FINANCIAL REPORTING BY RATE-REGULATED ENTERPRISES

FOREWORD

Rate-regulated industries are core sectors of the Canadian economy. They have a common characteristic in that they provide services that are considered essential to the public. Most rate-regulated enterprises are required to maintain their accounting records in accordance with uniform systems of accounts prescribed by regulatory agencies. This accounting has not always agreed with GAAP as applied to business enterprises in general.

Some maintain that exceptions for rate-regulated enterprises should be permitted. Otherwise, the orderly markets and trading of a rate-regulated enterprise's securities might be seriously disrupted, which could adversely affect the enterprise's ability to maintain and expand its service capability on an economically sound basis. It has also been argued that any refusal to permit rate-regulated enterprises to defer costs for accounting and reporting purposes that are deferred for rate-making purposes might jeopardize the opportunity to recover similar types of costs through revenues established in future rate proceedings. Others have maintained that permitting rate-regulated enterprises to depart from GAAP as applied to other business enterprises when preparing general purpose financial statements — other than in strictly limited circumstances — undermines the credibility of standard setting. They note that regulatory agencies are often inextricably involved in the political process and are subject to short-term pressures. There is the danger that accounting practices might be managed to hide from users of financial statements adverse impacts on an enterprise. The validity of the concerns expressed by both groups needed to be examined.

Exceptions for rate-regulated enterprises from the accounting followed by other types of business enterprises have been advocated for many years. A bulletin issued by the CICA's Accounting and Auditing Research Committee in September 1967 noted that "the general principles of income measurement should be the same in regulated industries as they are in other enterprises, and that the income tax allocation basis should have equal relevance. However, the Committee recognizes that there may be rare cases where compliance with the recommendations of this Bulletin would be inappropriate for the purpose of achieving a proper matching of costs and revenues." Since that time, Canadian accounting standards have permitted the occasional additional exception for rate-regulated enterprises.

It looked as if the tide might be turning when the Accounting Standards Board issued an Exposure Draft on "Income Taxes" in March 1996. The Exposure Draft proposed that rate-regulated enterprises should record future tax liabilities or assets the same way as other business enterprises do. It stated that "a regulator ... cannot relieve an enterprise of a liability or asset that was not created by the regulator. ... It is appropriate to recognize an asset or liability for amounts that may be recovered or payable under the ... rate formula. That asset or liability is a temporary difference for which a future income tax liability or future income tax asset would be recognized."

Concerns expressed by rate-regulated enterprises persuaded the Accounting Standards Board to back off from this position, at least temporarily. The final standard, issued in December 1997, indicated that "pending further study of accounting for rate regulated enterprises as a whole, rate regulated enterprises are not required to record future income taxes for temporary differences that arise from assets and liabilities relating to their rate regulated activities to the extent that these future income taxes will be included in the rates charged to customers in the future and will be recoverable at that time ..."

In the late 1990s, accounting by public sector rate-regulated enterprises was also raising some concerns for the CICA Public Sector Accounting Board. One of the key issues related to the essential characteristics of a rate-regulated enterprise, in particular, the required degree of independence of the enterprise being regulated from the rate-setting body.

These concerns led to a proposal being presented, for consideration by both the CICA's Accounting Standards Board and its Public Sector Accounting Board, for a project on financial reporting by rate-regulated enterprises, culminating in the publication of a Research Report.

The objective of this project was to address accounting and reporting issues pertinent to rate-regulated enterprises and to propose what specific guidance the Accounting Standards Board (and possibly the Public Sector Accounting Board) should provide to meet the special needs of such enterprises and the users of their general purpose financial reports. Under its terms of reference, the Study Group set up to undertake this project was asked to consider:

1. What constitutes a rate-regulated enterprise for financial reporting purposes? Is the definition in *CICA Handbook – Accounting* paragraph 3465.09 sufficiently clear, or how should it be amended?
2. What criteria must an enterprise meet to be considered rate regulated?
3. What is the nature of rate regulation and to what degree must it be independent of the enterprises being regulated?
4. Should rate regulation over private sector enterprises be distinguished from rate regulation over public sector enterprises? If so, what are the distinguishing criteria?
5. Does rate regulation introduce an economic dimension in some circumstances that should affect what constitutes "generally accepted accounting principles" (GAAP) for the enterprises being regulated?

6. Can accounting prescribed by rate-regulating authorities be considered, in and of itself, GAAP for rate-regulated enterprises and, if so, to what extent?
7. In setting accounting standards, should the Accounting Standards Board focus on rate-regulated enterprises *per se*, or on rate-regulated activities?
8. Are there any differences among the various types of rate-regulated enterprises or regulatory frameworks that would have an impact on the extent to which GAAP, as set out in the *CICA Handbook – Accounting*, should apply?
9. Assuming that the Recommendations in the *CICA Handbook – Accounting* generally apply to rate-regulated enterprises, are any exemptions needed because of their "special circumstances"? What other changes, if any, need to be made?
10. What additional guidance is needed relating to specific accounting and reporting issues encountered by rate-regulated enterprises?
11. What other information specific to the nature of rate-regulated enterprises should be included in general purpose financial statements or elsewhere?

The CICA expresses its appreciation to John Browne, chair, and the members of the Study Group for undertaking this project, and to J. Paul-Émile Roy, Principal, Research Studies, for providing technical support to the Study Group and for drafting the report under the Study Group's direction. Thanks are also expressed to those who assisted the Study Group by providing comments on a draft of the Research Report.

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EXECUTIVE OVERVIEW

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. 1(1) 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.

Chapter 1

INTRODUCTION

"Rate regulation" is imposed by a government, which creates legislation setting up a regulatory authority and gives it jurisdiction to approve the rates of specific enterprises or categories of enterprises.

OUTLINE OF THE REPORT

The objective of this Research Report is to address accounting and reporting issues pertinent to rate-regulated enterprises and to propose what specific guidance should be provided to meet the special needs of such enterprises and the users of their general purpose financial statements. The terms of reference for this project are set out in the Foreword to this Report.

Chapter 1 provides an overview of the financial reporting environment in which rate-regulated enterprises operate. Chapter 2 examines the nature of rate regulation. Chapter 3 considers the differing viewpoints on accounting by rate-regulated enterprises that have been proposed and explains the approach the Study Group considers the most appropriate and the reasons for its decision. Chapter 4 then reviews accounting standards and financial reporting practices in Canada and elsewhere, and assesses what further accounting guidance should be provided.

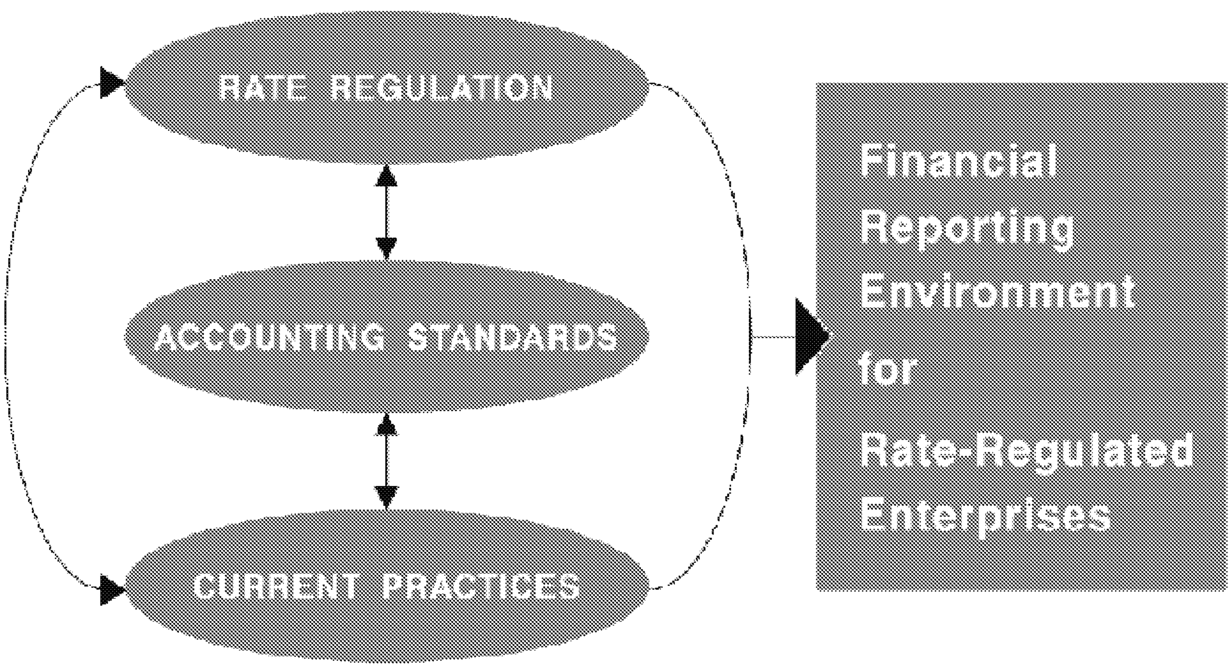
Using the financial reporting environment as the foundation, Chapter 5 discusses whether regulatory authorities can establish GAAP, the relationship of rate regulation to accounting, and the circumstances under which the effects of rate regulation should be reported in general purpose financial statements. Chapter 6 examines the criteria an enterprise must meet to qualify as rate-regulated for financial reporting purposes. Chapter 7 proposes general principles for financial reporting by rate-regulated enterprises in the private sector and Chapter 8 assesses whether those general principles should also be applied to rate-regulated enterprises in the public sector. Chapter 9 illustrates how the general principles can be applied to specific accounting and financial reporting issues.

Several appendices supplement the discussions contained in this Research Report. Appendix A compares the conceptual frameworks in Canada and the United States. Appendix B presents the results of a survey of current disclosure practices by industry and is supplemented by Appendix C, which presents selected illustrative financial statement disclosures. Appendix D reports on a survey of public sector practices. Appendix E provides an overview of rate regulation in the electric power industry. A glossary of terms and a selected bibliography are also included.

FINANCIAL REPORTING ENVIRONMENT

To address accounting and reporting issues pertinent to rate-regulated enterprises, it is important to understand the financial reporting environment in which they operate. Exhibit 1.1 depicts that environment as having three components: rate regulation, accounting standards and current reporting practices. Each of the components interacts significantly with the others. For example, rate regulation can impose requirements that affect accounting and financial reporting. In turn, this will be reflected in the reporting practices of rate-regulated enterprises. The following provides an overview of the three components (they are discussed further in Chapters 2, 3 and 4).

Exhibit 1.1



Rate Regulation

"Rate regulation" is the restriction in the setting of prices that can be charged to customers for services or products. From an economic perspective, rate regulation can have a direct bearing on the economic resources, obligations and performance of a rate-regulated enterprise. Traditionally, rate regulation has been imposed on essential public services where competition was considered inadequate to protect customers; for example, electric utilities, gas distribution utilities, pipelines, telecommunication companies and transportation companies. In some of these industries, there has been a trend to increasing competition and the removal of rate regulation or movement from cost-based to performance-based rate regulation. This raises questions about whether accounting for the effects of rate regulation will continue to be a significant issue, whether separate accounting standards are warranted for rate-regulated enterprises, and whether such standards should apply equally to the private and pubic sectors. 1(2)

Accounting Standards

Accounting standards and current practices in Canada recognize that, in certain circumstances, rate regulation can affect the future economic benefits and obligations that should be reported in the financial statements. In fact, the *CICA Handbook – Accounting* establishes the criteria that an enterprise must meet to be considered "rate regulated" for financial reporting purposes. 2(3) Unlike the situation under US standards, however, there are relatively few situations where the guidance provided in the *CICA Handbook – Accounting* is specifically directed at rate-regulated enterprises. Consequently, the practice of looking to US standards for guidance has developed. 3(4)

Generally Accepted Accounting Principles

In July 2001, the Accounting Standards Board (AcSB) issued an exposure draft on "Generally Accepted Accounting Principles," a proposed new *Handbook* Section that will describe what constitutes GAAP and its sources. These sources are divided into three levels — Board pronouncements (Level 1), Board authorized pronouncements (Level 2) and other sources of GAAP (Level 3). This proposed new Section addresses the relative status and authority of *Handbook – Accounting* italicized Recommendations, non-italicized paragraphs and appendices, Accounting Guidelines (Level 1), Abstracts of Issues Discussed by the Emerging Issues Committee, board-authorized implementation guidance (Level 2), and other sources of GAAP, such as US (FASB) Financial Accounting Standards and International Accounting Standards, prevalent practice, generally or within a particular industry, and Canadian research reports and studies (Level 3). It includes explanatory paragraphs to help a reader understand where to look fr guidance, especially when the *Handbook* is silent.

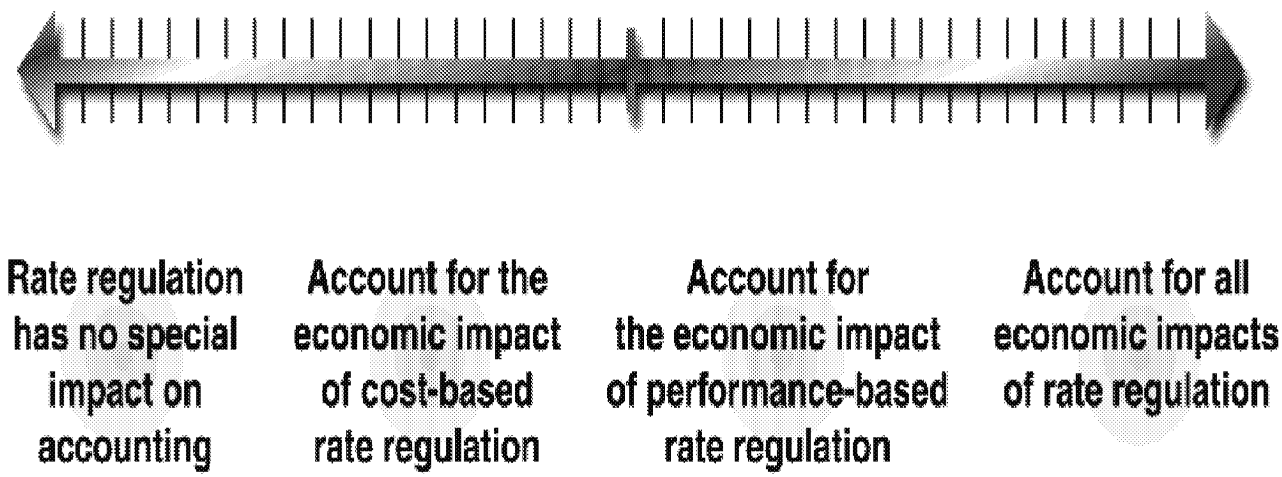
The AcSB therefore proposes removing the existing coverage of generally accepted accounting principles in paragraphs .59 and .60 of "Financial Statement Concepts," *Handbook* Section 1000. In light of the clearer definition of GAAP, the AcSB also proposes removing paragraph 1000.61 and paragraph .06 of "General Standards of Financial Statement Presentation," *Handbook* Section 1500, which deal with a departure from *Handbook* Recommendations, and to revise *Handbook* Section 1500, primarily to update the requirements and clarify that anything required by GAAP must be incorporated in the financial statements, which includes notes and supporting schedules.

WHY IS GUIDANCE NEEDED?

Widely diverging views have been expressed on the need for the differential treatment in the application of GAAP to rate-regulated enterprises. Exhibit 1.2 outlines the major views as a continuum, with the mileposts reflecting some common points. To keep pace with the new forms of rate regulation, practice is evolving. What is considered to be current practice is approximated by the mid point on the continuum.

Exhibit 1.2

VIEWS ON THE NEED FOR DIFFERENTIAL TREATMENT



There is no special impact of rate regulation for which to account

According to this view, rate regulation does not have an economic impact that should be reported in the financial statements. Those holding this view maintain that accounting for any perceived impact of rate regulation distorts the financial statements and may result in artificial income smoothing.

