



## International Financial Reporting Standards: Regulatory Assets and Liabilities Considerations for Power and Utility Companies

International Financial Reporting Standards (IFRS) promises to bring a number of significant accounting changes for companies in the Power & Utilities (P&U) industry. One of the most critical and widely-discussed industry specific IFRS conversion matters has been accounting for regulatory assets and liabilities.

November 2008 Deloitte poll of P&U companies revealed that 43% of the respondents considered regulatory assets and liabilities as the most significant conversion matter, followed by property, plant and equipment (27%) and income taxes (4%).

So far, in practice, entities in jurisdictions that have adopted IFRS have generally not recorded assets and liabilities resulting from regulation as assets and liabilities under IFRS, leading to a significant one-time adjustment to equity in the year of adoption and more volatile earnings going forward. According to Edison Electric Institute, at December 31, 2008, the investor-owned electric utility industry alone reported regulatory assets and liabilities of approximately \$100 billion and \$20 billion respectively. Therefore, it is not surprising that as utilities in the U.S. start preparing for the conversion to IFRS, discussions around treatment of such assets and liabilities under IFRS have been escalating. This topic is even more urgent for utilities in Brazil and Canada where companies must convert by 2010 and 2011, respectively, as utilities in these jurisdictions also recognize significant regulatory assets and liabilities in accordance with guidance in SFAS 71, *Accounting for the Effects of Certain Types of Regulation* (codified in ASC 980), herein referred to as SFAS 71, or similar local GAAP standards.

In response to the Canadian, Brazilian and the U.S. constituents' concerns around the lack of specific IFRS guidance for rate-regulated activities, the International Accounting Standards Board (IASB or the Board) has been working on a project with the goal to develop a separate international accounting standard that would address accounting for regulated utilities. The Exposure Draft (ED) of the proposed standard was released on July 23, 2009 with a 120-day comment period.

### Background to the U.S. Standard

Most U.S. investor-owned utilities are subject to rate regulation by state or federal commissions. The effects of rate regulation on the application of accounting principles have long been recognized by standard-setting bodies in establishing accounting principles for use in preparing general-purpose financial statements. For years it has been a common practice in the ratemaking process to defer recognition of costs considered abnormal or as having benefits applicable to future ratepayers.

In the early 1980s the Financial Accounting Standards Board (FASB) presented a threshold issue: "Should accounting prescribed by regulatory authorities be considered in and of itself generally accepted for purposes of financial reporting by rate-regulated enterprises?" The FASB concluded that regulatory-prescribed accounting should not be considered generally accepted per se, but rather that the Board should specify how generally accepted accounting principles apply in the regulatory environment. As a result, in December 1982 the FASB issued SFAS 71 to provide guidance in preparing general purpose financial statements for public utilities and other companies if their operations meet certain criteria in the standard. SFAS 71 focused attention on the type of regulation required for there to be a departure from GAAP as applied to industry



in general. Also, it provided clearer direction on when rate decisions provide a basis for special accounting treatment, including specific responses to each of the primary concerns that had been raised by the industry. For a company to be able to apply SFAS 71 the rates it charges to its customers need to be established by or be subject to approval by a regulator and must recover costs of providing regulated services or products, and the company should be able to collect these rates from its customers. SFAS 71 recognizes that a principal consideration introduced by rate regulation is the cause-and-effect relationship of costs and revenues. Regulators sometimes include costs in allowable costs in a period other than the period in which the costs would be charged to expense by an unregulated enterprise and that procedure can create assets (future cash inflows that will result from the rate-making process), reduce assets (reductions of future cash inflows that will result from the rate-making process), or create liabilities (future cash outflows that will result from the rate-making process) for the regulated enterprise. Thus, under SFAS 71, a regulated utility is required to capitalize a cost as a regulatory asset or recognize an obligation as a regulatory liability, if it is probable that through the ratemaking process there will be a corresponding increase or decrease in future revenues.

### **What led to the IASB's issuance of the exposure draft on accounting for rate-regulated entities?**

IFRS currently does not provide specific guidance on regulatory assets and liabilities or on the recovery of costs and deferral of excess profits through future increases and decreases in regulated tariffs. However, the issue of how regulated assets and liabilities should be addressed under IFRS has come up at standard setting discussions several times in the past four years. International Financial Reporting Interpretations Committee (IFRIC), which develops interpretations for approval by the IASB, similar to the Emerging Issues Task Force (EITF) in the U.S., first addressed this matter during its discussions on service concessions. At that time, IFRIC concluded that "entities applying IFRS should recognize only assets that qualified for recognition in accordance with the IASB's, *Framework for the Preparation and Presentation of Financial Statements* (Framework), and relevant accounting standards, such as IAS 11, *Construction Contracts*, IAS 18, *Revenue*, IAS 16, *Property, Plant and Equipment* (IAS 16), and IAS 38, *Intangible Assets* (IAS 38)." In other words, the IFRIC thought that "an entity should recognize regulatory assets to the extent that they meet the criteria to be recognized as assets in accordance with existing IFRS. Whether the assets are labeled as "regulatory" should not affect their recognition."

