

International Accounting Standards Board
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Exposure Draft ED/2009/8 *Rate-regulated Activities*

Grant Thornton International is pleased to comment on the International Accounting Standards Board's (the Board) Exposure Draft ED/2009/8 *Rate-regulated Activities* (the ED). We have considered the ED as well as the accompanying draft Basis for Conclusions.

We support the Board's objectives in publishing the ED. We believe the question of whether or not IFRS permits or requires the recognition of regulatory assets and liabilities in particular circumstances has not to date been resolved satisfactorily. This issue is of course of critical interest to rate-regulated entities that may be affected, especially in jurisdictions transitioning to IFRS whose current GAAP includes requirements in this area.

We also support the Board's tentative conclusion that it is appropriate to recognise regulatory assets and liabilities in particular circumstances. In forming this view, we have considered whether such assets and liabilities meet the corresponding definitions in the Framework. Views on this matter within our organisation have been mixed; the Framework definitions are probably insufficiently precise or specific to provide a definitive answer. On balance, however, we believe it is credible to assert that some forms of rate-regulation establish in-substance rights to recover incurred costs (and in-substance obligations to refund amounts collected) and that those rights and obligations are assets and liabilities. Moreover, we believe that the recognition of these assets and liabilities can be decision-useful. This information provides users with a measure of the extent to which past transactions are expected to affect future prices.

Subject to some detailed comments set out in the Appendix, we agree with the general approach set out in the ED to determine the circumstances in which regulatory assets and liabilities exist (and should therefore be recognised).

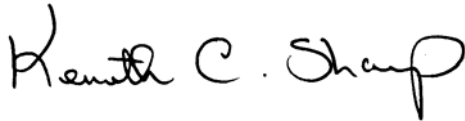
We do not agree with:

- the ED's proposal to measure those assets and liabilities at expected present value measure. We believe that a cost-based measurement is more appropriate.
- the inclusion of regulatory adjustments in the carrying value of property, plant and equipment and intangible assets. We think this will impair comparability between entities within the proposed scope of the ED and those outside that scope and suggest that regulatory assets and liabilities should be clearly distinguished in the Statement of Financial Position.

We expand on these remarks and make a number of other comments and suggestions in our responses to the Invitation to Comment, set out in the Appendix to this letter.

If you have any questions on our response, or wish us to amplify our comments, please contact our Executive Director of International Financial Reporting, Andrew Watchman (andrew.watchman@gtuk.com or telephone + 44 207 391 9510).

Yours sincerely,

A handwritten signature in black ink that reads "Kenneth C. Sharp". The signature is written in a cursive, flowing style.

Kenneth C Sharp
Global Leader - Assurance Services
Grant Thornton International

Responses to invitation to comment questions

Scope

Question 1 - 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?

As a general comment, we are unclear as to why the ED needs a detailed scope section. We suggest that the ED should instead address all rate-regulated activities that give rise to regulatory assets and liabilities. The emphasis will then shift from a scope requirement to clear and robust definitions of regulatory assets and liabilities. We are concerned that, as drafted, the ED uses the scope section to address definitional matters.

Turning to the substance of the proposed scope definition, we comment below on the two proposed criteria:

Authorised body empowered to establish rates that bind customers

We agree with this condition.

Rate designed to recover the specific costs the entity incurs and to earn a specified return

We largely agree with this condition, subject to the following comment.

We are unclear as to why the rate must be designed to earn a specified return. If an entity has incurred costs that it has a right to recover then we believe it has an asset irrespective of whether an additional return will be earned. The draft Application Guidance at B6 seems to emphasise the need for 'a sufficient return for shareholders to justify application of the [draft] IFRS'. This exacerbates our concern.

Recognition and measurement

Question 2 - 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?

Consistent with our response to Question 1, we suggest that the emphasis should be on definitions and supporting guidance that establish a clear and robust basis to determine whether or not a regulatory asset (or liability) exists. We agree that if such an asset or liability exists then it should be recognised. Accordingly, we agree that no additional recognition criteria should be necessary.

