Financial Reporting by rate-regulated enterprises – Terms of Reference

Rate-regulated enterprises are a significant part of the Canadian economy. They include, for example, multi-billion-dollar electric utilities and natural gas pipeline companies, and encompass both the private sector and the public sector. The form of regulation can vary from regulation that is based on the cost of providing services to regulation that is based on performance. For telecommunications companies, much of the industry has been deregulated and now operates in a competitive marketplace. For others, such as the electric utilities, the process of deregulation is just beginning.

In light of the changing regulatory environment, the continued relevance of "special" accounting for rate regulation is currently the subject of considerable debate. There are differing views on whether the impact of rate regulation should be reported. Some feel that it results in artificial income smoothing. Others, including the Study Group, are of the opinion that rate regulation can have a direct bearing on the enterprise's economic resources and that this should be reflected in the financial statements. There are also differing views on the appropriate accounting approach. What constitutes generally accepted accounting principles (GAAP) for rate-regulated enterprises and how the *CICA Handbook - Accounting* requirements should be applied to them need to be clearly established. To provide that guidance, the Accounting Standards Board and the Public Sector Accounting Board are jointly sponsoring this research project:

- to address accounting and reporting issues pertinent to rate-regulated enterprises; and
- to suggest the steps that the two boards should take to meet the special needs of such enterprises and the users of their general purpose financial statements.

To provide much-needed guidance to preparers, practitioners and users, this Report proposes that the Accounting Standards Board issue a new *Handbook* Section on accounting for the effects of rate regulation. The new Section would replace the current *Handbook* material. In addition, it would establish general principles for assessing, in a particular situation, whether, and, if so, the degree to which, rate regulation has an economic impact that should be recognized and how it should be reported in general purpose financial statements. In this regard, it is anticipated that the discussion of general principles and differential accounting treatments set out in this Report will provide a useful reference source.

Because the economic benefits and obligations created by rate regulation are similar for many private and public sector enterprises, the consensus of the Study Group is that the general purpose financial statements of rate-regulated enterprises in the public sector should be prepared on a basis consistent with that of rate-regulated enterprises in the private sector. Accordingly, the Public Sector Accounting Board should specifically recognize in *CICA Public Sector Accounting Handbook* that certain public sector entities should apply, where applicable, the accounting recommendations for rate-regulated enterprises contained in the *CICA Handbook - Accounting*. One of the ten members of the Study Group, however, strongly feels that different criteria are needed for a public sector enterprise to qualify as rate regulated for financial reporting purposes. In his opinion, there is usually no "independent third party regulator" because the government normally controls both the affected enterprise and the regulatory agency.

SUMMARY OF CONCLUSIONS

This Research Report addresses 12 primary issues and a multitude of secondary issues. The following outlines, on a chapter-by-chapter basis, the primary issues and the conclusions reached by the Study Group that undertook this project. Support for those conclusions is provided in the relevant chapters, along with an analysis of any alternative views on the issues.

CHAPTER 1

Issue 1 - Is accounting for the effects of rate regulation still a relevant issue?

Accounting for the effects of rate regulation in the general purpose financial statements of rate-regulated enterprises is an important issue and will remain so for the foreseeable future.

CHAPTER 2

Issue 2 - What is rate regulation?

Under rate regulation, an enterprise's rates are established by, or are subject to approval by, a regulator. There are a number of basic regulatory processes and methodologies and, within each, there can be different applications that vary with the regulator, the entity being regulated and the circumstances faced.

CHAPTER 3

Issue 3 - What is the appropriate accounting approach?

Different approaches have been suggested for accounting for rate regulation. The approach adopted should be based on a framework that recognizes the economic impacts of rate regulation, identifies the financial reporting concepts that should guide the recognition of those impacts to the extent that they exist, and considers existing practice in both Canada and the US.

CHAPTER 4

Issue 4 - What is the current financial reporting environment?