When European Union companies listed on a regulated market started to prepare their consolidated financial statements in accordance with IFRS in 2005, IFRIC received another request from its constituents for guidance for operations subject to price regulation. Specifically, IFRIC was asked whether SFAS 71 could be applied under the hierarchy in IAS 8, *Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8), as IAS 8 allows companies, in the absence of specific IFRS guidance, to consider the pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards, other accounting literature and accepted industry practices, to the extent that these do not conflict with IFRS. In response IFRIC concluded that the recognition criteria in SFAS 71 were not fully consistent with the recognition criteria in IFRS, and would require the recognition of assets under certain circumstances which would not meet the recognition criteria of relevant IFRS. Thus IFRIC decided again not to add the regulatory asset and liability issue to its agenda. In late 2007 IFRIC received a second request (from Roundtable for Consistent Application of IFRS and the National Standard Setters Group) to add the issue to their agenda on the grounds that the accounting for regulatory assets and liabilities is widespread, has practical relevance and there is significant divergence in practice. While determining the scope and the timeline of this issue, IFRIC received a number of letters from the U.S. and Canadian companies, utility organizations, regulators, and analysts, supporting further discussions of recognition of regulatory assets and liabilities under IFRS.

At its November 2008 meeting IFRIC concluded that the criteria for adding the regulatory assets and liabilities issue to the agenda were not met, mainly because divergence in practice did not seem to be significant, and therefore decided tentatively not to add the issue to its agenda. This decision triggered a flow of letters from the U.S. utilities and others who disagreed with IFRIC's decision and suggested that the IASB add the matter to its project plan. At its December 18, 2008 meeting the IASB agreed unanimously to add the regulatory asset and liability project to its agenda with a plan to clearly define the scope of the project to concentrate on common characteristics of a regulatory scheme that might lend to the recognition of regulatory assets and liabilities. The IASB Staff (the Staff) developed the ED of the proposed standard over a six-month period, releasing it for public comment on July 23, 2009.



## Overview of the Exposure Draft

The objective of the ED is to establish whether and how assets and liabilities resulting from rate-regulated activities should be recognized and measured under IFRS. If adopted, the proposed IFRS would define regulatory assets and regulatory liabilities, set out criteria for their recognition, specify how they should be measured and outline required disclosures. Each of these areas is further described below:

### **Scope**

An entity would be required to apply the ED'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. The ED 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 SFAS 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.

### **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," 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 proposal requires the use of a probability-weighted cash flow approach and indicates that the following elements should be considered in the measurement:

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

The measurement criteria in the proposed standard differ from those in SFAS 71. SFAS 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, *Impairment of Assets*. Any impairment loss is then allocated to the assets of the cash generating unit. 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 SFAS 71.

#### ***Presentation and Disclosure***

The ED 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.”

#### ***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.

#### **Where do we go from here?**

In a Deloitte December 2008 poll of utility companies, 8% of the respondents were planning to write a letter to IASB and encourage further IFRS guidance for rate-regulated activities, 31 % stated that they would encourage peers, regulators, investors, and others to get involved and 49% would continue to closely follow the developments in this area.

Now that the ED has been issued and the comment period is open, the development of the IFRS guidance around regulatory assets and liabilities is in the hands of constituents. Companies should be reading the ED carefully, considering related impacts on their current financial statements. Every comment letter supporting and improving the ED will contribute towards the release of a standard that will meet the industry’s needs.

As this is the first time for many P&U companies to be writing a comment letter to the IASB, some companies have already reached out to us to assist them with this process. If your company needs assistance in preparing a response, please contact your Deloitte partner or Jan Umbaugh and Bill Graf at [USNationalEnergy&ResourcesIPPD@deloitte.com](mailto:USNationalEnergy&ResourcesIPPD@deloitte.com).