Account for the economic impact of cost-based regulation

According to this view, there are economic impacts of rate regulation that should be reported in financial statements, but only where rates are cost based. Those holding this view maintain that this is consistent with existing Canadian and US accounting standards that encompass the reporting of economic benefits (regulatory assets) and economic obligations (regulatory liabilities) by rate-regulated enterprises. They would prefer to maintain the status quo. In other words, entities meeting the definition of "rate-regulated enterprise" in various sections of the Handbook would normally report regulatory assets and liabilities resulting from cost-based rate regulation.

Account for the economic impact of performance-based regulation

This view is similar to the one above, except that it would also encompass the impacts of performance-based regulation. Those holding this view maintain that, in many cases, performance-based regulation is essentially cost-based.

Account for all economic impacts of rate regulation

According to this view, if the actions of a regulator have an economic impact on an enterprise, that economic impact should be reflected in the general purpose financial statements, regardless of the method of regulation employed. Those holding this view maintain that the rate-setting process can affect future revenues and, thereby, create future economic benefits and obligations.

Survey of Canadian Rate-regulated Enterprises and Canadian Practice

Given the alternative views regarding the need for the differential treatment in the application of GAAP to rate-regulated enterprises and to investigate the extent to which rate-regulated enterprises are still prevalent, the following work was undertaken:

- a survey of 25 rate-regulated enterprises across Canada providing hydro-electric, natural gas transmission and distribution, and telecommunications services; 4(5)
- a discussion group meeting of 10 individuals (six from rate-regulated enterprises, one regulator, one consultant to rate-regulated enterprises, an academic and a legislative auditor).

The August 1999 survey posed the question: "Is accounting for rate-regulated enterprises still a relevant issue in light of deregulation or incentive-based regulation?" In the opinion of those responding to the survey (there was a 40% response rate, that is, 10 responses), **the issue of accounting for rate-regulated enterprises is still very relevant**. The lack of response from representatives in the telecommunications industry indicates, however, that it may no longer be a relevant issue in that particular industry because deregulation is occurring.

The discussion group, which met in October 1999, unanimously agreed that **accounting for rate-regulated enterprises is still a relevant issue**. When industry representatives were asked whether they would be concerned if the exceptions for rate-regulated enterprises were removed from the *Handbook*, they indicated that such removal would be a significant issue for their enterprises.

As part of the above-noted survey, a second question was asked: "What are the significant accounting issues in your enterprise?" Survey respondents identified several significant issues: the definition of rate-regulated enterprises (or activities); the use of accrual versus cash basis of accounting; comparability and consistency of information reported by rate-regulated enterprises; and variations in the application of GAAP. With respect to the need for guidance, they identified a number of significant concerns about accounting for fixed / capital assets, income taxes, intercompany gains and losses, employee future benefits, foreign exchange and financial instruments.

At the above-noted discussion group meeting, all those present confirmed the significance of the accounting concerns raised in the survey. They felt that a research project would be extremely useful for anyone involved with accounting for rate-regulated enterprises, including the enterprises themselves, regulators, auditors, academics and those providing consulting services to such enterprises. Such a project would consider whether the differential treatment provided in the *Handbook* is still relevant and also provide guidance on how the accounting recommendations in the *Handbook* should be applied to rate-regulated enterprises.

While there is a move to allowing competition and relying on competitive forces to replace rate regulation, the prevailing view is that there will continue to be natural monopolies that require rate regulation, at least for the foreseeable future. Monopolies that will continue to be subject to rate regulation represent a significant portion of the Canadian economy. For example, electric transmission and distribution in Québec have an investment base in the range of $23 billion. It was noted that rate regulation has traditionally been, and will continue to be, a necessary instrument for governments to ensure "just and reasonable rates" where effective competition does not exist.

With respect to deregulation, it was observed that:

- Only specific business activities or services of a utility are being deregulated.
- Even with deregulation in some sectors, many monopolies still exist.
- The utilities industry in Canada is facing different forms of regulation as opposed to deregulation.

With respect to incentive-based regulation, it was observed that:

- Incentive-based regulation retains most elements of cost-based regulation and cost recovery from the customer.
- Incentive-based regulation is a variation of cost-of-service regulation, which allows an entity to earn more than its allowed rate of return if it is able to reduce its costs, but increases the risk that it will earn less than its allowed rate of return if it is unable to

manage its costs.

- Accounting issues that are relevant under regulation are still present in incentive-based regulation.

In summary, guidance is needed on accounting for rate-regulated enterprises because:

- Regulation has an impact on what a regulated enterprise reports in its financial statements because rate regulation can create assets and liabilities, and can affect an enterprise's cash flows and what should be reported in accordance with GAAP.
- There is no clear distinction between accounting principles used for rate-setting purposes (sometimes referred to as "regulatory accounting principles" or "RAP") and generally accepted accounting principles or "GAAP".
- There is little specific guidance in Canada on accounting by regulated enterprises, and what is available is somewhat dated.

Other Steps Taken by the Study Group in the Preparation of This Report

In addition to the survey of Canadian rate-regulated enterprises and practice referred to above, other steps taken during the preparation of this report were as follows:

- Reviewing Canadian and US accounting standards and other accounting literature on this subject.
- Monitoring any developments in the United Kingdom on this subject.
- Holding informal discussions with staff at the US Governmental Accounting Standards Board (GASB) regarding US standards and practice on this subject (particularly as they relate to US public sector rate-regulated enterprises).
- Having one of the Study Group members present its preliminary findings at the 2000 conference of legislative auditors.
- Distributing an "associates draft" to colleagues of Study Group members and other interested parties for their comment. The Study Group distributed 34 copies of the draft and received and analyzed 19 responses. Those who responded included rate-regulated enterprises' staff and their auditors, other representatives from public accounting firms, legislative auditors, provincial comptrollers, and consultants in the area of rate regulation.
- Undertaking a survey of federal, provincial and territorial comptrollers regarding current financial reporting practices of public sector rate-regulated enterprises within their jurisdiction. Excerpts from their responses are set out in Appendix D.

CONCLUSION

This chapter states the objective of this research project and sets out an outline of the report. It assesses whether accounting for the effects of rate regulation is still a relevant issue and whether there is a need for guidance.

In the Study Group's view, 5(6) 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

RATE REGULATION IN CANADA

Rate regulation can have a direct bearing on the economic resources and performance of a rate-regulated enterprise. There are a number of basic methodologies and applications that vary with the regulator, the entity being regulated and the circumstances faced.

INTRODUCTION

Chapter 1 of this Research Report concluded that 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. Furthermore, more specific guidance is needed on the application of GAAP to rate-regulated enterprises to meet the needs of both preparers and users of their general purpose financial statements.

Developing appropriate guidance requires a sound understanding of the financial reporting environment in which rate-regulated enterprises currently operate. As noted in Chapter 1 (Exhibit 1.1), that environment encompasses rate regulation, accounting standards and current reporting practices. In this chapter, the Study Group examines the first of these components. It defines "rate regulation" and explains the basic rate-setting processes and methodologies being used in Canada.

RATE REGULATION — WHAT IT IS AND HOW IT OPERATES

Rate regulation is the restriction in the setting of prices that can be charged to customers for services or products. Under rate regulation, an enterprise's rates are established by, or are subject to approval by, a regulator.

The goal of rate regulation is to set "just and reasonable rates." Generally, rate regulation is imposed where an enterprise has a monopoly or a dominant market position that gives it excessive market power. In such situations, there is a lack of effective competition to constrain the prices that the enterprise can charge. To compensate, governments impose rate regulation.

In most cases, governments impose rate regulation by creating legislation setting up a regulatory authority and giving it jurisdiction to approve the rates of specific enterprises or categories of enterprises (for example, electric distribution utilities). Enterprises falling within the jurisdiction of the regulatory authority are not allowed to charge prices other than those approved by the regulatory authority.

In Canada, both the federal and provincial governments have created regulatory authorities. Whether an enterprise is subject to federal or provincial authority depends on whether its activities are deemed to fall under federal or provincial jurisdiction. For example, telecommunications fall under federal jurisdiction. Telecommunications enterprises that are subject to rate regulation are within the jurisdiction of the Canadian Radio-television Telecommunications Commission (CRTC), which was created under federal legislation. Electric power distribution falls under provincial legislation. Electric distribution utilities subject to rate regulation are within the jurisdiction of provincial regulators, such as the Alberta Energy and Utilities Board. 1(7)

The norm is for a government to create a separate regulatory authority. A government may regulate rates through other means, however, such as empowering the governing body of government-owned utilities to set rates in accordance with a statute. For example, prior to the restructuring of the Ontario electric power industry, the board of directors of Ontario Hydro was given statutory authority to set rates for the utility that would allow it to recover the costs of providing services to customers. 2(8)

In the past, rate regulation tended to be applied to an entire organization. With acquisitions, diversification and deregulation, rate regulation may be applied to only a portion of an organization's operations. In some cases, an organization may have both regulated and non-regulated operations, and the regulated operations may be subject to the authority of different regulators.

There is no universal method of rate regulation. The rate-setting process and the application of that process can vary from one jurisdiction to another. Within a jurisdiction, it can vary from one enterprise to another. In addition, rate regulation is constantly evolving.

Rate-setting Processes

Traditionally, regulatory authorities have convened public hearings to review the rate applications of large utilities. After the utility prepares a submission setting out its proposed rates, and the support for those rates, the regulatory authority may decide to hold a hearing. Usually, three to five members of the regulatory authority form a panel to preside over these proceedings. Prior to the public hearing, the regulatory authority and other interested parties, called "interveners," submit written questions, to which the regulated enterprise must respond.

The questions deal with clarification of the regulated enterprise's submission.

Interveners may also make a submission and, where they do so, they must also respond to written questions from the regulated enterprise, the regulatory authority and other interveners. At the public hearing, any individual who has made a submission on behalf of the regulated enterprise must submit to cross-examination under oath by lawyers representing interveners or, in the case of submissions on behalf of an intervener, lawyers representing the regulated enterprise or other interveners. In some cases, the witnesses may be cross-examined by the members of the regulatory panel. After the hearing is completed, the members of the panel make a decision based on the submissions, the response to the written questions and the testimony given at the public hearing.

As an alternative to a public hearing, a regulatory authority may have a "paper hearing." This is similar to the above process, except that there is no hearing. The regulated enterprise and interveners make written submissions, submit written questions and provide written responses. Based on this written documentation, the regulatory authority makes a decision.

There is currently a trend to negotiated settlements. The regulated enterprise and representatives of its customers negotiate allowed rates, or at least issues that affect the determination of allowed rates. Issues that cannot be settled by negotiation go to the regulator for resolution. Also, the regulator must approve any settlement.

The negotiation process is intended to be more informal and less adversarial than the normal regulatory process. It is expected to be less costly and offers the opportunity for better settlements. In the hearing process, the regulated enterprise and other interested parties put their position to the regulator, who then renders a decision based on the evidence presented. With a negotiated settlement, the regulated enterprise can negotiate rates with the other interested parties, which offers the opportunity for a settlement that is preferred by all parties.

Rate-setting Methodologies

The legislation empowering a regulatory authority usually provides little direction on how rates are to be established, except that the rates must be "just and reasonable" or a similar general statement. Usually, regulatory authorities have significant discretion in deciding the regulatory methodology that will be used in setting allowed rates and how that methodology will be applied.

There are a number of basic regulatory methodologies and, for each, there can be applications that vary with the regulator, the entity being regulated and the circumstances faced. In some cases, a specific rate must be charged; in other cases, a maximum limit is set on the rates.

In the past, the primary regulatory methodology for the major utilities was "cost-of-service" regulation, also referred to as "return-on-rate-base" regulation. Under this approach, rates are set to give the utility the opportunity to recover its costs of providing service plus a fair return.

In recent years, however, there has been a trend to performance-based regulatory methodologies, such as price-cap regulation. With price-cap regulation, initial rates often reflect the cost of service, but are allowed to increase, or are required to decrease, in accordance with a formula over time.

The following provides a brief description of the most common rate-setting methodologies:

- cost of service / return-on-rate base;
- price cap;
- revenue cap;
- hybrid price cap / cost of service;
- benchmarking.

Cost of Service / Return-on-Rate Base

Under cost-of-service regulation, the rates are set to provide a rate-regulated enterprise the opportunity to recover its costs and earn a return on its investment. The regulator establishes the revenues required to cover the expected cost of providing the regulated service, including a fair return on the investment in the regulated operations. This amount is called the "revenue requirement." The regulator then sets rates that will provide the enterprise with a reasonable opportunity to recover its revenue requirement. Exhibit 2.1 shows the equation that is frequently used to determine the revenue requirement.

Exhibit 2.1

DETERMINING THE REVENUE REQUIREMENT

Operating, Maintenance and Administrative Costs (OM&A Costs)

+

Allowed return on investment (rate base)

=

Revenue Requirement

OM&A costs include all office and field operating costs, various taxes, including income taxes, and depreciation. This component of the cost of service is merely a sum of the costs for the period, usually one year. The allowed return is intended to cover interest expense and provide a fair return on equity. It is equal to the allowed rate of return times the investment in regulated operations, which is referred to as the "rate base." The allowed return reflects the cost of debt and a return on equity. The cost of debt is based on the actual debt outstanding plus the forecast cost of any proposed debt issues for the year. The return on equity is based on what investors require on non-regulated investments of similar risk. Exhibit 2.2 presents a simplified example of the allowed return calculation.

Rates may be set for a short period, such as a year, or may be set until changed. In the latter case, the enterprise seeks new rates when existing rates will not allow it to recover its costs and earn a fair return. Alternatively, the regulator may seek a rate review when allowed rates are considered excessive. As a result, a regulated enterprise's actual return is usually close to its allowed return.

Exhibit 2.2

ALLOWED RETURN CALCULATION

	Amount	Ratio		Cost Rate		Cost
Component	($ millions)					
Long-term debt		70%	X	10%	=	7.0%
Common equity			X	15%	=	4.5%
	200					**11.5%**
Rate Base	**200**					

In this example, the rate-regulated enterprise would have a deemed or actual common equity ratio of 30%, an allowed rate of return on common equity of 15%, and a rate of return on rate base of 11.5%.

Using the example above, if actual revenues and costs equal forecast costs (including a fair return), the following would be the financial statement results:

If the rate base is $200 million, then net income would be:
$200 million x 30% x 15% = $9 million

Interest expense would be:
$200 million x 70% x 10% = $14 million

If OM&A costs are $60 million, then revenues would be:
$60 million + $9 million + $14 million = $83 million

The return on rate base would be:
$200 million x 11.5% = $23 million (or $9 million + $14 million)

With cost-of-service regulation, there is a direct link between the costs that an enterprise is expected to incur and its expected revenue — rates are set to allow the enterprise to recover its expected costs. Although regulators may follow GAAP in determining the amount of any specific cost to be included in the cost of service, it is not always the case. Regulatory authorities may decide that additional considerations are appropriate in setting "just and reasonable" rates, for example:

- *Cost deferral*
  Where certain specific costs are subject to material variation, are difficult to predict and are largely outside the control of management, a regulator may require a regulated enterprise to place the difference between the expected and actual amount of those costs in a deferral account. The amount in the deferral account may then be used to increase or decrease the future revenue requirement. This results in a portion of the costs (or cost savings) of one period being included in the revenue requirement of another. In some cases, deferral balances may be refunded or recovered in a lump sum and the revenue requirement is not adjusted.
- *Rate smoothing*
  To avoid rate fluctuations or to smooth out an increase in rates, a regulator may defer costs (or cost savings) with the deferred amount to be reflected in future rates.
- *Cost disallowance*
  Where a regulator decides that a cost was not prudently incurred, it may disallow all or part of the cost, thereby reducing (or eliminating) any future recovery of that cost.

In most cases, where a regulator decides to defer the recovery of a cost, it is assumed that the regulated enterprise will recover that cost. With rates set below what would be recoverable in an unregulated market, the enterprise can usually collect any increase in rates required to recover the deferred cost.

