensive income***

*iii. **The statement of cash flows***

*iv. **The note disclosures; or***

*v. **The management commentary***

We note that question 7 deals with the question of whether rate regulation gives rise to balances which meet the definitions of an asset and a liability as defined in the current Conceptual Framework, or in the Conceptual Framework Discussion Paper, published in July 2013. Our comments in response to question 1 are not based on whether any of those definitions are met, and are instead focused on whether information about the economic effects of rate regulation would be appropriate candidates for inclusion in financial statements.

In determining the information about an entity's rate regulated activities which should be included in its financial statements or accompanying documents, it is appropriate to consider the objective of general purpose financial reporting as set out in Chapter 1 of the Conceptual Framework. We note that the DP includes a number of extracts from this chapter (for example, paragraphs 2.3 to 2.5) and agree that the references paragraphs OB2 to OB4 of the Conceptual Framework are relevant.

In addition to the text of paragraph OB4 which is quoted in the DP, that paragraph includes a number of examples of how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources:

> 'Examples of such responsibilities include protecting the entity's resources from the unfavourable effects of economic factors such as price and technological changes....'

If users of financial statements need information about how an entity has been protected from price risk by its management and governing board, it follows that if the entity is protected from price (or other related) risk by some other means, the related information should be provided. Chapter 1 of the Conceptual Framework focuses on an entity's economic resources and claims against the reporting entity; if these resources and claims are altered by the effects of rate regulation, this implies that it is appropriate for the economic effects of rate regulation to be reported.

Chapter 3 of the Conceptual Framework includes the fundamental qualitative characteristics of financial information, being relevance and faithful representation. In the context of decisions taken by users of financial statements, if the economic effects of rate regulation are that the reporting entity will experience stability and/or predictability in its future cash inflows and outflows such that there is enhanced certainty over those cash flows, it would appear appropriate for information about those economic effects to be included in financial statements. This is because it would have the potential to provide both confirmatory and, in particular, predictive value about historic and forecast future cash flows.

We also note that rate regulated entities may make distributions of profit to shareholders, or engage in share buy-back arrangements, the amounts of which can be dependent on the amount of profit which has been recorded in a particular period. The inclusion of assets and liabilities relating to rate regulation would reduce the potential, for example, for excessive dividends to be paid to shareholders at the end of a reporting period in which the entity has made significant excess profits, which will be 'clawed back' through subsequent regulatory adjustments to selling prices.

Consequently we believe that, in principle, the following information should be included in the financial statements of an entity that is subject to rate regulation:

Statement of financial position

- Amounts attributable to rate regulation, including separate line items for stand-alone regulatory assets and liabilities, and for regulatory adjustments to the carrying amounts of assets and liabilities that are required to be recognised in accordance with all other IFRSs.

Statement of profit or loss and other comprehensive income

- The effects of regulatory adjustments by line item

Statement of cash flows

- Working capital movements that are attributable to regulatory assets and liabilities

Note disclosures

- Disclosures as set out in IFRS 14.30-36
- A reconciliation between profit in accordance with other IFRSs and regulatory profit
- A reconciliation between estimated and actual regulatory returns during the reporting period

Management commentary

- Disclosures as set out in IFRS 14.30 (if not included in the note disclosures)

b) ***How do you think that information would be used by investors and lenders in making investments and lending decisions?***

As noted above, and as contemplated in the Conceptual Framework, users of financial statements have an interest in the future cash flows that are expected to be generated by an entity, together with the extent to which those cash flows are subject to volatility and risk. In making their investing and lending decisions, they will therefore have an interest in the effects of rate regulation on an entity's cash flows which are linked to regulatory asset and liability balances, both during the current and future reporting periods.

We note that the question refers to investors and lenders; while we agree that these are likely to be the primary users who will have an interest in the effects of rate regulation on an entity, we believe that a wider range will have an interest. These include governmental bodies, organisations that have responsibility for the ongoing stability of supply of a regulated activity, and other bodies that are reliant on the regulated entity for future cash flows (such as individuals or entities that have responsibility for pension schemes for which the regulated entity is the sponsoring employer).

*Question 2*

***Are you familiar with using financial statements that recognise regulatory deferral account balances as regulatory assets or regulatory liabilities, for example, in accordance with US generally accepted accounting principles (GAAP) or other local GAAP or in accordance with IFRS 14? If so, what problems, if any, does the recognition of such balances cause users of financial statements when evaluating investment or lending decisions in rate-regulated entities that recognise such balances compared to:***

a) ***Non-rate regulated entities; and***

b) ***Rate-regulated entities that do not recognise such balances?***

Our experience is primarily of entities that recognise regulatory assets and regulatory liabilities in accordance with US GAAP. We are not aware of any problems that this recognition causes users of financial statements.