Accounting pronouncements and practices in Canada recognize that, in certain circumstances, rate regulation can affect what should be reported in the financial statements. In the United States, accounting pronouncements also recognize the effects of rate regulation. They establish a comprehensive framework for reporting the economic impact of rate regulation and provide detailed guidance to rate-regulated enterprises. In the United Kingdom, accounting pronouncements do not address the effects of rate regulation. Nonetheless, there is increasing interest in developing a conceptual framework for accounting by regulated industries. Accounting standards that were issued by the International Accounting Standards Committee (IASC) do not address the effects of rate regulation.

Issue 5 - What further guidance should be provided?

General guidance on accounting for the effects of rate regulation should be issued as a new Section in the *CICA Handbook - Accounting*. The new Section would replace the material currently contained in the Handbook relating to rate-regulated enterprises and would provide any additional guidance that is considered necessary. It would set out general principles to provide a "framework" for applying GAAP to rate-regulated enterprises within the boundaries established by "Financial Statement Concepts," Section 1000. The general principles would provide the basis for assessing, in a particular situation, whether rate regulation has an economic impact that should be reported and, if so, how it should be reported in general purpose financial statements.

CHAPTER 5

Issue 6 - Can regulatory authorities establish GAAP?

Regulatory authorities cannot establish GAAP. The Recommendations in the *CICA Handbook - Accounting* constitute GAAP. Although the actions of regulators may affect rates and the resulting economic impact may affect what should be reported in accordance with GAAP, this does not give them the right to determine how that economic impact should be reported in general purpose financial statements.

Issue 7 - Can rate regulation have an economic impact?

Regardless of the rate-setting process or methodology used, from an economic perspective, rate regulation can have a direct bearing on the economic resources, obligations and performance of a rate-regulated enterprise. It can influence rates that, combined with market conditions, can have an economic impact on current and future revenues and cash flows, thereby affecting future economic benefits and obligations.

Issue 8 - Should the effects of rate regulation be reported in general purpose financial statements?

The economic benefits and obligations created by rate regulation and resulting from past transactions or events, and the changes in these amounts, meet the definition of a financial statement element set out in "Financial Statement Concepts," Section 1000 of the *CICA Handbook - Accounting*. Where they also meet the recognition criteria set out in Section 1000, those elements should be reported in the general purpose financial statements of a rate-regulated enterprise as assets, liabilities, revenues, expenses, gains and losses.

CHAPTER 6

Issue 9 - What is a rate-regulated enterprise?

The *CICA Handbook - Accounting* establishes the criteria that must be met if an enterprise is to be considered "rate regulated" for financial reporting purposes. The criteria for qualifying as a "rate-regulated enterprise" in Canada are essentially the same as those in the United States. To eliminate minor differences with US accounting standards, the *Handbook* definition should be amended to conform to the wording used in SFAS 71. For rate regulation to have an impact on what should be reported in accordance with GAAP, it is not a prerequisite for the entire operations of the enterprise to be subject to rate regulation; it is only necessary that a subset of the enterprise's operations be subject to rate regulation. Consequently, where only some of an enterprise's operations are rate regulated, the financial statements would reflect the economic impact of rate regulation on only that portion of operations. This approach is consistent with current practice and with US GAAP.

CHAPTER 7

Issue 10 - What general principles should be used by rate-regulated enterprises?

Rate-regulated enterprises should use the following general principles when preparing general purpose financial statements in accordance with GAAP:

Application

1. The economic impact of rate regulation should be reflected in the general purpose financial statements of an enterprise that has regulated operations that meet all of the following criteria:
    - The enterprise's rates for regulated services or products provided to its customers are established by, or are subject to approval by, an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.
    - The regulated rates are designed to recover the specific enterprise's costs of providing the regulated services or products, including a fair return on investment.
    - In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

2. If some of an enterprise's operations are regulated and meet the above criteria, the financial statements should reflect the economic impact of rate regulation on only that portion of operations.
3. When an enterprise that has regulated operations no longer meets the criteria set out in Principle 1, it should discontinue reflecting the economic impact of rate regulation and reflect the effects of discontinuation in its general purpose financial statements.

Recognition of Regulatory Assets and Liabilities

4. Rate-regulated enterprises should recognize a regulatory asset in their financial statements, when all of the following conditions are met:
    - Rate regulation creates an economic benefit in the form of increased future revenues as a result of a past transaction or event.
    - It is probable that the enterprise's regulator will set future rates sufficient to provide the economic benefit.
    - Future rates sufficient to provide additional revenue at least equal to the economic benefit will be chargeable and collectible from customers.
    - There is an appropriate basis for measuring the asset and a reasonable estimate can be made of the amount involved.