Price Cap

With price-cap regulation, prices are capped, with the capped rates changing each period in accordance with a formula. In its simplest form, rates are allowed to increase by a percentage amount equal to the rate of inflation less a productivity factor. Where the measure of productivity is greater than the rate of inflation, rates must be decreased.

Increase in allowed rates = Inflation – Productivity

The formula may include provision for what is sometimes referred to as a "Z" or exogenous factor. This is an adjustment for costs or cost savings not covered by the basic formula. Generally, amounts covered by the "Z" factor must be material and outside the control of management. A common example is an unexpected change in income tax rates. If income tax rates increase, the rates of the rate-regulated enterprise are allowed to increase beyond what would be allowed by the formula to cover the increase in this cost. The "Z" factor recognizes the difficulty in developing a simple formula that will deal with all economic and other events.

The price-cap methodology may contain deferral accounts. As noted above under cost-of-service regulation, these accounts deal with specific costs that vary significantly, are difficult to predict or are largely outside the control of management. Differences between the expected and actual level of the costs are placed in a deferral account and recovered through an increase in future rates or used to reduce future rates.

With price-cap regulation, there are usually periodic reviews of the formula to ensure that the resulting rates are just and reasonable. These reviews are undertaken every three to six years. The reviews may result in an adjustment to the base rates and/or the formula for increasing (decreasing) rates. In some cases, the formula may have an "off ramp" that will allow for an early review under specific conditions. As with the "Z" factor, the "off ramp" recognizes that a simple formula cannot deal with all possible situations.

It has been argued that price-cap regulation breaks the link between rates and costs; rate increases are based on the price-cap formula and not on changes in the costs of the regulated enterprise. There is rarely a complete break, however, between rates and costs. For example:

- Initial rates will often reflect the cost of service.
- The price cap formula is usually intended to reflect reasonably expected changes in costs.
- In the periodic reviews, rates will often be evaluated against the cost of service.
- The "Z" factor allows for changes in rates to reflect costs, or cost savings, not covered by the price-cap formula.
- Deferral accounts result in an adjustment in rates to reflect differences between the expected and actual level of specific costs.

Revenue Cap

Revenue-cap regulation is essentially the same as price-cap regulation, except that revenues are capped rather than rates (that is, revenues are allowed to increase at a rate equal to inflation less productivity). With price-cap regulation, prices are regulated and total revenues will fluctuate with changes in demand. With revenue-cap regulation, total revenues are regulated and prices will fluctuate with changes in demand. For example, with price-cap regulation, an increase in demand will result in an increase in total revenues whereas, with revenue-cap regulation, rates would fall.

Revenue-cap regulation is applied where costs are essentially fixed. In some cases, the formula may require an adjustment factor to deal with the expected changes in variable costs in response to expected changes in demand. As with price-cap regulation, there is usually not a complete break between rates and costs.

Hybrid — Price Cap / Cost of Service

The hybrid methodology is a modification of the price-cap and cost-of-service methodologies. Rates are set in accordance with a price-cap formula. At the end of the year, the actual return on equity is compared to the allowed return on equity. A portion of earnings in excess of that allowed must be returned to customers through a reduction in future rates. In some cases, a portion of any earnings below those allowed is shared with customers through an increase in future rates. The hybrid methodology increases the link between allowed rates and costs, since a portion of cost savings (and in some cases, cost overages) are passed on to customers through adjustments to future rates.

Benchmarking

With benchmarking, rates are based on prices, or costs, of other organizations. They may be the prices of non-regulated enterprises or regulated enterprises. The use of benchmarking is limited by the difficulty in finding comparable enterprises and situations against which to benchmark rates. Also, the prices against which rates are benchmarked may not be just and reasonable.

The use of rates charged by other regulated enterprises poses additional problems. In effect, the regulator grants rate-setting authority over the enterprise to the regulator of the enterprises against which rates are benchmarked. With benchmarking there is a break between rates and costs, at least the costs of the regulated enterprise.

CONCLUSION

In this chapter, the Study Group defines what is meant by "rate regulation," and discusses the various processes and methodologies that may be used.

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

ACCOUNTING FOR RATE REGULATION

Views differ on whether, and, if so, the extent to which, differential accounting by rate-regulated enterprises should be permitted. This chapter considers those differing views and sets out the Study Group's view on the approach that should be taken.

INTRODUCTION

Chapter 1 noted that there were differing views on the need for differential treatment in the application of GAAP to rate-regulated enterprises. The major views were set out as a continuum in Exhibit 1.2. As a related issue, there are also differing views on the approaches that should be taken with respect to accounting by such enterprises. This chapter examines some of those approaches.

APPROACHES TO ACCOUNTING FOR RATE REGULATION

Approaches that could be taken with respect to accounting for rate-regulation include the following.

No Differential Treatment

Under this approach, rate-regulated enterprises would be required to follow GAAP as prescribed for other types of business enterprises. No differential treatment would be permitted.

Those supporting this viewpoint believe that the action of a regulator does not, in itself, provide compelling support for altering the timing of recognition of costs and revenues from that otherwise expected under GAAP. As far as they are concerned, no true economic difference exists between regulated and non-regulated enterprises, only a different source for how prices are determined.

In their opinion, it is questionable whether the financial statements, and in particular, the income statement, would truly reflect the operations for a particular period, since certain costs and revenues would not be recognized in the period in which they were incurred or earned. Any changes in rates made by the regulator to permit the recovery or return of such deferred amounts are, in their opinion, properly reflected in subsequent periods in which the revenues are actually received. It is noted that "the goal of accrual accounting for a business enterprise is to account in the periods in which they occur for the effects of transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable." 1(9) By permitting such transactions, events and circumstances to be reflected in a period in which they do not occur does not reflect the goal of accrual accounting.

Accounting for Rate Regulation Strictly Limited to Those Differences Specifically

Permitted

Under this approach, rate-regulated enterprises would follow GAAP tailored to their particular economic circumstances only where this is expressly permitted by the Accounting Standards Board (AcSB) or the CICA's Emerging Issues Committee (EIC).

Those who support this viewpoint maintain that the *Handbook* already provides comprehensive accounting standards for rate-regulated enterprises. The situations where differential accounting can be applied should be strictly limited to those where such a differential treatment is specifically permitted by an accounting standard in the *Handbook* or by an *Abstract* issued by the EIC. In their opinion, there are few fundamental differences between regulated business enterprises and non-regulated business enterprises. These differences can best be dealt with from a financial reporting point of view on a specific basis when determined necessary as part of the formal accounting standard-setting process.

Current industry practice goes beyond what would be permitted under this approach.

Canada-US GAAP Harmonization

Under this approach, the accounting standards followed by Canadian rate-regulated enterprises would be conformed to those issued by the US FASB.

The AcSB has, for the past few years, been working with major foreign standards-setting bodies toward the convergence of accounting standards. The goal of convergence is to develop a single set of internationally accepted accounting standards. Recognizing that international harmonization will take some years and that Canada's most important foreign market is the United States, the AcSB has also been working on a more accelerated basis to eliminate the major differences between Canadian and US GAAP.

In line with the AcSB's focus on harmonization, some maintain that US standards provide a useful basis for developing Canadian guidance on accounting for rate-regulated enterprises. They note that the US has already codified in standards (such as Statement of Financial Accounting Standards (SFAS) 71, 90 and 101) more principles related to accounting for regulated operations and, therefore, there is no need to re-invent the wheel — US standards should be adopted *verbatim*. Those holding this view maintain that the different business conditions and environment do not warrant a "made-in-Canada" solution.

It was also suggested that, in light of the AcSB's focus on harmonization, the project might review Canadian and US GAAP as it relates to rate-regulated enterprises. In this regard, an evaluation of similarities and differences could provide the basis for adopting US GAAP, except where the different economic environment dictated alternative accounting standards.

Codify Current Canadian Practice

Under this approach, GAAP for rate-regulated enterprises would be governed by current Canadian practice, which has evolved through application of existing *Handbook* sections, industry practice and US GAAP.

Those supporting this viewpoint have noted that a body of GAAP has already been established for rate-regulated enterprises through practices currently followed by such enterprises. In their opinion, these practices are compatible with the provisions of specific *Handbook* sections and reflect the economic impact of rate regulation. Appendix B to this Research Report presents the results of a survey of accounting and financial statement disclosure practices. It shows that almost all financial statements of rate-regulated enterprises recognize the impact of rate regulation and indicate that they are currently being prepared in accordance with GAAP. This suggests that the fundamental issue to be addressed in this Research Report is not **whether**, but **how** GAAP should apply to rate-regulated enterprises.

Current Canadian practice also recognizes the different economic environments in Canada and the US. For example, in the United States, income taxes are accounted for according to the liability method. When a rate-regulated enterprise recovers income taxes on a taxes payable basis, US GAAP permits a corresponding regulatory asset to be recorded, if appropriate. This results in an income statement that reflects the taxes payable charge and a balance sheet grossed up to record both the future taxes and the regulatory asset. This is of little consequence in the United States because balance sheet credits such as future taxes do not attract capital taxes. In Canada, however, future income taxes need not be recorded to the extent that they will be included in rates charged to customers in the future. If the US practice had been prescribed, rate-regulated enterprises would have been subjected to capital taxes.

It was suggested by those who support this approach that this Research Report project might review and codify existing Canadian practices, and then explain that the differential treatment in the application of GAAP merely reflect the economic consequences of the regulator's actions. Such consequences arise because the regulator may use a basis other than GAAP to measure the costs that are to be included in rates.

GAAP Followed by Rate-regulated Enterprises should be Governed by the Economic Impact of Rate Regulation

Under this approach, accounting standards would be included in the *Handbook* to explicitly recognize the economic impact of rate regulation.

Those who support this approach maintain that the consequences of the rate-setting process often create future economic benefits and obligations, which meet the criteria for the recording of assets and liabilities as set out in "Financial Statement Concepts," *Handbook* Section 1000. They maintain that any action of a rate regulator that has an economic impact on a rate-regulated enterprise should be reflected in the financial statements. In their opinion, an approach that permits no differences from GAAP followed by other business enterprises clearly does not recognize that the actions of a rate regulator often have an economic impact on the enterprise. This is, in their opinion, contrary to the basic accounting concepts set out in Section 1000. They do not agree that this approach is contrary to the requirements of the *Handbook*. In their opinion, it is, in fact, the approach required by Section 1000. Further, the *Handbook* specifically acknowledges that "no rule of genera application can be phrased to suit all circumstances or combination of circumstances that may arise." 2(10) The fact that the application of GAAP, in some situations, may be different simply reflects that statement.

APPROACH TO THE PROJECT

After concluding that guidance is needed on accounting for rate-regulated enterprises and considering the different approaches referred to above, the Study Group decided that a comprehensive foundation is called for. Having considered how rate regulation works (see Chapter 2), it was considered important to look at what current standards require and how the issues are being addressed in current practice in both Canada and the US (see Chapter 4); and what further accounting guidance should be provided in accordance with the mandate set out in the terms of reference for this project (see Chapter 5).

The Study Group also decided that it was essential to review the basic financial statement concepts set out in *Handbook* Section 1000 and the related FASB Concepts Statements in the US to determine whether differential treatment by rate-regulated enterprises is conceptually sound (see Chapter 5 and Appendix A). After all, according to Section 1000, it is expected that the financial statement concepts will be used by preparers of financial statements and accounting practitioners in exercising their professional judgment as to the application of GAAP and in establishing accounting policies in areas in which accounting principles are developing.

With that foundation, general principles could be developed for application to specific accounting issues and appropriate accounting guidance provided to rate-regulated enterprises in both the private sector and the public sector (see Chapters 6 to 9). Without that foundation, it might be very difficult to determine (much less justify) whether and how the impact of rate regulation should be reported under GAAP.

CONCLUSION

This chapter sets out and analyzes some of the approaches that have been suggested for accounting by rate-regulated enterprises. It also sets out the Study Group's views on the approach that should be undertaken. This approach is 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

ACCOUNTING STANDARDS AND FINANCIAL REPORTING PRACTICES

Rate regulation imposes requirements that can have an impact on accounting and financial reporting. In turn, this can have a direct bearing on the current reporting practices of rate-regulated enterprises.

INTRODUCTION

As previously noted, developing appropriate guidance on accounting for the effects of rate regulation requires a sound understanding of the financial reporting environment in which rate-regulated enterprises currently operate. In Chapter 2, the Study Group examined the first component of that environment — rate regulation. In Chapter 3, various approaches that could be taken with regard to accounting by rate-regulated enterprises were considered.

This chapter examines the second and third component of the financial reporting environment depicted in Chapter 1 (Exhibit 1.1) — accounting standards and current financial reporting practices. The first component, "rate regulation" was considered in Chapter 2. The primary focus of this chapter is on standards and practices in Canada and the United States, but the current situation in the United Kingdom is also considered.

ACCOUNTING STANDARDS AND FINANCIAL REPORTING PRACTICES

Canadian accounting pronouncements and practices recognize that, in certain circumstances, rate regulation can affect what should be reported in the financial statements. Accounting standards and practices in the United States also recognize the effects of rate regulation and provide considerable guidance to rate-regulated enterprises. In the United Kingdom, although accounting pronouncements do not address the effects of rate regulation, there is considerable 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.

Standards and Practices in Canada

In Canada, the *Handbook* establishes the criteria an enterprise must meet in order to be considered "rate regulated" for financial reporting purposes. When those criteria are met, the *Handbook* provides for differential treatment in the application of accounting standards to such enterprises.

"Income Taxes," *Handbook* Section 3465, paragraph .09, defines a rate-regulated enterprise as:

> an enterprise which meets all of the following criteria:
>
> (i) the rates for regulated services or products provided to customers are established by or are subject to approval by a regulator or a governing body empowered by statute or contract to establish rates to be charged for services or products;
>
> (ii) the regulated rates are designed to recover the cost of providing the services or products; and
>
> (iii) it is reasonable to assume that rates set at levels that will recover the cost can be charged to and collected from customers in view of the demand for the services or products and the level of direct and indirect competition. This criterion requires consideration of expected changes in levels of demand or competition during the recovery period for amounts recorded as recoverable under the rate formula.

The definition of rate-regulated property, plant and equipment in "Property, Plant and Equipment," *Handbook* Section 3061, paragraph .10, is the same, with the exception that, in the last sentence, "for amounts recorded as recoverable under the rate formula" is replaced by "for any capitalized costs."

The following differential treatment in the application of accounting standards to rate regulated enterprises is currently permitted or required in the *Handbook*:

1. "Consolidated Financial Statements," *Handbook* Section 1600, "Intercompany Gains and Losses," states:

    > Where a parent or subsidiary manufactures or constructs facilities for a regulated public utility in the consolidated group, any intercompany gain or loss is deemed to have been realized to the extent that the transfer price on such facilities is recognized for rate-making purposes by a government regulatory body (paragraph 1600.29).

2. "Property, Plant and Equipment," *Handbook* Section 3061, states:

    > For an item of rate-regulated property, plant and equipment, the cost includes the directly attributable allowance for funds used during construction allowed by the regulator (paragraph 3061.23).
    >
    > In determining the net recoverable amount of an item of rate-regulated property, plant and equipment, the enterprise considers the extent to which rates will provide for the recovery of the cost of the asset (paragraph 3061.46).

> For rate-regulated operations, the regulator may require the difference between net carrying amount and the proceeds on disposal of an item of property, plant and equipment to be considered in the determination of future rates charged to customers. In such circumstances the difference is deferred, provided there is reasonable assurance that: (a) any excess of net carrying amount over proceeds on disposal will be recovered through future rates; or (b) any excess of proceeds on disposal over net carrying amount will serve to reduce future rates (paragraph 3061.53).