In fact, it is arguable that users of those financial statements are provided with more useful information than users of financial statements of rate-regulated entities that do not recognise regulatory assets or regulatory liabilities. Rate regulation is typically designed to result in stability of profitability and of cash flows. If the related assets and liabilities are not recognised, volatility is reported in financial statements which, economically, does not exist due to the effects of rate regulation. We also note that for the purposes of reporting by US entities, Forms 10-K typically include disclosures about regulatory assets and liabilities which enables users of those financial reports to have a good understanding of the adjustments that are created by rate regulation.

*Question 3*

***Do you agree that, to progress this project, the IASB should focus on a defined type of rate regulation (see Section 4) in order to provide a common starting point for a more focused discussion about whether rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed (see paragraphs 3.6-3.7)? If not, how do you suggest that the IASB should address the diversity in the types of rate regulation summarised in Section 3?***

We agree.

*Question 4*

***Paragraph 2.11 notes that the IASB has not received requests for it to develop special accounting requirements for the firm of limited or 'market' rate regulation that is used to supplement the inefficient competitive forces in the market (see paragraphs 3.30 to 3.33).***

***a) Do you agree that this type of rate regulation does not create a significantly different economic environment and, therefore, does not require any specific accounting requirements to be developed? If not, why not?***

***b) If you agree that this type of rate regulation does not require any specific accounting requirements, do you think that the IASB should, alternatively, consider developing specific disclosure requirements? If so, what would you propose and why?***

Our understanding is that these types of rate regulation, which are often developed to address inefficiencies in the market or to protect consumers, do not give rise to rights and obligations that might be recorded as assets or liabilities. To the extent that those activities result in changes, or constraints, on an entity's cash flows, it would appear appropriate for disclosures to be included in financial statements.

*Question 5*

*Paragraphs 4.4 - 4.6 summarise the key features of defined rate regulation. These features have been the focus of the IASB's exploration of whether defined rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might be developed in order to provide relevant information to users of general purpose financial statements.*

*a) Do you think that the description of defined rate regulation captures an appropriate population of rate-regulatory schemes within its scope? If so, why? If not, why not?*

Yes. The features described in these paragraphs are typical of rate-regulated arrangements for which we believe additional information should be included in financial statements.

*b) Do you think that any of the features described should be modified in order to include or exclude particular types of rate-regulatory schemes or rate-regulated activities included within the scope of defined rate regulation? Please specify and give reasons to support any modifications to the features that you suggest, with particular reference to why features may or may not give rise to circumstances that result in particular information needs for users of the financial statements.*

We do not consider that modifications are needed.

*c) Are there any additional features that you think should be included to establish the scope of defined rate regulation or would you omit any of the features described? Please specify and give reasons to support any features that you would add or omit.*

Further consideration might be given to the various recovery mechanisms that are typically seen in practice. The focus of paragraphs 4.4 - 4.6 appears to be on arrangements under which under or over recoveries by a rate-regulated entity during a particular reporting period will be compensated through an adjustment to subsequent amounts that are billed to customers. However, there are other features, such as how, at the end of a regulatory period, the rate-regulated entity will be compensated for, or need to settle, under or over cost recoveries during the regulatory period. These arrangements may differ, depending on whether the rate regulated arrangement will be renewed/extended, or terminated with another entity then carrying out the activities.

*Question 6*

***Paragraphs 4.62-4.72 contain an analysis of the rights and obligations that arise from the features of defined rate regulation.***

a) ***Are there any additional rights or obligations that you think the IASB should consider? Please specify and give reasons.***

   No. We agree with the discussion in those paragraphs, and agree that a key feature is the rate-regulated entity's right to the revenue requirement, which is established through the rate setting mechanism.

b) ***Do you think that the IASB should develop specific accounting guidance or requirements to account for the combination of rights and obligations described? Why or why not?***

   Yes. As noted elsewhere in this comment letter, we believe that the effects of defined rate regulation on an entity's financial position and results, and cash flows, are important to users of financial statements. Consequently, those effects should be reflected in a rate-regulated entity's financial statements.

*Question 7*

***Section 5 outlines a number of possible approaches that the IASB could consider developing further, depending on the feedback received from this Discussion Paper. It highlights some advantages and disadvantages of each approach.***

a) ***Which approach, if any, do you think would best portray the financial effects of defined rate regulation in IFRS financial statements and is most likely to provide information that investors and lenders consider is most relevant to help them make their investing and lending decisions? Please give reasons for your answer.***

   If adjustments are to be made to amounts reflected in a rate-regulated entity's primary financial statements, we believe that the approach set out in paragraph 5.34(c) should be followed, being recognition through specific IFRS requirements. Because of the different ways in which regulatory adjustments are recovered by a rate-regulated entity, approach (iii), being a combination of modifications of costs and revenue, would appear to be the most appropriate.