5. A regulatory asset should be valued at the lower of the expected economic benefit and the cost incurred to acquire the economic benefit.
6. Where the economic benefit is increased and the increase meets all of the conditions in Principle 4, or a portion of the economic benefit that previously did not meet all of the conditions in Principle 4 now meets those conditions, the value of the regulatory asset should be increased by the related amount.
7. Where all or a portion of a regulatory asset no longer meets the conditions in Principle 4, the value of the regulatory asset should be reduced by the related amount.
8. Rate-regulated enterprises should recognize a regulatory liability in their financial statements when all of the following conditions are met:

- Rate regulation creates an economic obligation in the form of decreased future revenues, or payments to customers, as a result of a past transaction or event.
- It is probable that the enterprise's regulator will set rates sufficient to reduce revenues by the amount of the liability or require payments to customers equal to the liability.
- There is an appropriate basis for measuring the liability and a reasonable estimate can be made of the amount involved.

9. Where the economic obligation is increased, or a portion of the economic obligation that previously did not meet all of the conditions in Principle 8 now meets the conditions, the value of the regulatory liability should be increased by the related amount.
10. Where all or a portion of a regulatory liability no longer meets the conditions in Principle 8, the value of the regulatory liability should be reduced by the related amount.

Recognition of Revenues, Expenses, Gains and Losses

11. The financial statements of rate-regulated enterprises should report the changes in regulatory assets and liabilities as revenues, expenses, gains or losses.

Presentation and disclosure

12. Notes to the general purpose financial statements of rate-regulated enterprises should disclose:
    - that the enterprise (or certain of its operations) is rate regulated for financial reporting purposes or, alternatively, that the enterprise was rate regulated in the prior period, but no longer meets the established criteria for a rate-regulated enterprise;
    - the regulator(s) and the jurisdiction(s) covered (even if the enterprise no longer qualifies as rate regulated);
    - that the financial statements are prepared in accordance with Canadian GAAP.

13. Notes to the general purpose financial statements of rate-regulated enterprises should disclose how rate regulation affects the reported values of individual assets and liabilities on a going-forward basis.

CHAPTER 8

Issue 11 - Do the General Principles apply to the public sector?

With respect to the scope of public sector activities that may be considered "rate regulated" for financial reporting purposes, the consensus of the Study Group is that the application of General Principle 1 should be limited to government business enterprises (GBEs) that meet all the criteria for qualifying as a rate-regulated enterprise. In this regard, *CICA Public Sector Accounting Handbook* Recommendations should specifically recognize that only GBEs that qualify as rate-regulated enterprises for financial reporting purposes should apply the accounting recommendations for rate-regulated enterprises contained in the *CICA Handbook - Accounting*.

One Study Group member, however, feels strongly that in order for a GBE to qualify as a rate-regulated enterprise for financial reporting purposes, the regulatory agency must be independent of both the GBE and government. The consensus of the Study Group is that the

General Principles regarding application, recognition, presentation and disclosure apply equally to all GBEs that meet the criteria in General Principle 1, since the economic benefits and obligations created by rate regulation are similar for many private and public sector enterprises. Therefore, the general purpose financial statements of rate-regulated enterprises in both the public and private sectors should be prepared on a consistent basis. One member would support this position only in the unlikely event that the regulatory agency is independent of both the GBE and the government.

CHAPTER 9

Issue 12 - What additional guidance is needed for specific accounting and reporting issues encountered by rate-regulated enterprises?

While detailed guidance for recognizing the economic impact of rate regulation on the financial reporting of rate-regulated enterprises is not essential, additional guidance would help avoid any misunderstanding and, at the same time, illustrate how the general principles should be applied in practice. Accordingly, this chapter addresses specific issues that are considered of interest to the regulatory community. Emphasis is given to areas that may have a material impact on general purpose financial statements. Consideration is also given to circumstances that may indicate the need to discontinue accounting for the effects of rate regulation.