3. "Income Taxes," *Handbook* Section 3465, states:

> *A rate regulated enterprise need not recognize future income taxes in accordance with the Recommendations of this Section to the extent that future income taxes are expected to be included in the approved rate charged to customers in the future and are expected to be recovered from future customers. If future income taxes are not recognized in accordance with the Recommendations of this Section, the rate regulated enterprise should disclose the following, in addition to the information to be disclosed in accordance with paragraphs 3465.91 and 3465.92:*
>
> *(a) the reason why future income tax liabilities and future income tax assets have not been recognized; and*
>
> *(b) the amount of future income tax liabilities, future income tax assets and future income tax expense that have not been recognized. (paragraph 3465.102)*

Pending further study of accounting for rate regulated enterprises as a whole, rate regulated enterprises are not required to record future income taxes for temporary differences that arise from assets and liabilities relating to their rate regulated activities to the extent that these future income taxes will be included in the rates charged to customers in the future and will be recoverable at that time as set out in paragraph 3465.102. (paragraph 3465.103)

Future income taxes would be recognized in accordance with the remainder of this Section to the extent that future income taxes are not expected to be included in the rates charged to customers in the future. In addition, a rate regulated enterprise that chooses to recognize future income taxes despite the expectation that they will be included in the rates charged to customers in the future would recognize all future income tax liabilities and future income tax assets in accordance with the requirements of this Section. (paragraph 3465.104)

4. "Interest Capitalized," *Handbook* Section 3850, states:

> This Section does not apply to interest capitalized by rate regulated enterprises as part of an allowance for funds used during construction when such enterprises disclose the allowance for funds used during construction in the period. (paragraph 3850.02)

In addition to the above-noted definition and differential treatment, the *Handbook* makes reference to "public utilities" in one other instance — "Segment Disclosures," Section 1701.

Paragraph 1701.18 discusses the aggregation criteria for reportable segments and states:

> Operating segments often exhibit similar long-term financial performance if they have similar economic characteristics. ... Two or more operating segments may be aggregated into a single operating segment if aggregation is consistent with the objective and basic principles of this Section, if the segments have similar economic characteristics, and if the segments are similar in each of the following areas:
>
> - The nature of the products and services.
> - The nature of the production processes.
> - The type or class of customer for their products and services.
> - The methods used to distribute their products or provide their services.
> - If applicable, the nature of the regulatory environment (for example, banking, insurance, or **public utilities**). (emphasis added)

With regard to accounting and reporting practices in Canada, Chapter 1 noted that a 1999 cross-industry survey identified several accounting issues that were significant for rate-regulated enterprises. In view of the large number of issues identified, and to assess the current state of accounting and financial reporting by rate-regulated enterprises, the Study Group undertook a survey of current practices in corporate annual reports. The survey spanned the years 1999 and 2000 and covered 25 rate-regulated enterprises in four sectors: electric, natural gas distribution, natural gas transmission and telecommunications. Appendix B to this Research Report presents the findings. It shows that, for the most part, the survey companies disclosed in notes to the financial statements:

- the names of the regulatory authority or authorities;
- accounting requirements prescribed for regulatory purposes;
- pertinent information on specific issues related to the economic impact of rate-regulation, for example, on income taxes and capital assets; and

- that general purpose financial statements are prepared in accordance with GAAP.

Standards and Practices in the United States

Principles to recognize the economic impact of rate regulation have been applied to US rate-regulated enterprises since at least 1962, when they were authorized by an addendum to *Accounting for the "Investment Credit,"* AICPA Accounting Principles Board Opinion 2. In 1982, *Accounting for the Effects of Certain Types of Regulation*, Statement of Financial Accounting Standards (SFAS) 71, formalized many of those principles, and also modified some of them.

Since its issuance, SFAS 71 has been the principal authoritative source of guidance on accounting and financial reporting requirements for rate-regulated enterprises in the United States. In addition, several other Statements have been issued over the years to provide guidance on specific topics. 1(11) These and other "authoritative pronouncements" issued by the FASB, its Emerging Issues Task Force (EITF), the AICPA and the staff of the Securities and Exchange Commission (SEC) are listed in Exhibit 4.1. For SFAS 71 and some of the more significant Statements, a brief commentary on their application to rate-regulated enterprises is provided below.

SFAS 71 provides guidance on preparing general purpose financial statements for most public utilities. Certain other companies with regulated operations that meet specified criteria are also covered. Although the business activities of utility companies are essentially the same as those of other companies that manufacture products or provide services, their regulated status creates operational and accounting situations that are peculiar to regulated companies. In this regard, SFAS 71 refers to the "economic dimension" that regulation brings to utilities and the need for accounting to reflect that dimension. In general, the type of regulation covered by SFAS 71 requires allowed rates (prices) to be set at levels intended to recover the estimated costs of providing regulated products or services, including the cost of capital.

According to SFAS 71, recovery of certain costs may be provided either before or after the costs are incurred. If regulation provides assurance that incurred costs will be recovered in the future, companies are required to capitalize those costs. If current recovery is provided for costs expected to be incurred in the future, companies are required to recognize a liability equal to the amount received.

A significant conclusion reached in SFAS 71 is that rate regulators can determine the timing of recovery of costs through rates and, therefore, can affect the value of assets and liabilities recognized in accordance with GAAP. Specifically, rate actions of a regulator can provide reasonable assurance of the existence of an asset and can also reduce or eliminate the value of an asset. Furthermore, rate actions of a regulator can impose a liability on a regulated enterprise. A regulator, however, cannot eliminate a liability that it did not impose.

Exhibit 4.1

ACCOUNTING GUIDANCE IN THE UNITED STATES THAT SPECIFICALLY RELATES TO RATE-REGULATED ENTERPRISES

FASB — Statements of Financial Accounting Standards (SFAS)

- SFAS No. 71, Accounting for the Effects of Certain Types of Regulation
- SFAS No. 90, Regulated Enterprises — Accounting for Abandonments and Disallowances of Plant Costs
- SFAS No. 92, Regulated Enterprises — Accounting for Phase-in Plans
- SFAS No. 98, Accounting for Leases (Application, Specific Aspects, Sale-Leaseback Transactions by Regulated Enterprises, paragraphs 58 & 59)
- SFAS No. 101, Regulated Enterprises — Accounting for the Discontinuation of Application of FASB Statement No. 71
- SFAS No. 109, Accounting for Income Taxes, paragraphs 57 & 58 (also, Basis for Conclusions, paragraph 125 and Application, Specific Aspects, paragraphs 252-255)
- SFAS No. 142, Goodwill and Other Intangible Assets (Amendments to Existing Pronouncements, Appendix D, item D8)
- SFAS 143, Accounting for Asset Retirement Obligations, paragraphs 19-21 (also, Basis for Conclusions, paragraphs B67-B73)
- SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets (Basis for Conclusions, paragraphs B59-B61)
- FASB Technical Bulletin No. 87-2, Computation of a Loss on an Abandonment

Emerging Issues Task Force (EITF)

- EITF Issue 91-6, Revenue Recognition of Long-Term Power Sales Contracts
- EITF Issue 92-7, Accounting by Rate-Regulated Utilities for the Effects of Certain Alternative Revenue Programs
- EITF Issue 92-12, Accounting for OPEB Costs by Rate Regulated Enterprises
- EITF Issue 93-4, Accounting for Regulatory Assets
- EITF Issue 96-17, Revenue Recognition under Long-Term Power Sales Contracts That Contain Both Fixed and Variable Pricing Terms
- EITF Issue 97-4, Deregulation of the Pricing of Electricity — Issues Related to the

Application of FASB Statements No. 71 and 101

Securities and Exchange Commission, Staff Accounting Bulletins (SEC SAB)

SAB 92 Accounting and Disclosures Relating to Loss Contingencies

- Topic 10-A, Financing by Electric Utility Companies Through Use of Construction Intermediaries
- Topic 10-B, Estimated Future Costs Related to Spent Nuclear Fuel and Nuclear Electric Generating Plants
- Topic 10-C, Jointly Owned Electric Utility Plants
- Topic 10-D, Long-Term Contracts for Purchase of Electric Power
- Topic 10-E, Classification of Charges for Abandonments and Disallowances
- Topic 10-F, Presentation of Liabilities for Environmental Costs

SFAS 71, paragraph 5, establishes three criteria for determining whether an entity is covered by the Statement:

- An enterprise's rates for regulated services must be established by or 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. 2(12)
- The regulated rates must be designed to recover the specific enterprise's costs of providing the regulated services or products.
- In view of the demand for the regulated services or products and the level of competition, it must be reasonable to assume that rates set at levels that will recover the enterprise's costs can be charged to and collected from customers.

Regulated Enterprises — Accounting for the Discontinuation of Application of FASB Statement No. 71, SFAS 101, requires that an enterprise whose operations cease to meet the specified criteria should discontinue application of SFAS 71. Generally, that discontinuation would be reported by eliminating from the rate-regulated enterprise's financial statements the effects of rate regulation. The carrying amounts of plant, equipment and inventory measured and reported pursuant to SFAS 71 should not be adjusted, however, unless those assets are impaired, in which case the carrying amounts of those assets should be reduced to reflect that impairment. The net effect of the adjustments should be included in income for the period of discontinuance and classified as an extraordinary item.

Regulated Enterprises — Accounting for Abandonments and Disallowances of Plant Costs, SFAS 90, acknowledges that regulators may partially or totally disallow construction costs from rate base and/or cost of service recovery. SFAS 90 states that, when it becomes probable that certain plant costs will be disallowed for rate-making purposes, and a reasonable estimate of the amount of the disallowance can be made, that amount should be recognized as a loss. Because of the increased cost of construction and lower demand than originally expected, US electric utilities abandoned plants under construction in the 1980s and, in many cases, regulators disallowed all or a portion of the costs. SFAS 90 requires that the cost of an asset should be removed from construction work in progress or utility plant in service when it becomes probable that the asset will be abandoned. To the extent that the cost of the asset will be recovered in future rates, a separate new asset is recorded. The value of the new asset is dependent upon the amount of return on investment, if any, that the regulator allows on the abandoned plant and the length of the recovery period. This amount is equivalent to the present value of the future revenues expected to be provided to recover the allowable cost of the abandoned plant. The recorded amount of the asset is adjusted as necessary if new information indicates that the estimates used to record the asset have changed and that adjustment is recognized in income as a loss or gain.

Regulated Enterprises — Accounting for Phase-in Plans, SFAS 92, noted that, at the time the Statement was issued in 1987, the cost of some plant construction had been significantly greater than in prior years. To moderate the initial rate increase when a newly completed plant went into service, some regulators had adopted phase-in plans. SFAS 92 applies to the construction of new plants. It defines a phase-in plan as any method of cost recovery for rate-making purposes that defers expense recognition beyond the period such costs would be charged to expense under GAAP applicable to enterprises in general. It essentially eliminated the recognition of phase-in plans for financial reporting purposes.

Some utilities enter into sale and leaseback transactions related to recently completed plants. SFAS 71 requires that the timing of expense recognition and the related amortization of a capital lease obligation and asset be modified to conform to the rate treatment of the lease payment. This generally results in a smaller amortization of the capital lease asset in the earlier years of a lease for a utility than would be recorded by a non-regulated enterprise. As a result, when a utility enters into a capital lease for a newly completed plant that is treated as an operating lease for rate-making purposes, the lease is considered a phase-in plan. For costs to be deferred under the plan, the SFAS 92 criteria must be met. Additionally, if the regulator has not allowed a return on the leased asset or the deferred amounts, this would be considered a disallowance and would be accounted for in accordance with the provisions of SFAS 90.

Accounting for Leases: Sale-Leaseback, Transactions Involving Real Estate, Sales-Type Leases of Real Estate, Definition of the Lease Term, and Initial Direct Costs of Direct Financing Leases, SFAS 98, effectively prohibits recognition of a sale in many sale-leaseback transactions. This is particularly true for nuclear power plants, in which the lessee / utility's continuing responsibility for nuclear decommissioning costs would prohibit sale recognition.

Accounting for Asset Retirement Obligations, SFAS 143, 3(13) applies to all entities and to legal obligations associated with the retirement of a tangible long-lived asset. If a reasonable estimate can be made, an entity must recognize the fair value of a liability for an asset retirement obligation in the period in which the obligation is incurred. If a reasonable estimate of fair value cannot be made at that time, the liability is to be recognized as soon as a reasonable estimate of fair value can be made. An asset in the same amount will also be established and subsequently allocated to expense using a systematic and rational method over its useful life. SFAS 143 acknowledges that, for rate-regulated enterprises, there may be a difference in the timing of the recognition of period costs for financial reporting and for rate-making purposes, and that it may be necessary to recognize a regulatory asset or liability with respect to such timing difference.

Accounting for the Impairment or Disposal of Long-Lived Assets, SFAS 144, applies to all enterprises, including rate-regulated enterprises. In most cases, rate-regulated enterprises currently operating under traditional cost of service rate-making principles and, therefore, continuing to meet the applicability provisions of SFAS 71 would also comply with SFAS 144. Paragraph 7 of this Statement requires that "an impairment loss shall be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable [that is, it exceeds the sum of the undiscounted cash flows expected to result from its use and eventual disposition] and exceeds its fair value." Rate-regulated enterprises are therefore required to charge a regulatory asset to earnings when and if recovery is no longer probable.

In summary, a number of authoritative pronouncements issued by the FASB in the US provide detailed guidance to regulated enterprises. They recognize that the economic impact of rate regulation should be reported in the general purpose financial statements of such enterprises. To qualify as a rate-regulated enterprise in the US, such enterprises must meet the criteria set out in SFAS 71.

Standards and Practices in the United Kingdom

In the United Kingdom, there are no specific accounting standards or guidelines for reflecting the effects of rate regulation on financial reporting. In other words, rate-regulated enterprises are obliged to follow the same accounting principles as non-rate-regulated enterprises in preparing their general purpose financial statements. In addition, they must prepare regulatory statements according to the requirements of the relevant regulatory authority. Often, regulatory accounting requirements vary significantly from GAAP for preparing general purpose financial statements.

"How does the existence of industry regulators with price-setting powers affect accounting practices in the telecommunications, gas, airports, electricity and water industries in the United Kingdom?" "What is distinctive about accounting for regulated industries?" These and other pertinent questions were addressed in the 1994 UK report, *Accounting for Regulation in UK Utilities*. 4(14) The principal issues identified in the report included the impact of privatization, the relative lack of conventions and standards surrounding current cost accounting and the special significance of accounts for price-setting purposes.

The report's principal research findings included the following:

- Regulatory accounting requirements vary significantly between the regulated industries.
- In addition to the regulatory or supplementary accounts prepared by the regulated companies, the regulators appear to keep their own sets of books which seem, at least in some instances, to unravel the effects of certain accounting choices made by the companies.
- Companies have used their discretion in accounting matters immediately before and after privatization to change some of their accounting policies and practices. In certain cases, particularly where there have been changes in asset lives and the basis for charging depreciation, the primary motivation was to bring policies more in line with those of other private sector companies.
- The difference in approach can be attributed to the different regulatory structures in the various industries, the different degree of media and public interest in them and the particular circumstances experienced by the industries during the period covered by the research.

The report recommended that:

- Regulatory standards should be issued by a body under the joint auspices of the Accounting Standards Board (ASB) and the industry regulators or by a body established by the regulators, in which case the standards should be approved by the ASB.
- There should be industry representation on the standard-setting body.
- Regulatory accounts should be brought within the aegis of the Financial Reporting Review Panel.

With regard to the lack of consistency in regulatory accounting, it has been observed that: 5(15)

- Although the regulator may be able to obtain consistent information from businesses by way of specific information requests, this source is not open to other stakeholders who must rely on published information. Informed comment on issues is difficult if regulated industries are not required to publish information in a consistent manner or if key values such as the regulatory asset base are not published at all.
- Accounting for regulation needs to be given a higher policy profile and be seen as an important part of the normal regulatory process, based on a comprehensive accounting framework. Accounting for regulation is important because regulation is designed to

achieve certain objectives. These regulatory objectives need to be clearly stated to, first, achieve a firm basis for public understanding and consent to the regulatory system as a whole and, second, to provide a framework for judging the performance of both regulators and regulated companies.