   We do not support the recognition of an intangible 'regulatory licence' asset, and agree with the difficulties outlined in the DP. It is not clear how:

   - changes in value of the licence (including revaluations) could properly be dealt with, without causing unintended consequences to the accounting for some other intangible assets,

- how the licence could be amortised in such a way that reflects the economic effects of the rate regulation adjustments, or
- how an intangible asset approach could be applied when the overall effect of rate regulation would be to record a liability.

We also do not support the use of regulatory balances for the purposes of IFRS financial statements (that is, the inclusion of regulatory amounts for affected line items, replacing those amounts that would otherwise be reported in accordance with IFRS). If only regulatory amounts were to be presented for the affected line items, it would not be possible for a user of financial statements to understand the effects of rate regulation. The approaches adopted by regulators in different jurisdictions also vary, meaning that financial statements of rate-regulated entities in different jurisdictions would not be comparable.

b) ***Is there any other approach that the IASB should consider? If so, please specify and explain how such an approach could provide investors and lenders with relevant information about the financial effects of rate regulation.***

We do not believe that the IASB needs to explore other approaches.

c) ***Are there any additional advantages or disadvantages that the IASB should consider before it decides whether to develop any of these approaches further? If so, please describe them.***

No.

***If commenting on the asset/liability approach, please specify, if it is relevant, whether your comments reflect the existing definitions of an asset and a liability in the Conceptual Framework, or the proposed definitions suggested in the Conceptual Framework Discussion Paper, published in July 2013.***

*Conceptual Framework*

We consider that, under the definition in the existing Conceptual Framework, adjustments arising from rate regulation do not give rise to balances that meet the definitions of an asset and a liability.

When considering the definition of an asset, a key difficulty is that, as at a rate regulated entity's reporting date, there is typically no amount that is unconditionally due to the entity at that point; the recovery is dependent on the supply of future services. This, in itself, would be less of an issue if there was only one customer, because adjustments to billings to a single customer under a long term contract could simply be accrued or deferred at the end of each reporting period. However, supplies under rate regulated arrangements are made to a portfolio of customer which can and does change in its composition over time, meaning that an accrual or deferral of revenue cannot be made as each of the customers cannot be identified.

When considering the definition of a liability, similar considerations to those set out above for assets apply. In addition, the economic effect of a forced reduction in selling price in a future period (or periods) is typically a reduction in profits, and not the imposition of losses. Consequently, the recognition of a liability cannot be justified because no obligation to transfer economic resources exists.

*Conceptual Framework Discussion Paper*

We do not consider that the proposed definitions would change the analysis and conclusions set out above.

We have given consideration to whether and how an approach might be developed which would justify the recognition of assets and liabilities. One potential route might be to consider whether, for the purposes of an entity that is subject to defined rate regulation, the portfolio of customers could be viewed as a single unit of account, which might then enable the accrual or deferral of revenue together with the recognition of associated assets and liabilities. This might be more straightforward for those arrangements in which the supplying entity is the sole supplier to customers in a particular country or region, which will typically be the case; however, it would be necessary to ensure that this approach would remain operational in the event that, for example, there were two or more rate-regulated entities providing the same (or substantially the same) goods or services to a particular portfolio of customers, where the customers could choose their supplier. One way to achieve this might be simply to require entities that are (or have certain activities that are) subject to defined rate regulation to view their related customer base as a single unit of account; this would enable the accrual/deferral of revenue and recognition of associated assets and liabilities under both the current and proposed definitions in the Conceptual Framework while restricting the application of this approach to a narrow and well defined set of entities. We believe that this approach could be justified by the characteristics that are unique to defined rate regulation.

If the approach of viewing the customer base as a single unit of account were not to be followed, we believe that amounts arising from rate-regulated activities should nevertheless be recognised as assets and liabilities in primary financial statements prepared in accordance with IFRS. This could require a specified, narrow and clear exception to the existing requirements of IFRS on the basis that defined rate regulation is considered economically to give rise to assets and liabilities that should be recorded in financial statements. However, we consider this to be less conceptually sound than the unit of account approach outlined above and therefore a less satisfactory approach.

*Question 8*

***Does your organisation carry out activities that are subject to rate regulation? If so, what operational issues should the IASB consider if it decides to develop any specific accounting guidance or requirements?***

No.