Question 3 - 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?

We do not support the proposed measurement approach. We have three concerns:

- The proposed model and justification for recognition of an asset (or liability), are based on an entity's in-substance right to recover costs it has incurred (or the obligation to refund previously collected income). We believe it is inconsistent to then require this asset (or liability) to be measured at expected present value.
- We suggest that there is rarely a clear enough link between the costs incurred and the specific cash flows (amount or timing) to make an expected present value approach operational.
- We believe regulatory assets and liabilities are similar in nature to prepayments or deferred revenue which are measured on a cost basis. 'Expected present value' is not a well established basis of measurement in IFRS and should not in our view be introduced in this context.

Accordingly, we believe regulatory assets should be measured at cost and amortised on a systematic basis over the period in which the rate-setting arrangements facilitate their recovery.

Question 4 - 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?

We do not support this proposal. We believe that regulatory assets and liabilities should be clearly identified and distinguished in the Statement of Financial Position. This is in order to:

- facilitate comparison between rate-regulated entities that report regulatory assets and liabilities and those that do not
- maintain the integrity of the carrying values of property, plant and equipment and intangible assets reported in accordance with IAS 16 and IAS 38
- facilitate the application of the [proposed] IFRS when an entity does not continue to meet the scope criteria in paragraph 3 and must derecognise its regulatory assets and liabilities. Paragraph 21 on derecognition does not address how the [proposed] IFRS would apply in this case to regulatory costs included in property plant and equipment and intangible assets.

Question 5 - 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?

We agree with these proposals.

Disclosures

Question 6 - 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.

We agree with the proposed disclosures in the context of the ED's overall proposals.

We note that the disclosure proposed in paragraph 26(d) (significant measurement assumptions) may not be necessary under our preferred cost-based measurement approach.

Transition

Question 7 - 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?

Yes, we believe this approach is appropriate.

Other issues

Question 8 - Do you have any other comments on the proposals in the exposure draft?

Taxation

Regulators sometimes ignore the deferred tax consequences of some current events when establishing rates to be charged to a regulated entity's customers with the implicit or explicit understanding that the future payment of those tax consequences will be included in the establishment of rates to be charged to the regulated entity's customers in that future period. If a regulator requires an entity to recover past deferred tax expense from customers through future rates, the ED does not provide guidance on how to account for that income tax effect.

We suggest that guidance should be provided to cover this situation.

Comments on illustrative examples

We are not clear as to the reason for including Example 7 (Determination of the Regulated Rate). If this example is retained in the final IFRS we suggest an explanation of how the information is used in applying the IFRS's requirements.

Definitions

The ED proposes definitions of 'regulatory asset' and 'regulatory liability' at Appendix A. We have a number of comments on these definitions:

- Consistent with our response to Question 1, we suggest that the types of rate-regulation that give rise to assets and liabilities should be incorporated into the definitions or guidance thereon, rather than being dealt with in the scope section.
- For the reasons set out in the same response we disagree with the inclusion of the words 'and to earn (pay) a specified return' in the proposed definitions.
- The proposed definitions refer to increasing rates in the context of regulatory assets, and decreasing rates in the context of regulatory liabilities. We note that a 'permitted cost' will have the effect that future rates will be higher than they would otherwise have been. However, future rates may not in fact be increased in overall terms. We assume the Board intends that a regulatory asset can arise even if overall rates are not expected to increase but this point might usefully be clarified.
- The proposed definitions refer to 'expected actions' of the regulator. We acknowledge that this terminology is intended to be applied in the context of the ED's scope and other guidance. However, when considered in isolation this phrase implies that an entity's expectation that a regulator will in fact permit a specific cost gives rise to a right of recovery. We think that a right of recovery (and, accordingly, an asset) arises only if the regulator is obliged to permit the costs in question under the applicable rate-setting regime. We therefore suggest that the required judgement should not be based on the regulator's expected actions, but rather on the entity's assessment of what the regulator is obliged to do under the applicable rate-setting regime.