- Regulated entities in the UK support the preparation of Statements of Recommended Practice (SORPs) which may be developed for specialized industries, such as the regulated sector. The Accounting Standards Board (ASB) in the UK has recognized the requirement for accounting guidance for such specialized industries. For incidences where they have not developed such guidance, the SORP mechanism provides a means for an independent organization to develop specialized accounting guidance that carries a form of ASB endorsement. A SORP cannot override an accounting standard in the UK. The ASB has issued a policy for the development of SORPs, a fundamental feature being that the ASB will recognize bodies for the purpose of issuing SORPs. ASB-recognized bodies must, as a condition of recognition, agree to abide by the ASB's code of practice in producing SORPs. Furthermore, SORPs issued by ASB-recognized bodies will include a negative assurance statement from the ASB. As of January 2001, no SORPs had been issue for the various rate-regulated sectors in the UK.

In summary, there continues to be considerable interest and discussion in the UK about the need to develop a conceptual framework for accounting by regulated industries. It is viewed that, without a framework, the process of regulation will continue to be discretionary, rather than publicly accountable.

WHAT FURTHER GUIDANCE SHOULD BE PROVIDED?

By comparison to the United States, Canadian standards specifically address only a few issues. Consequently, the current reporting practices of Canadian rate-regulated enterprises may vary. Further, rate regulation is evolving rapidly (refer to the analysis in Chapter 2), and additional guidance is being sought on what constitutes GAAP for rate-regulated enterprises and how the *Handbook* requirements should be interpreted by them.

In this regard, the terms of reference for this project ask the Study Group to consider the following question: "Assuming that the Recommendations in the *Handbook* generally apply to rate-regulated enterprises, is differential treatment needed, due to their special circumstances?" The Study Group is of the opinion that rate regulation can influence rates that, combined with market conditions (demand and competition), can have an economic impact on current and future revenues and cash flows, thereby affecting assets (future economic benefits) and liabilities (future obligations). This is discussed further in Chapter 5. Accordingly, the potential economic impact of rate regulation warrants recognition in the general purpose financial statements of rate-regulated enterprises in accordance with GAAP.

In the Study Group's opinion, more guidance is needed, therefore, on the application of GAAP to the unique economic circumstances of rate-regulated enterprises. In this respect, the terms of reference call for the Study Group to suggest what type of guidance the CICA Accounting Standards Board should provide to meet the special needs of rate-regulated enterprises and the users of their general purpose financial statements.

In response to the terms of reference, the Study Group discussed various ways of providing such guidance, including:

- supplementary material to accompany applicable Sections of the *Handbook*;
- new accounting standard(s) with or without removing current differential treatment;
- one or more accounting guidelines; and/or
- making reference only to this CICA research report, when it is published.

The Study Group is of the opinion that general guidance on accounting for the effects of rate regulation should be issued as a new Section to the *Handbook*. The new Section would replace the material currently contained in the *Handbook*, including all of the differential treatments in the application of Accounting Recommendations that are identified in this chapter of the Research Report.

There are a number of reasons why a new *Handbook* Section is the preferred approach to proving guidance. First, accounting standards set out in a *Handbook* Section are at the top of the GAAP hierarchy and, therefore, are the most authoritative source for the exercise of professional judgment. Second, it is automatically subject to due process through exposure drafts for changes to accounting standards. Third, a conceptual framework is necessary to apply GAAP to rate-regulated activities. Fourth, such an approach is consistent with that taken in other situations, for example, insurance companies — a separate *Handbook* Section that deals only with the differential accounting treatments. Fifth, it would ensure that the AcSB considers consequential amendments whenever it is issuing or revising another standard.

In addition, following the traditional approach in developing accounting and reporting standards for rate-regulated enterprises could provide several benefits:

- It could help to minimize the possibility of Canada / US GAAP differences.
- It could facilitate comprehensive consideration, in one place, of issues facing rate-regulated enterprises.
- It could provide a means for disseminating detailed guidance, as needed, to financial statement preparers, auditors and users.

With respect to the nature of the guidance to be included in the new *Handbook* Section, the Study Group reviewed the financial statement concepts and general standards of financial statement presentation that underlie the development of accounting standards in Canada. 6(16) It also compared the conceptual accounting frameworks of Canada and the United States (refer to Appendix A to this Research Report). Because of the similarities in the conceptual frameworks of Canada and the United States, accounting standards in the United States also provide a useful source of reference for developing Canadian guidance on financial reporting by rate-regulated enterprises.

CONCLUSION

In this chapter, the Study Group completes its review of the current financial reporting environment within which rate-regulated enterprises operate. In the Study Group's view, accounting pronouncements 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.

The Study Group is of the opinion that general guidance on accounting for the effects of rate regulation should be issued as a new Section in the *Handbook*. 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.

With respect to the nature of the guidance to be included in the new *Handbook* Section, the Study Group is of the opinion that general principles should be established to provide a "framework" for applying GAAP to rate-regulated enterprises within the boundaries established by "Financial Statement Concepts," *Handbook* Section 1000. It is anticipated that the general principles will 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

RATE REGULATION AND FINANCIAL REPORTING

The manner in which rate regulation is applied, not its mere existence, is the pervasive economic factor that supports any modification in the application of generally accepted *accounting principles.*

INTRODUCTION

Chapter 2 of this Research Report reviewed the nature of rate regulation and how it operates in Canada. Chapter 4 noted that accounting pronouncements in Canada implicitly recognize that, in certain circumstances, rate regulation can affect what should be reported in the financial statements. In this regard, the Study Group proposed that a new Section be included in the *CICA Handbook – Accounting* to provide guidance on reporting the economic impact of rate regulation in financial statements.

The potential for rate regulation to create economic benefits and obligations raises two questions. Can regulatory authorities establish GAAP? Should the economic impact of rate regulation be reflected in the general purpose financial statements of rate-regulated enterprises and, if so, how? In this chapter, the Study Group addresses these and other interrelated matters.

RATE REGULATION AND ACCOUNTING PRINCIPLES

As previously noted in Chapter 1, the distinction between RAP (regulatory accounting principles used for rate-making purposes) and GAAP (generally accepted accounting principles set out in the *Handbook* for preparing general purpose financial statements) needs to be clarified. Accordingly, this chapter begins with brief explanations of RAP and GAAP and then considers whether regulatory authorities can establish GAAP.

Regulatory Accounting Principles

Regulatory authorities often prescribe the accounting principles and procedures that a regulated enterprise must follow for regulatory purposes. In some cases, they develop a detailed uniform system of accounts, while in other cases they make specific rulings dealing with specific costs as the need arises. These accounting principles and procedures are developed to support the calculation of allowed rates and to assist the regulatory authority in reviewing the periodic data submitted by the regulated enterprises. 1(17)

In most cases, the majority of the accounting principles and procedures prescribed by regulatory authorities are consistent with GAAP. The objective of regulatory reports differs, however, from the objective of general purpose financial statements. The key difference is that the regulatory reports are usually intended to support rate regulation.

For rate-making purposes, a regulatory agency may exclude certain of the regulated enterprise's costs. Excluded items typically arise from activities that are not subject to regulation or from projects or activities that the agency does not believe should be recoverable from customers through the rates they pay. On the other hand, a regulatory agency may include certain types of costs, but in different periods than they would be reflected in the general purpose financial statements of non-regulated businesses. In addition, as discussed in Chapter 2, a regulatory agency may include "return on equity" as part of "costs" for rate-making purposes.

Generally Accepted Accounting Principles (GAAP) 2(18)

GAAP is the term used to describe the basis on which financial statements are normally prepared. GAAP encompasses the conventions, rules and procedures necessary to define accepted accounting practices at a particular time. Pronouncements of the Accounting Standards Board, as set out in the *Handbook*, are the primary source of GAAP. When a matter is not covered by a Board pronouncement, the most relevant "other source of GAAP" referred to in the *Handbook* would be consulted.

Unless the basis of accounting used to prepare general purpose financial statements falls within the range of acceptable choices set out in the *Handbook*, it is unlikely to constitute GAAP.

CAN REGULATORY AUTHORITIES ESTABLISH GAAP?

As noted in Chapter 1, this research project is concerned solely with the effects of rate making on the application of GAAP to general purpose financial statements. In this regard, a key issue raised in the terms of reference is: "Can accounting prescribed by rate-regulating authorities be considered, in and of itself, GAAP for rate-regulated enterprises and, if so, to what extent?" In other words, can regulatory accounting principles (RAP) be considered "generally accepted" for purposes of financial reporting by rate-regulated enterprises?

The Study Group acknowledges that, for regulatory reporting purposes, the regulators have the authority to prescribe accounting principles for the enterprises they regulate. As is clearly indicated in the *Handbook*, however, such principles do not constitute GAAP. They are intended to support the calculation of allowed rates and to assist the regulatory authority in reviewing the periodic data submitted by the regulated enterprises. They are not intended to meet the objectives of general purpose financial statements.

Accounting for the Effects of Certain Types of Regulation, SFAS 71, paragraph 52, indicates that respondents to a Discussion Memorandum on this subject expressed the view that, "unless an accounting order indicates the way a cost will be handled for rate-making purposes, it causes no economic effects that would justify deviation from the generally accepted accounting principles applicable to business enterprises in general. The mere issuance of an accounting order not tied to rate treatment does not change an enterprise's economic resources or obligations. In other words, the economic effect of regulatory decisions — not the mere existence of regulation — is the pervasive factor that determines the application of generally accepted accounting principles." Paragraph 54 of that SFAS indicates that "the Board concluded that regulatory-prescribed accounting should not be generally accepted *per se*, but rather that the Board should specify how generally accepted accounting principles apply in the regulatory environment."

It has been argued that it would be onerous to require a regulated enterprise to maintain records necessary to prepare financial reports on two bases: one for the regulatory authority and another for the public. In the Study Group's experience, however, differences that exist currently between regulatory accounting principles and GAAP usually are not extensive in number, and adjustments to reconcile any differences should be simple to determine and apply.

In the Study Group's view, regulatory authorities cannot establish GAAP. Under statutory authority, the standards set out in the *Handbook* constitute GAAP. Although the actions of the regulator may affect rates, and the resulting economic impact may affect what should be reported in accordance with GAAP, this does not give regulatory authorities the authority to determine what should be considered in and of itself GAAP for financial reporting purposes by rate-regulated enterprises.

SHOULD THE IMPACT OF RATE REGULATION BE REPORTED?

There are differing viewpoints on whether the impact of rate regulation should be reported.

Impact of Rate Regulation should not be Reported

As noted in Chapter 3, there is a viewpoint that reporting the impact of rate regulation distorts the financial statements and may result in artificial income smoothing. There is also a concern that, in some situations, rate regulators are effectively transferring wealth to existing customers from future customers who are thereby required to absorb, through increased rates, costs incurred in a previous period. For example, rate regulators have, for rate-setting purposes, often prescribed that income taxes should be accounted for on the taxes payable basis. By failing to recognize a future liability for taxable temporary differences, as defined in "Income Taxes," *Handbook* Section 3465, paragraph .09, net income for the related periods is, in the opinion of those who express this concern, not properly reported. While rate regulators unquestionably have the authority to take such action for the purposes of setting rates, it should not be reflected in general purpose financial statements. Employee future benefits is another instance where, for rate-setting purposes, many regulators have required such benefits to be accounted for on a pay-as-you-go basis, whereas accounting standards require them to be accounted for in the period that gives rise to the benefit.

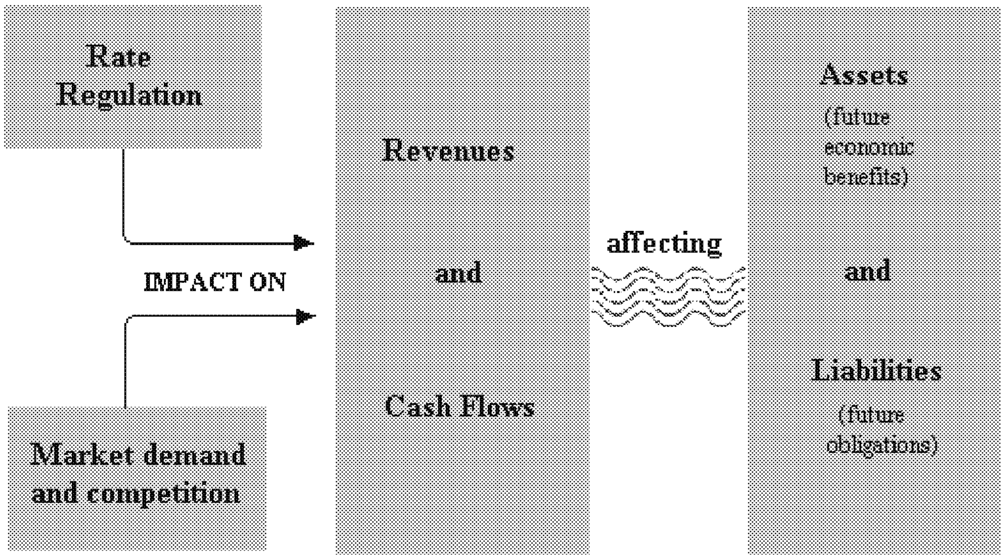
Impact of Rate Regulation should be Reported

The Study Group maintains, however, that, by restricting prices, rate regulation can affect the amount and timing of a rate-regulated enterprise's revenues. Within a period, the economic impact may be related to both current rates and future rates.

Exhibit 5.1 shows that rate regulation, when combined with market conditions (market demand

and competition), can have an economic impact on the revenues and cash flows of an enterprise, thereby affecting assets (future economic benefits) and liabilities (future obligations).

Exhibit 5.1



By changing future rates as a result of transactions or events in the current (or prior) period, rate regulation can create economic benefits and obligations. The benefits would be in the form of higher allowed rates and, therefore, higher revenues and cash flows. The obligations would be in the form of lower allowed rates and, therefore, lower revenues and cash flows. For example:

- A regulator employing cost-of-service regulation may decide that a cost that would normally be expensed in the current period will be deferred and included in the calculation of a future revenue requirement. Therefore, as a result of incurring the cost, the enterprise can expect to have an increase in future rates and an increase in future revenues and cash flows approximately equal to the amount of the deferred cost.
- A regulator may require that an enterprise share with its customers any earnings above a specified threshold. The sharing would be accomplished through a reduction in future rates. Therefore, as a result of having earnings above the threshold in the current period, the enterprise will be required to reduce rates and, therefore, cash flow, in a future period or periods.

A regulator cannot, however, eliminate a liability that it did not create, such as a liability to an enterprise's bondholders.

For rate regulation to have an economic impact, it must be effective, that is, it must restrict rates from what they would be in the absence of rate regulation.

- In the case of an economic benefit, future allowed rates sufficient to provide additional revenue equal to the benefit must be chargeable and collectible from customers. Otherwise, there is no economic benefit. Where market conditions or other factors restrict the rates that an enterprise can charge and collect from customers, the economic benefit would be limited to the additional revenues collectible from customers.
- In the case of an economic obligation, future allowed rates without the reduction to accommodate the obligation must be chargeable and collectible from customers. Where this condition is not met, a reduction in future allowed rates will not reduce revenues and, consequently, will have no economic impact. Therefore, from an economic perspective, where market conditions or other factors restrict the ability of an enterprise to charge and collect rates from customers, the economic obligation would be limited to the reduction in revenues collectible from customers.

Consequently, in the Study Group's opinion, there is no distortion or artificial smoothing where the economic benefits and obligations meet the definition of a financial statement element. On the contrary, a failure to report the economic benefits and obligations would distort the financial statements, at least in those cases where the recognition criteria are met.