*Question 9*

***If, after considering the feedback from this Discussion Paper and the Conceptual Framework project, the IASB decides to prohibit the recognition of regulatory deferral account balances in IFRS financial statements, do you think that the IASB should consider developing specific disclosure-only requirements? If not, why not? If so, please specify what type of information you think would be relevant to investors and lenders in making their investing or lending decisions and why.***

If this were to be the conclusion reached, we consider that the IASB would need to develop disclosure requirements. However, these disclosure requirements would need to provide the information that is necessary to enable users of financial statements to make adjustments that would incorporate the effects of rate regulation on an entity's financial statements, because this information would be regarded as being of important to those users. This would appear to be a lower quality solution than the inclusion of separate line items (or separate disclosures on the face of the primary statements) that would depict the effects of rate regulation on an entity's financial performance and position.

*Question 10*

***Sections 2 and 6 discuss some of the information needs of users of general purpose financial statements. The IASB will seek to balance the needs of users of financial statements for information about the financial effects of rate regulation on an entity's operations with concerns about obscuring the understandability of financial statements and the high preparation costs that can result from lengthy disclosures (see paragraph 2.27).***

a) *If the IASB decides to develop specific accounting requirements for all entity that are subject to defined rate regulation, to what extent do you think the requirements of IFRS 14 meet the information needs of investors and lenders? Is there any additional information that you think should be required? If so, please specify and explain how investors or lenders are likely to use that information.*

b) ***Do you think that any of the disclosure requirements of IFRS 14 could be omitted or modified in order to reduce the cost of compliance with the requirements, without omitting information that helps users of financial statements to make informed investing or lending decisions? If so, please specify and explain the reasons for your answer.***

Please see our response to question 1.

*Question 11*

***IFRS 14 requires any regulatory deferral account balances that have been recognised to be presented separately from the assets and liabilities recognised in the statement of financial position in accordance with other Standards. Similarly, the net movements in regulatory deferral account balances are required to be presented separately from the items of income and expense recognised in the statement(s) of profit or loss and other comprehensive income.***

***If the IASB develops specific accounting requirements that would apply to both existing IFRS preparers and first-time adopters of IFRS, and those requirements resulted in the recognition of regulatory balances in the statement of financial position, what advantages or disadvantages do you envisage if the separate presentation required by IFRS 14 was to be applied?***

While we agree with the separate presentation of regulatory adjustments in the primary financial statements, we believe that these should be included within the existing headings and line items and not presented separately after all other amounts have been presented. While we acknowledge and understand why the approach required by IFRS 14 was adopted, this is an interim standard and we do not believe that it would be appropriate to adopt an approach which, due to the presentation it requires, suggests that the recognition of regulatory adjustments to assets and liabilities might not be wholly appropriate, or might represent less reliable balances, to record in financial statements.

In addition, the inclusion of regulatory adjustments within existing headings and line items would result in better disclosure of information to users of financial statements. For example, regulatory assets and liabilities would be classified on the face of the primary statements as current and non-current, assisting users in assessing short and long term liquidity.

The separate presentation of regulatory adjustments within the primary statements is important, as it enables users of financial statements to assess the effects of rate regulation on an entity and the associated future cash flows and financial performance. Because of the importance of rate regulation on those entities, we do not believe that note disclosure alone would give sufficient prominence being given to those adjustments.

*Question 12*

***Section 4 describes the distinguishing features of defined rate regulation. This description is intended to provide a common starting point for a more focused discussion about whether this type of rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements should be developed.***

***Paragraph 4.73 suggests that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature of defined rate regulation. Do you think that this is a necessary condition in order to create enforceable rights or obligations, or do you think that co-operatives or similar entities, which operate under self-imposed rate regulation with the same features as defined rate regulation (see paragraphs 7.6-7.9), should also be included within defined rate regulation? If not, why not? If so, do you think such co-operatives should be included within the scope of defined rate regulation only if they are subject to formal oversight from a government department or other authorised body?***

We agree that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an essential feature of defined rate regulation.

We consider that, although self-imposed rate regulation might give rise to similar effects as defined rate regulation, a self-imposed arrangement does not give rise to the same economic effects as one in which the terms of the arrangement are imposed on an entity by a regulator.

*Question 13*

***Paragraphs 7.11-7.22 highlight some of the issues that the IASB may consider if it continues to progress this project.***

***Do you have any comments or suggestions on these or any other issues that may or may not have been raised in this Discussion Paper that you think the IASB should consider if it decides to develop proposals for any specific accounting requirements for rate regulated activities?***

We have no further comments.