---

#### **Endnotes**

<sup>1</sup> For comprehensive analysis of the development of U.S. utility industry, regulation, rate-making concepts and utility accounting and reporting practices, please refer to “Accounting for Public Utilities”, published by LexisNexis

<sup>2</sup> 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”



## Contacts

### IFRS Solutions Center:

#### D.J. Gannon

National Leadership Partner  
IFRS Solutions Center  
Deloitte & Touche LLP  
+1 202 220 2110  
[dgannon@deloitte.com](mailto:dgannon@deloitte.com)

### Industry Contacts:

For more information,  
please contact:

#### Greg Aliff

Vice Chairman  
U.S. Energy & Resources  
Leader  
Deloitte LLP  
+1 703 251 4380  
[galiff@deloitte.com](mailto:galiff@deloitte.com)

#### Bill Graf

Partner  
Deloitte & Touche LLP  
+1 312 486 2673  
[wgraf@deloitte.com](mailto:wgraf@deloitte.com)

#### Andy Hickey

Partner  
Deloitte & Touche LLP  
+1 212 436 5322  
[ahickey@deloitte.com](mailto:ahickey@deloitte.com)

#### Brian Murrell

Partner  
Regulatory & Capital  
Markets Consulting  
Deloitte & Touche LLP  
+1 212 436 4805  
[bmurrell@deloitte.com](mailto:bmurrell@deloitte.com)

#### Mike Reno

Partner, Deloitte Tax LLP  
+1 202 378 5027  
[mreno@deloitte.com](mailto:mreno@deloitte.com)

#### Jan Umbaugh

Partner  
Deloitte & Touche LLP  
+1 561 962 7706  
[jumbaugh@deloitte.com](mailto:jumbaugh@deloitte.com)

#### David Yankee

Partner, Deloitte Tax LLP  
+1 312 486 9842  
[dyankee@deloitte.com](mailto:dyankee@deloitte.com)

## Resources

Deloitte has extensive IFRS experience in the P&U industry. With thousands of IFRS-experienced professionals in our global network, we provide a comprehensive array of services related to IFRS. As a multidisciplinary organization, we can help companies address a wide range of IFRS issues.

### Deloitte offers companies assistance with:

- Evaluating the potential impacts of IFRS
- Assessing readiness for IFRS conversions
- Implementing IFRS conversions, providing support with technical research, project management, and training
- Addressing the implications of IFRS in such areas as tax, finance operations, technology, and valuation

### Deloitte's U.S. Energy & Resources group:

We proudly serve power and utilities clients, helping them address their most critical challenges in order to deliver value for their shareholders and execute initiatives designed to further their strategic objectives.

### Overview of Our Power & Utilities Group:

- Audits half of the Fortune 1000 utilities and energy companies
- Provides accounting and enterprise risk services to 79 percent of the Fortune 500 utilities and energy companies
- Provides consulting services to the entire top 10 utilities and energy companies in the Fortune 1000
- Provides financial advisory services to 9 out of 10 utilities and energy companies in the Fortune 1000
- Provides tax services to the entire top 10 utilities and energy companies in the Fortune 1000
- More than 1,500 U.S. practitioners serving the industry, including over 350 partners, principals and directors

### Power & Utilities industry involvement:

Our practitioners understand that leadership demands active participation across the industry's diverse community. We actively participate in the following organizations:

- American Gas Association
- Edison Electric Institute
- Electric Power Supply Association
- United States Energy Association

### Thought leadership:

- [2008 Deloitte Electric Consumer Survey](#)
- [2008 Deloitte Utility Commissioners Survey](#)
- [2008 Deloitte Energy Conference Summary Report](#)
- [The Risk Intelligent Enterprise: ERM for the Energy Industry](#)

To receive copies of thought leadership articles, please contact [USEnergyIFRS@deloitte.com](mailto:USEnergyIFRS@deloitte.com).

### Technical Publications:

- [Power & Utilities Accounting, Financial Reporting and Tax Update](#)
- [Energy Quarterly Brief](#)

### Deloitte's online resources:

For a wealth of online resources related to IFRS, visit [www.deloitte.com/us/ifrs](http://www.deloitte.com/us/ifrs). Available materials include newsletters, whitepapers, pocket guides, timelines, webcasts, podcasts, and more.

### International accounting resources:

The International Accounting Standards Board (IASB) develops international financial reporting standards for general purpose financial statements. Visit the IFRS section of [www.iasb.org](http://www.iasb.org) for additional details and copies of the standards.

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

### About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, and its network of member firms, each of which is a legally separate and independent entity. Please see [www.deloitte.com/about](http://www.deloitte.com/about) for a detailed description of the legal structure of Deloitte Touche Tohmatsu and its member firms. Please see [www.deloitte.com/us/about](http://www.deloitte.com/us/about) for a detailed description of the legal structure of Deloitte LLP and its subsidiaries.