Financial Statement Elements

"Financial Statement Concepts," *Handbook* Section 1000, paragraph .25, states that the "elements of financial statements are the basic categories of items portrayed therein in order to meet the objective of financial statements." 3(19) In defining the objective of financial statements, paragraph 1000.15, states that they provide information about:

- an entity's economic resources, obligations and equity / net assets;
- changes in an entity's economic resources, obligations and equity / net assets; and
- the economic performance of the entity.

Paragraph 1000.25 states that "there are two types of elements: those that describe the economic resources, obligations and equity / net assets at a point in time, and those that describe changes in economic resources, obligations and equity / net assets over a period of time. Notes to the financial statements ... are not considered to be an element." *Assets* and *liabilities*, *equity*, *income* and *revenues*, *expenses*, *gains* and *losses*, and *performance* (profit or *earnings*) are identified as the elements of financial statements.

Elements at a point in time — assets and liabilities

Paragraph 1000.29, defines *assets* as "economic resources controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained." In situations where a regulator allows an amount to be recovered through an increase in future rates as a result of a past transaction or event, the expectation of receiving that amount will meet the definition of an asset. The increase in rates represents an economic benefit in the form of higher revenues and cash flows. For example, if a regulator permits a cost that would normally be expensed in the period to be recovered in future rates, the rate-regulated enterprise will have an asset once it has incurred the cost. This is based on the assumption that future rates will be increased to provide additional revenues in an amount equal to the asset and that those higher rates will be recoverable from customers.

Paragraph 1000.32 defines *liabilities* as "obligations of an entity arising from past transactions or events, the settlement of which may result in the transfer or use of assets, provision of services or other yielding of economic benefits in the future." In situations where a regulator requires a decrease in future rates as a result of a past transaction or event, the resulting amount will meet the definition of a liability. The reduction in revenue represents the yielding of an economic benefit. For example, if a regulator requires that a portion of excess income be returned to customers through a decrease in future rates, the rate-regulated enterprise would have a liability once the excess income is earned. This is based on the assumption that future rates will be decreased to reduce revenues by an amount equal to the liability and that the rates (without the reduction) would be recoverable from customers.

Elements over a period of time — revenues, expenses, gains and losses

Section 1000 defines revenues, expenses, gains and losses as follows:

> *Revenues* are increases in economic resources, either by way of inflows or enhancements of assets or reductions of liabilities, resulting from the ordinary activities of an entity. Revenues of entities normally arise from the sale of goods, the rendering of services or the use by others of entity resources yielding rent, interest, royalties or dividends. (paragraph 1000.37)
>
> *Expenses* are decreases in economic resources, either by way of outflows or reductions of assets or incurrences of liabilities, resulting from an entity's ordinary revenue generating or service delivery activities. (paragraph 1000.38)
>
> *Gains* are increases in equity / net assets from peripheral or incidental transactions and events affecting an entity and from all other transactions, events and circumstances affecting the entity except those that result from revenues or equity / net assets contributions. (paragraph 1000.39)
>
> *Losses* are decreases in equity / net assets from peripheral or incidental

> transactions and events affecting an entity and from all other transactions, events and circumstances affecting the entity except those that result from expenses or distributions of equity / net assets. (paragraph 1000.40)

The Study Group is of the opinion that, if an economic benefit or obligation resulting from rate regulation meets the definition of an asset or liability, the **change** in the economic benefit or obligation would meet the definition of one of the elements that describes changes in economic resources, obligations and equity / net assets over a period of time. In this regard, revenues, expenses, gains and losses reflect the changes in the assets and liabilities of a rate-regulated enterprise, other than those that result from equity or net asset contributions. Furthermore, if an economic resource or obligation meets the definition of a financial statement element, the economic impact should be reported to meet the above-noted objective of financial statements.

Recognition Criteria

Paragraph 1000.41 states that "recognition is the process of including an item in the financial statements of an entity. Recognition consists of the addition of the amount involved into statement totals together with a narrative description of the item ... in a statement." It does not mean disclosure in the notes to the financial statements.

According to paragraph 1000.44, two criteria must be met before a financial statement element is recognized:

(a) the item has an appropriate basis of measurement and a reasonable estimate can be made of the amount involved; and

(b) for items involving obtaining or giving up future economic benefits, it is probable that such benefits will be obtained or given up.

The economic benefits and obligations created by rate regulation will, in most cases, meet the first criterion. Regulatory authorities generally provide clear direction as to the amount of an economic benefit or obligation, or the formula for determining the amount. For example, where recovery of a cost is deferred to a future period, the regulator will often state the specific amount that is being deferred.

In most cases, the second criterion will also be met. Regulatory authorities are usually consistent in their treatment of a rate-regulated enterprise. Generally, the decisions and past actions of a regulatory authority are a good indicator of what it will allow in the future. For example, if a regulator states that a cost will be deferred, it is highly probable that it will allow an increase in future rates to provide sufficient additional revenues to cover that cost. In addition, where a regulator allows an increase in rates to provide additional revenues, it is likely that the enterprise will be able to charge and collect those rates from customers. Similarly, where a regulator requires a decrease in rates to reduce revenues by a given amount, it is likely that the enterprise will have a reduction in revenues approximately equal to that amount. 4(20)

As explained in Chapter 2, what a rate-regulated enterprise is allowed to collect from customers (allowed revenues) is usually very close to what it actually collects (actual revenues). Because rate regulation is imposed to restrict rates where a rate-regulated enterprise has excessive market power, the enterprise can usually increase rates up to the amount allowed by the regulator. This assumption would not be valid where market conditions require rates below what the regulator allows. Where market conditions can effectively restrict rates, enterprises may be freed from rate regulation in those markets; if maintained, rate regulation would be ineffective.

In summary, the Study Group is of the opinion that 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 as set out in *Handbook* Section 1000. Where they also meet the recognition criteria set out in that Section, those elements should be reported in the general purpose financial statements of a rate-regulated enterprise as assets, liabilities, revenues, expenses, gains and losses.

As previously noted, the *Handbook* specifies two criteria that must be met before an element is recognized in the financial statements. Nevertheless, some would argue that economic benefits and obligations created by rate regulation should not be recognized in general purpose financial statements unless there is also a contractual commitment associated with them.

According to paragraph 1000.31, it is not essential that access to a benefit be legally enforceable for a resource to be an asset, provided an entity can control the benefit through other means. In the Study Group's view, an enterprise will have adequate control over the use of an economic benefit where it is probable that the regulatory authority will allow an increase in future rates sufficient to provide additional revenue at least equal to the benefit and it is probable that those rates will be recoverable from customers.

In discussing the characteristics of a liability, paragraph 1000.34 states that:

> Liabilities do not have to be legally enforceable provided that they otherwise meet the definition of liabilities; they can be based on equitable or constructive obligations. ... A constructive obligation is one that can be inferred from the facts in a particular situation as opposed to a contractually based obligation. 5(21)

The Study Group is of the opinion that a constructive obligation will exist where it is probable that a regulatory authority will require a reduction in future rates so as to reduce revenues by an amount equal to the obligation and it is probable that, without the reduction, rates would be recoverable from customers.

The Study Group also notes that contractual commitments are not required in recognizing other assets and liabilities reported in the financial statements. For example:

- The *Handbook* states that the value of an item of property, plant and equipment should be written down by the amount that its carrying value exceeds its net recoverable amount (paragraph 3061.38). In most cases, the net recoverable amount will be represented by future revenues, yet there is no requirement that there be a contractual commitment associated with those future revenues, or even an identification of the customers who will provide those revenues.
- The *Handbook* requires recognition of a future tax liability ("Income Taxes" *Handbook* Section 3465, paragraph .22) even though there is no legal liability to pay the taxes at the time they are recognized. The liability is based on an expectation of what the tax legislation will be at some future date.

CONCLUSION

In this chapter, the Study Group examines the relationship between rate regulation and financial reporting. It considers whether regulatory authorities can establish GAAP for rate-regulated enterprises and whether the effects of rate regulation should be reported in the general purpose financial statements of rate-regulated enterprises.

The Study Group is of the opinion that regulatory authorities cannot establish GAAP. Although the actions of the regulator 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.

Regardless of the rate-setting process or methodology used, it is the opinion of the Study Group that, 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.

In the Study Group's view, 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 *Handbook* Section 1000. Where they also meet the recognition criteria set out in that Section, 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

DEFINING A RATE-REGULATED ENTERPRISE

FOR FINANCIAL REPORTING PURPOSES

To qualify as a "rate-regulated enterprise" for financial reporting purposes, an organization must be subject to a rate-setting authority, the rates must be based on the costs of service and the rates must be collectible from customers.

INTRODUCTION

In Chapter 5, the Study Group concluded that the effects of rate regulation should be reported in the financial statements of a rate-regulated enterprise. But what constitutes a "rate-regulated enterprise for financial reporting purposes" (hereafter referred to as just "rate-regulated enterprise")? As part of the terms of reference for this research project, the Study Group was asked to consider the following:

- Is the definition in the *CICA Handbook – Accounting* ("Income Taxes," *Handbook* Section 3465 paragraph .09) sufficiently clear, or how should it be amended?
- What criteria must be met for an enterprise to be considered rate regulated?
- In setting accounting standards, should the Accounting Standards Board focus on rate-regulated enterprises *per se*, or on rate-regulated activities? 1(22)

In addressing these questions, the Study Group started with the existing definition of a rate-regulated enterprise in the *Handbook*. Where this definition is met, the *Handbook* currently provides for limited differential treatment in the application of accounting standards. Because of the similarities in both the conceptual frameworks and the economic environments of Canada and the United States, the Study Group concluded that accounting standards in the US provide a useful source of reference for developing Canadian guidance on financial reporting by rate-regulated enterprises. 2(23) Therefore, the Study Group also took into consideration what constitutes a rate-regulated enterprise under US GAAP and whether the existing definitions in Canadian and US accounting standards should be considered as synonymous.

It is important to note that meeting the definition of a rate-regulated enterprise is just the first step in regarding whether an enterprise is entitled to apply differential treatment in the application of accounting standards for recognizing the economic effects of rate regulation. Under the approach proposed by the Study Group, a rate-regulated enterprise must still meet the conditions embodied in the General Principles set out in Chapter 7 of this Research Report for recognizing assets, liabilities and the change in assets and liabilities as a result of rate regulation.

WHAT IS A RATE-REGULATED ENTERPRISE?

The *Handbook* and *Accounting for the Effects of Certain Types of Regulation*, SFAS 71, provide guidance, in Canada and the US respectively, for the preparation of general purpose financial statements by rate-regulated enterprises. As a first step in applying that guidance, an enterprise has to meet established criteria.

Meeting the criteria, however, does not necessarily mean that the rate-making process will have an economic impact that should be reported in the enterprise's financial statements. According to the *Handbook* (paragraph 3465.09), a rate-regulated enterprise is an enterprise that meets all of the following criteria [emphasis added]:

- The rates for regulated services or products provided to customers are established by or are **subject to approval by a regulator or a governing body** empowered by statute or contract to establish rates to be charged for services or products. (Criterion 1)
- The regulated rates are **designed to recover the cost** of providing the services or products. (Criterion 2)
- It is reasonable to assume that rates set at levels that will recover the cost **can be charged to and collected from customers** in view of the demand for the services or products and the level of direct and indirect competition. This criterion requires consideration of expected changes in levels of demand or competition during the recovery period for amounts recorded as recoverable under the rate formula. (Criterion 3)

Similarly, SFAS 71 states, in paragraph 5, that it applies to general purpose external financial statements of an enterprise that has regulated operations that meet all of the following criteria [emphasis added]:

- 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. (Criterion 1)
- The regulated rates are **designed to recover** the specific enterprise's **costs** of providing the regulated services or products. (Criterion 2)
- 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. (Criterion 3)

Under both definitions, an enterprise must meet all three criteria (and continue to meet them) to qualify as a rate-regulated enterprise for financial reporting purposes. The added emphasis highlights that an enterprise would qualify as a rate-regulated enterprise only if all three conditions are met, namely, it is subject to a rate-setting authority; the objective of rate regulation is to recover the costs of providing services; **and** the rates are recoverable from customers. At any point in time, if an enterprise fails to meet all three criteria, it would no longer apply the accounting recommendations applicable to rate-regulated enterprises. 3(24)

The following analysis explains, compares and discusses the application of the above-noted criteria to private sector enterprises (Chapter 8 considers the application of the criteria to public sector enterprises). On the basis of that analysis, it is the opinion of the Study Group that the *Handbook* adequately sets out the criteria that an enterprise must meet to be considered rate regulated. Although the specific wording may differ somewhat, the definition in SFAS 71 should be accepted as synonymous with the definition in the *Handbook*. To eliminate any potential differences with US accounting standards, the Study Group concluded that, in its opinion, the *Handbook* definition should be amended to conform to the wording used in SFAS 71.

Rate-setting Authority

As noted in Chapter 2, rate regulation is the restriction in the setting of prices that can be charged to customers for services or products. It is possible, however, that an enterprise may decide to impose restrictions on its own rates. Such self-regulation would raise questions about whether the restrictions would remain in force and, therefore, whether the rate-making process will have an economic impact. Accordingly, the Study Group is of the opinion that the definition of a rate-regulated enterprise should be limited to enterprises where rate regulation is imposed on them by an outside party, or in those rare situations where a governing body is empowered by statute or contract to establish the enterprise's rates. An enterprise whose management unilaterally imposes restrictions on its own rates, without being required to do so by contract or statute, would, therefore, not qualify.

With respect to specific wording differences between Canada and the US, a question was raised about the need to include the words "independent" and "third-party" as qualifiers of the term "regulator." It was noted that independence increases the assurance that economic benefits and obligations created by rate regulation actually exist.

It is the opinion of the Study Group that, for the most part, private sector rate-regulated enterprises in Canada are subject to rate regulation by an independent regulatory authority. In other words, there is a distinct and separate relationship between the rate regulator and the owners of a rate-regulated enterprise. In the private sector, there are a few situations where the governing body of the rate-regulated enterprise has been given the authority by statute or contract to establish rates to be charged for services or products. 4(25)

It must be noted, however, that, to qualify as a rate-regulated enterprise, an enterprise would also have to meet the second and third criteria of the definitions. 5(26) Issues relating to these two criteria are considered in the following paragraphs.

Cost-based Rates

At first glance, the above-noted definitions of a rate-regulated enterprise would seem to cover various types of rate regulation. 6(27) This is, however, not the case. The type of regulation covered by the *Handbook* and SFAS 71 requires that rates be designed to recover the expected costs of providing regulated services or products. To meet this criterion, it would appear that rates *must* be cost based (in light of the changing regulatory environment, this issue is further examined in a later section of this chapter).

With cost-based rates, there is a direct link between cost and revenues (assuming rates are chargeable and collectible from customers). The allowed rates must be set so that, based on forecasted volumes and costs as determined in the regulatory process, revenues will equal costs, including a fair return on investment. 7(28)

An alternative view is that the cost-based requirement should be removed from the definition of a rate-regulated enterprise. According to this view, the impact of rate regulation should be reflected in general purpose financial statements if the conditions set out in *Handbook* Section 1000 are met. In particular, it should be sufficient that rate regulation produces economic benefits or obligations as a result of past transactions or events and that the related amounts meet the recognition criteria, regardless of the regulatory methodology employed. At present, there is nothing in Section 1000 that requires rates to be cost based. Of course, consistent with historical cost accounting, the recognition of any asset would be limited to the cost of acquiring the asset.

As an example, in a case where rates are not cost based, a regulatory authority may allow an increase in rates over a three-year period if the rate-regulated enterprise undertakes a customer education program in the current period. The expected increase in future revenues associated with the rate increase would represent an economic benefit resulting from a past transaction. The enterprise would, therefore, record an asset once it completes the education program and becomes entitled to the increase in future revenues. The asset would be recorded at the lesser of the expected increase in future revenues and the cost of the education program incurred by the rate-regulated enterprise to acquire the additional future revenues. The asset would be amortized over the period in which the associated additional revenues are earned.

Another example is where a rate-regulated enterprise fails to meet certain quality of service standards and the regulatory authority imposes a penalty in the form of a reduction in future rates. Regardless of the method of rate regulation (cost of service, benchmark or any other method), as long as it is reasonable that there will be a decrease in future revenues as a result of the failure to meet the standards in the current or past period, the regulated enterprise would record a liability. This is because the reduction in future rates would represent a yielding of future economic benefits that the regulated enterprise cannot avoid and that resulted from a past event; that is, failure to meet the quality of service standards. 8(29)

The Study Group is of the opinion that, to meet the definition of a rate-regulated enterprise, rates should cover the costs of providing services, including a fair return. This requirement ensures a link between rates and costs. The link between rates and costs is important because it provides the basis for deferral accounting and differential treatment in the application of accounting standards. In addition:

- It establishes a point of reference, inherited from the cost-based regulation history of rate-regulated enterprises.
- It follows the economics of cost-of-service rate regulation whereby (1) revenues = costs + return and (2) to the extent certain actual costs differ from forecast costs, they are deferred if allowed by the regulator.
- Under the matching principle, there must be a direct cause and effect relationship between revenues and costs.
- Without this link, it may not be possible to establish that an economic benefit or obligation has been created as a result of a past transaction or event, or to measure the amount of that benefit or obligation.
- It is consistent with current practice and with US accounting standards.

After considerable debate, the Study Group decided to take a broad perspective on what constitutes cost-based rates because the traditional cost-of-service form of regulation is increasingly being replaced by performance-based methods of regulation. With cost-of-service regulation, rates are set on the basis of expected costs, but are reviewed on a frequent basis, so that actual revenues are usually very close to the expected cost of service on which the rates are based. With the new methods of regulation, the link between the regulated enterprise's allowed rates and its specific costs may not be as direct. Many of these new methods, however, are in several respects fundamentally cost based.

Price-cap regulation is one of the new forms of performance-based regulation (rate-setting methodologies are discussed in Chapter 2). Under this approach, rates are set for a period of three to six years and allowed to increase each year on the basis of a formula that is independent of the regulated enterprise's actual costs. In most cases, there is still an indirect link between costs and rates. For example, initial rates are often based on the cost of service (which includes a fair return). The price-cap formula is usually intended to provide the regulated enterprise with a reasonable opportunity to cover its cost of service. Every three to six years, there is a review of the pricing formula, which often includes an evaluation of rates against the cost of service. The formula may allow for the recovery of costs not covered by the basic formula. For example, where a regulated enterprise incurs unusual costs outside the control of management, it may seek approval from the regulatory authority to recover the costs in future rates.

The Study Group is of the opinion that the definition of a rate-regulated enterprise should encompass enterprises whose regulated rates are set to reflect the reasonably expected costs of providing regulated service. It believes that most types of rate regulation would meet this criterion, including certain types of performance-based and incentive-based regulation. As a result, in its opinion, the definition should not be limited to any particular methodology for approval or fixing of rates. The only requirement should be that the methodology adopted by the regulator produces allowed rates so that, based on expected volumes and costs as recognized in the regulatory process, revenues will equal costs, including a fair return on investment.

Recoverability of Costs of Providing Service

The third criterion in the above-noted definitions states that it must be reasonable to assume that rates set to recover the costs of providing service can be charged to and collected from customers. This criterion requires consideration of expected changes in levels of demand or competition during the recovery period.

Where market conditions do not permit an enterprise to charge and collect the rates allowed under regulation, rate regulation will not be effective in restricting the setting of rates. The Study Group is of the opinion that, in such situations, rate regulation will not have an economic impact because it will not affect future revenues and cash flows. Whether an enterprise is subject to effective regulation may change over time because of changing levels of demand and competition. For example, in the case of long-distance telephone services, competition has resulted in prices that are lower than the rates allowed by regulatory authorities. As a result, regulated rates may no longer be collectible from customers. Accordingly, many telecommunications enterprises (such as Bell Canada) now fail to meet the definition of a rate-regulated enterprise and, for financial reporting purposes, they have discontinued accounting for the effects of rate regulation. Assessing the recoverability of rates requires judgment because many of the factors that determine whether regulation is effective change gradually over time as a result of deregulation initiatives, regulatory philosophy, competition and customer demand.

In the Study Group's view, to create an economic benefit, rate regulation must result in an increase in the future revenues that will be collected from customers; to create an economic obligation, rate regulation must result in a decrease in future revenues collected from customers. Therefore, if rate regulation is to affect what is reported in financial statements, it must be likely that rates designed to recover the cost of providing regulated services or products can be charged to and collected from customers.

SHOULD THE FOCUS BE ON ENTERPRISES OR OPERATIONS?

In applying the definition of a rate-regulated enterprise, questions may arise as to whether the three criteria must apply to the entire organization or to just a portion of its operations. The Study Group observed that the existing definitions of a rate-regulated enterprise have not required that the entire enterprise be subject to rate regulation; an explicit statement, however, would be helpful. In the United States, for example, SFAS 71 specifically states, in paragraph 6, that: "If some of an enterprise's operations are regulated and meet the criteria of paragraph 5, this Statement shall be applied to only that portion of the enterprise's operations."

The Study Group also observed that, with mergers, acquisitions and industry restructuring, part of an enterprise's operations may be opened to competition and deregulated. As a result, it is becoming increasingly common for only parts of a business to be subject to rate regulation or for different parts of a business to be subject to different forms of rate regulation. Even where an entire business is subject to the same rate regulation, it may face different market conditions so that the third criterion in the above-noted definitions will be met for only a portion of its operation.

In the Study Group's view, for rate regulation to have an impact on what should be reported in accordance with GAAP, it is only necessary that a subset of the enterprise's operations be subject to rate regulation. If some of an enterprise's activities are rate regulated, the financial statements should reflect the economic impact on only that portion of operations.

FULL OR PARTIAL COST-BASED RATES?

In applying the second criterion of the definition of a rate-regulated enterprise, situations may arise where only a portion of an enterprise's rates are cost based, that is, a portion of allowed rates is based on certain specific costs of providing service, while the remainder is derived from some other basis.

This issue would become significant if a tight definition of cost-based regulation were employed that excluded performance-based regulation. For example, a gas distribution utility may be regulated under a price-cap formula that includes a deferral of gas price variances. Differences in the cost of gas from a predetermined level are deferred and collected, or rebated, to customers through an adjustment to future rates. Other than the deferral account, it may be deemed that rates are not cost based.

According to one view, to the extent that a portion of the rates is cost based, there could be an economic impact in that future rates could be affected by past transactions or events resulting in future economic benefits or obligations. Also, there would be a direct link between certain specific costs and future rates. Therefore, an enterprise would be deemed to have met the second criterion if a portion of its rates is cost based. Of course, it would recognize regulatory assets and liabilities only where they relate to the cost-based portion of the rates.

An alternative view is that the full amount of the rates must be cost based for an enterprise to meet the definition of a rate-regulated enterprise and recognize any impacts of rate regulation.

The Study Group did not reach a conclusion on this issue.

CONCLUSION

The *Handbook* establishes the criteria that an enterprise must meet to be considered rate regulated for financial reporting purposes. As part of the terms of reference for this research project, the Study Group was asked to reconsider what constitutes a rate-regulated enterprise and whether the definition in *Handbook* should be amended. In other words: "What criteria must be met for an enterprise to be considered rate regulated?" and "Should the focus be on rate-regulated enterprises, *per se*, or on rate-regulated activities?"

In addressing these questions, the Study Group took into consideration the guidance provided in US accounting standards. After considerable discussion and debate, the Study Group concluded that the criteria for qualifying as a rate-regulated enterprise in Canada are essentially the same as those in the US. To eliminate minor differences with US accounting standards, the Study Group concluded that the *Handbook* definition should be amended to conform to the wording used in SFAS 71.

The Study Group also concluded that, 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

GENERAL PRINCIPLES FOR ACCOUNTING AND FINANCIAL REPORTING

General principles provide useful guidance 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.

INTRODUCTION

In Chapter 4, the Study Group proposed that a new Section should be included in the *CICA Handbook – Accounting* to provide guidance on reporting the economic impact of rate regulation in the financial statements. This chapter focuses on general principles that would apply to situations where an enterprise recognizes the impact of rate regulation, and provides the basis on which accounting standards on specific issues, such as those outlined in Chapter 9, should be developed. It is important to establish general principles because it is difficult to envisage every situation where rate regulation can have an impact on what should be reported in accordance with GAAP or to prescribe the accounting for a specific issue that will be appropriate for all regulatory methodologies in all situations. Also, to cover every situation would require a large number of specific principles that would either be essentially the same or conceptually inconsistent.

In this chapter, the Study Group proposes general principles that specify which enterprises should report the economic impact of rate regulation in their general purpose financial statements, and when assets and liabilities that result from rate regulation, and any changes in them, should be recognized in those financial statements. These principles flow, for the most part, from the Study Group's conclusions in the previous chapters of this Research Report. A question arises, however, about what information should be disclosed in the notes to the financial statements. In response, the Study Group proposes general principles for presentation and disclosure, and provides guidance for applying those principles.

The following provides a four-step framework for applying GAAP to rate-regulated enterprises using the general principles proposed in this chapter:

1. Determine whether the enterprise is rate regulated for financial reporting purposes.
2. Determine the conditions under which assets and liabilities that result from rate regulation should be recognized in the financial statements.
3. Determine the conditions under which changes in the assets and liabilities that result from rate regulation should be recognized in the financial statements.
4. Determine what information should be disclosed in the notes to the financial statements.

IS THE ENTERPRISE RATE REGULATED?

In Chapter 6, the Study Group concluded that the criteria for qualifying as a rate-regulated enterprise for financial reporting purposes are essentially the same in Canada and the US. Accordingly, the *Handbook* definition should be amended to conform to the wording used in *Accounting for the Effects of Certain Types of Regulation*, SFAS 71.

The following general application principles emanate from the analysis in Chapter 6:

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.

WHEN SHOULD REGULATORY ASSETS AND LIABILITIES BE RECOGNIZED?

In Chapter 5, the Study Group concluded that the economic benefits and obligations created by rate regulation should be reported in the financial statements as assets and liabilities provided that they meet the recognition criteria set out in "Financial Statement Concepts." *Handbook* Section 1000.

Recognition (as defined in Chapter 5) is the process of incorporating an item in the financial statements of an entity. As noted in the *Handbook*, it consists of the amount and a narrative description of the item, with the amount being included in a financial statement total. Recognition cannot be substituted with notes, disclosure or other similar types of information.

The general criteria for recognition are that there be a reliable and relevant basis of **measurement** and that a **reasonable estimate** can be made. Also, the item must meet the definition of an element of financial statements. Even so, recognition is subject to a cost-benefit constraint 1(30) and a materiality 2(31) threshold.

The following general recognition principles emanate from the analysis in Chapter 5. In the Study Group's view, these principles provide a solid foundation for determining when the economic impact of rate regulation should be recognized in the general purpose financial statements of a rate-regulated enterprise.

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.

WHEN SHOULD CHANGES IN REGULATORY ASSETS AND LIABILITIES BE RECOGNIZED?

In Chapter 5, the Study Group concluded that the changes in the economic benefits and obligations created by rate regulation should be reported in the financial statements as revenues, expenses, gains and losses provided that they meet the recognition criteria set out in the *Handbook* Section 1000.

The following general recognition principle emanates from the analysis in Chapter 5.

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. 3(32)

WHAT INFORMATION SHOULD BE DISCLOSED IN NOTES TO FINANCIAL STATEMENTS?

In addition to reviewing the financial statement concepts set out in *Handbook* Section 1000, the Study Group also considered financial statement disclosure requirements. In this regard, the Study Group believes that rate-regulated enterprises should provide in their general purpose financial statements any information required for fair presentation of financial position, results of operations, or cash flows in accordance with GAAP. Furthermore, where the basis of valuation of assets is not self-evident, the basis should be explicitly stated.

With respect to disclosure in the notes and supporting schedules, the Study Group assessed the information needs of users of general purpose financial statements. 4(33) It also assessed the current reporting practices of rate-regulated enterprises. 5(34) Because rate regulation will usually limit the revenue-generating ability of an enterprise, and this can result in the creation of economic benefits and obligations, the Study Group is of the opinion that rate regulation is an important consideration for users in evaluating the economic performance of an enterprise.

Furthermore, the economic benefits and obligations created by rate regulation, and the consequential changes in assets and liabilities, can be material. Most enterprises are not subject to rate regulation, however, and even among rate-regulated enterprises the materiality of the economic impact can vary significantly. Therefore, the Study Group is of the opinion that financial statement users should be given information about the extent to which rate regulation has affected the financial position of an enterprise.

In the Study Group's view, the following general presentation and disclosure principles provide a solid foundation for determining what information about rate regulation and its economic effects should be disclosed in the financial statements of a rate-regulated enterprise.

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.

Appendix C presents several examples drawn from current practice that illustrate the types of disclosure encompassed by Principle 12. With regard to Principle 13, Exhibit 7.1 provides an example that illustrates one way to disclose the effects of rate regulation on the reported values of assets and liabilities. Alternatively, for specific financial statement items, the impact of rate regulation may be disclosed in individual notes to the financial statements.

CONCLUSION

The objective of this Research Report is to address accounting and reporting issues pertinent to rate-regulated enterprises and to propose what specific guidance should be provided to meet the special needs of such enterprises and the users of their general purpose financial statements. In Chapter 4, the Study Group proposed that a new Section be included in the *Handbook* to provide guidance on reporting the economic impact of rate regulation in the financial statements. It is the opinion of the Study Group that guidance on accounting and reporting by rate-regulated enterprises should focus on general principles that would apply to the reporting of all economic effects of rate regulation rather than on specific principles that would apply to narrowly defined issues, such as income taxes and foreign currency translation.

In this chapter, the Study Group proposes 13 general principles for applying GAAP to rate-regulated enterprises. The principles provide a basis for determining whether an enterprise is rate regulated for financial reporting purposes, the conditions under which assets and liabilities that result from rate regulation should be recognized in the financial statements, the conditions under which changes in the assets and liabilities that result from rate regulation should be recognized in the financial statements, and what information should be disclosed in the notes to the financial statements.

The general principles set out in this chapter cover three areas: application, recognition, and presentation and disclosure. They take into consideration the current requirements and guidance set out in the *CICA Handbook – Accounting*, the current practices of rate-regulated enterprises in Canada and the authoritative pronouncements issued in the United States.

Exhibit 7.1

DISCLOSING THE EFFECTS OF RATE REGULATION ON THE REPORTED VALUES OF ASSETS AND LIABILITIES

Note X — Regulatory Assets and Liabilities

The economic impact of rate regulation is reported in these financial statements. Regulatory assets represent future revenues associated with certain costs that will be recovered from customers in future periods through the rate-making process. Regulatory liabilities represent future reductions or limitations of increases in revenues associated with amounts that are to be refunded to customers through the rate-making process.

Regulatory assets and liabilities reflected in the financial statements as at December 31, 2001 relate to the following (in thousands):

	Reported	Disclosed In Notes
Future Income Taxes	$ xx,xxx	$ xx,xxx
Debt Financing Costs	x,xxx	
Environmental Costs	x,xxx	x,xxx
Postretirement Benefit Costs	x,xxx	x,xxx
Foreign Exchange	xxx	
Net Regulatory Asset (Liability)	**$ xx,xxx**	**$ xx,xxx**

At December 31, 2001, $xxx,xxx of reported regulatory assets and all regulatory liabilities are scheduled or expected to be recovered through rates charged or refunded to customers over periods ranging from 5 to 25 years. We intend to request recovery of the remaining regulatory assets in a general rate case filing expected in 2002. For additional information regarding future income taxes, debt financing costs, environmental costs, postretirement benefit costs, and related risks and uncertainties, refer to notes 3, 5, 7, 9 and 12 respectively.

Chapter 8

APPLYING GENERAL PRINCIPLES TO THE

PUBLIC SECTOR

Are the economic benefits and obligations created by rate regulation similar for both private and public sector rate-regulated enterprises? If so, are there any reasons why their general purpose financial statements should not be prepared on a consistent basis?

INTRODUCTION

In Chapter 7, the Study Group proposed General Principles for rate-regulated enterprises in the private sector to use when preparing their general purpose financial statements in accordance with GAAP. The General Principles cover three areas: application, recognition, and presentation and disclosure. In this chapter, the Study Group assesses the appropriateness of those principles for certain public sector enterprises.

At the outset, it must be acknowledged that the public sector environment is distinctly different from the private sector environment. Recognizing these differences, the CICA Public Sector Accounting Board (PSAB) was created to develop accounting standards for the public sector. Therefore, in assessing whether the General Principles should apply to the public sector, the Study Group discussed the characteristics of various types of government organizations and looked to the *CICA Public Sector Accounting Handbook* to identify whether certain government organizations are required to follow the private sector accounting standards set out in the *CICA Handbook – Accounting*. For additional guidance, it also considered public sector accounting standards established by the Governmental Accounting Standards Board (GASB) in the US.

After identifying which government organizations are required to follow the *Handbook – Accounting*, the Study Group debated at length whether, and to what extent, the criteria set out in General Principle 1 should apply. In other words, should the criteria for qualifying as a rate-regulated enterprise be the same for public sector enterprises as for private sector enterprises? Because governments own public sector enterprises and also establish the basis of rate regulation, the need for an "independent" rate-setting authority was given particular scrutiny. It also considered whether the other General Principles regarding application, recognition, presentation and disclosure should apply equally to all enterprises that meet General Principle 1. In other words, is rate regulation sufficiently similar in the public and private sectors to apply rate-regulated accounting rules in a consistent manner for both sectors? 1(35)

AUTHORITATIVE PRONOUNCEMENTS IN CANADA AND THE UNITED STATES

For purposes of applying PSAB's Recommendations, "public sector" refers to federal, provincial, territorial and local governments, government organizations, government partnerships, and school boards. "Government organizations" are organizations that are accountable for the administration of their financial affairs and resources either to a minister of the government or directly to the legislature or local government council, and are owned or controlled by the government. Government organizations are included in the reporting entity. 2(36)

The *Public Sector Accounting Handbook* notes that government organizations include government business enterprises (GBEs) 3(37) and government business-type organizations. 4(38) For purposes of their financial reporting, such organizations should adhere to the Recommendations in *Handbook – Accounting* unless otherwise directed to specific Accounting Recommendations of PSAB. 5(39)

In the United States, the Governmental Accounting Standards Board (GASB) establishes financial reporting standards for state and local governments, including states, cities, towns, villages and special-purpose governments, such as school districts and public utilities. Governmental accounting systems in the US are organized and operated on a fund basis. 6(40) Fund financial statements are used to report detailed information about governmental, fiduciary and proprietary funds.

Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting, GASB Statement 20, paragraph 2, states that "business-type accounting and financial reporting for state and local governmental entities has generally been defined by pronouncements of the Financial Accounting Standards Board (FASB), Accounting Principles Board (APB) Opinions and Accounting Research Bulletins (ARBs) of the Committee on Accounting Procedure." Statement 20 notes (in paragraphs 6 and 7) that proprietary activities **should** apply the pronouncements of the FASB, APB and ARB issued on or before November 30, 1989. They may also apply **all** FASB Statements and Interpretations issued after November 30, 1989, **except** for those that conflict with GASB pronouncements.

It is noteworthy that GASB Statement No. 20 indicates (in paragraph 9) that "*Accounting for the Effects of Certain Types of Regulation*, SFAS 71, does not specifically exclude state and local governmental entities from its scope, nor does it preclude its application to governmental entities." GASB Statement 20 notes that the FASB modified paragraph 5(a) of SFAS 71 to permit application by governmental utilities with rates set subject to a statute or contract. SFAS 71 and related pronouncements may be applied to proprietary activities that meet the criteria of those pronouncements for reporting as regulated enterprises.

GASB Statement 34, *Basic Financial Statements – and Management's Discussion and Analysis – for State and Local Governments*, notes that GAAP for enterprise funds are those applicable to similar businesses in the private sector. Statement 34 takes a further step, however, by emphasizing (in footnote 12) that "The provisions of FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, only apply to governments that have *qualifying* enterprise funds." 7(41)

RATE REGULATION AND THE PUBLIC SECTOR

In the "Introduction" to this chapter, the question was raised as to whether rate regulation is sufficiently similar in the public and private sectors to warrant consistent accounting rules for both sectors. There are differing views on this matter, centring on the following two key issues: independence of the rate regulator from the enterprise being regulated; and the types of government organizations that would qualify as rate-regulated enterprises under the definitions set out in Chapter 6 of this Research Report. These differing views are discussed in the remaining sections of this chapter.

NEED FOR AN INDEPENDENT REGULATOR

Required Criteria

General Principle 1 states that the economic impact of rate regulation should be reported 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.
- 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.

All three criteria must be met for either a private sector enterprise or a public sector enterprise to be considered a "rate-regulated enterprise" for financial reporting purposes and, therefore, to be able to account for the economic effects of rate regulation. Meeting the criteria, however, does not automatically mean that the rate-making process will have an economic impact that should be reported in the enterprise's financial statements through the recognition of a regulatory asset or a regulatory liability. Before that can happen, the fact that the rate-making decision will have an economic impact must be clearly demonstrated.

Independence is a Prerequisite 8(42)

There is a view that, with respect to rate regulation in the public sector, there is usually no "independent, third-party regulator" because the government controls both the enterprise and the regulatory agency. Those who hold this view argue that, unless the regulator is independent, the enterprise cannot be considered as rate regulated for financial reporting purposes. As a result, different criteria are needed if a public sector enterprise is to qualify as rate regulated for financial reporting purposes.

In considering whether different criteria are needed for the public sector, the proponents of this view observed that, as noted in the section on "Scope of Application," set out below, most government enterprises have governing boards and almost all are given the legislative power to set the rates they charge for their services and products. 9(43) They maintain that, in the public sector environment, the uncertainty arising from regular elections, different political party ideologies and occasional minority governments makes it difficult to recognize the economic impact of rate decisions that are other than short term. Further, regular elections and balanced budget legislation may mean that governments face additional pressures to "manage" financial results. In addition, because the decisions of regulators are not necessarily consistent from jurisdiction to jurisdiction, it is, in their opinion, more difficult for legislators and the public to compare the financial results of rate-regulated enterprises in the public sector. A government may also have an incentive to use the regulatory process to create assets and liabilities. For example, it may wish to contain the rates charged by a public sector utility without affecting its financial results. If the government uses the modified equity method of accounting for the utility, any reduction in profitability would flow through to the owning government, possibly turning a surplus into a deficit.

Those who support this view acknowledge that although, other things being equal, it would be highly desirable for accounting for rate regulation in the public sector to be consistent with accounting for rate regulation in the private sector, this is an issue of such significance that such a result is highly unlikely. Whereas, in the vast majority of cases, there is independent third-party rate regulation in the private sector, in that the regulators are independent of both the regulated enterprise and its owners, such is usually not the case for rate-regulated enterprises in the public sector. If the accounting by public sector rate-regulated enterprises is to be consistent with that in the private sector, this same standard or benchmark must apply equally to the public sector. In most cases, however, this is simply not possible.

Proponents of this view also maintain that, in the private sector, the regulator is not accountable for the financial performance of the regulated enterprise. This independence ensures that the regulator can balance and protect the interests of both the investors in the regulated enterprise and the consumer. It allows the regulator to make rate decisions that require the benefits and obligations arising from those decisions to flow through to both the regulated enterprise and the consumer. It is this authority and independence that provide the rigour to allow differential accounting for rate decisions. Without this authority and independence, there is a potential for the differential treatment for rate-regulated enterprises to be used to "manage" financial results. Further, there is insufficient assurance that the economic benefits or obligations of rate decisions will occur. Furthermore, allowing a self-governing board to "manage" its performance by creating, amending or deleting regulatory assets and liabilities may place that board in a conflict of interest position.

Finally, the proponents of this view note that many private sector rate-regulated enterprises have market mechanisms to provide additional checks and balances that do not exist in the public sector. For example, the shares and or debt of many private sector utilities are publicly traded, bringing the discipline of securities commission accounting and disclosure requirements into play, requirements that may be more onerous than Canadian GAAP. These types of external influences do not usually exist for public rate-regulated enterprises. 10(44) The best way to protect the public interest is to require a regulator to be independent.

Independence *per se* is Not the Key Factor 11(45)

Others are of the opinion that the key issue is not the independence of the regulator *per se*, but the credibility of the regulatory process, in particular, whether it is likely that the regulator will allow or require the future changes in regulated rates necessary to justify the recognition of regulatory assets and liabilities. For example, without independence, it is possible that a regulator may indicate that a cost will be deferred so that a regulatory asset can be recognized, even though there is no intention to allow for a future recovery of the deferred cost. At some future date, the regulator might then reverse that decision, with the result that the deferred cost will have to be written off and income reduced in that future period. In such a situation, there is a trade-off between two risks:

- the risk that an enterprise may recognize regulatory assets and liabilities that do not exist; and
- the risk that an enterprise may fail to recognize regulatory assets and liabilities that do exist.

It is noted that it is not uncommon in other areas of financial accounting for professional judgment to be exercised in determining whether assets or liabilities exist and the values at which they should be reported.

Those who support this view recognize that, in the public sector, it is rare to have a totally independent regulator because the same government that owns the regulated enterprise has legislative responsibility for the regulator. Occasionally, the governing board of the enterprise is empowered by statute or contract to set rates and is, in effect, the regulator. Consequently, if total independence were required, virtually all public sector enterprises would be precluded from qualifying as rate-regulated enterprises for financial reporting purposes.

The possibility that a government may unduly influence the rate-setting process for social or political reasons is acknowledged. 12(46) Nonetheless, this should not be a financial reporting issue as long as real economic benefits and obligations are created by rate regulation. For example, in the case of a deferred cost, a regulatory asset should be recognized when there are additional future revenues sufficient to recover the amount deferred, regardless of the reason for deferring the cost.

The role of financial reporting is to report on the economic resources and obligations of an enterprise, not to second-guess the motivation that led to the creation of those economic resources and obligations. Furthermore, a government's decisions should not be confused with rate-setting interference. For example, a government, as owner, could instruct the enterprise not to recover a certain cost, thereby creating a loss. Such a loss would be a loss under GAAP because it is created by reducing anticipated future cash flows, not by rate regulation.

With regards to differences in regulatory decisions between jurisdictions, this also happens with private sector rate-regulated enterprises. More important, failing to report the economic impact of differences in regulatory decisions will not enhance comparability, but make it more difficult.

Alternative Scenarios

In addressing the issue of independence, the Study Group debated three alternative scenarios. First, the regulator is an independent third party. Second, the regulator is not an independent third party but operates at arm's length from the management of the enterprise. Third, the governing body of an enterprise is empowered by statute or contract to establish rates.

The regulator is an independent third party

In Chapter 6, the Study Group noted that, for the most part, private sector rate-regulated enterprises in Canada are subject to rate regulation by independent regulatory authorities. This distinct and separate relationship between the rate regulator and the owners of a rate-regulated enterprise establishes the credibility of the regulatory process and justifies the recognition of regulatory assets and liabilities as long as it is likely that the regulator will allow or require the future changes in regulated rates. The same applies to a GBE that is subject to rate regulation by an independent regulatory authority. 13. For example, the Saskatchewan Telecommunications Holding Corporation (SaskTel), a provincial Crown corporation, has an independent third-party regulator, the CRTC, which has been established under federal legislation.13

The regulator is not an independent third party but operates at arm's length from the management of the enterprise

Although independent regulators are the norm in the private sector, this is generally not the case in the public sector. Usually, the same government that owns a rate-regulated enterprise also establishes the regulatory authority for that enterprise and is responsible for the legislation under which the regulator operates. Partly to assist in dealing with this issue, the Study Group undertook a survey of federal provincial and territorial comptrollers. Survey participants were asked whether their rate-regulated enterprises would continue to meet the first criterion if rates had to be established by an independent, third-party regulator. Most respondents said that, in their jurisdiction, rates were independently established because the regulator was operating at arm's length from the management of the enterprise (survey excerpts are provided in Appendix D to this Research Report). 14(47)

After considerable debate, the consensus of the Study Group 15(48) was that, as long as the regulator is operating at arm's length from the management of the regulated enterprise, the regulator need not be a completely independent third party. In such situations, there is sufficient assurance that the regulatory process is credible and there would be a significant reduction in the risk that the regulator would make decisions so as to "manage" the reported performance of the regulated enterprise. As a result, the risk of recognizing regulatory assets and liabilities that do not exist is outweighed by the risk of failing to recognize regulatory assets and liabilities that do exist. As noted below under "Required Disclosures," the Study Group believes that there should be disclosure of any actual or perceived lack of independence.

When there is no independent third-party regulator, professional judgment would be required to assess the credibility of the regulatory process. In this respect, the following conditions and circumstances merit consideration, either individually or in combination, when assessing whether the regulator is operating at arm's length from the management of the rate-regulated enterprise:

- Is the regulator a separate organization from the regulated enterprise?
- Is the regulator staffed by personnel who are neither employees nor directors of the regulated enterprise?
- Is there a public hearing process with opportunity for interested parties to participate?
- Does the regulator provide justification for its decisions?
- Are the decisions of the regulator public documents?
- Is there a well-defined plan in place for the deferral of costs and/or a history of recovering the related revenues?

If it is evident that the regulator is not operating at arm's length, the regulated enterprise would not meet the required criteria, and could not, therefore, apply the differential treatment for accounting for rate regulation.

A governing body is empowered by statute or contract to establish rates

In some cases, the governing boards of GBEs have been empowered by statute or contract to set rates for the enterprise. For example, in Nova Scotia, two rate-regulated entities are reported in the Province's summary financial statements, Halifax-Dartmouth Bridge Commission and Highway 104 Western Alignment Corporation. The toll rates of the Halifax-Dartmouth Bridge Commission are subject to approval of the Nova Scotia Utility and Review Board. The toll rates of Highway 104 are set in the agreement with the bondholders and agreed to by the corporation and the Province, but are not regulated by an independent third party, such as the Nova Scotia Utility and Review Board (survey excerpts are provided in Appendix D to this Research Report).

In such circumstances, the regulatory requirements for the setting of rates comes from the statute or contract, and this is in line with the first criterion. It must be emphasized, however, that to meet the definition of a rate-regulated enterprise, the enterprise would still have to meet the other two criteria: rates must be designed to cover the costs of providing service and rates necessary to cover the costs of service will be chargeable and collectible from customers.

Also, meeting the definition of a rate-regulated enterprise does not necessarily mean that rate regulation would have an economic impact that should be recognized in the financial statements. What it does mean is that the rate-regulated enterprise would then apply the General Principles set out in Chapter 7. For example, consistent with General Principle 4, it would recognize a regulatory asset where the following conditions are met, but only if all four conditions are met:

- Rate regulation (in the form of the board setting rates under its statute) 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 (that is, the board) 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.

Concern regarding the credibility of the regulatory process

One member of the Study Group has expressed concern about the credibility of the regulatory process in the second and third scenarios. In his opinion, if the regulator is not operating at arm's length from the owner of the rate-regulated enterprise, it is irrelevant whether or not the regulator is operating at arm's length from the management of the enterprise. For each jurisdiction, there is only one government and rate-regulated enterprises are part of that government. The government chooses when to carry out its activities through departments, agencies, rate-regulated enterprises or other government business enterprises, but it controls all of them. Further, recommendations allowing a self-governing board to "manage" its performance by inappropriately creating rate-regulated assets and liabilities may place that board in a conflict-of interest-position. He also indicated that, in his opinion, the majority of statutes provide little guidance on how the rates are to be determined.

The Study Group discussed these issues at length and has addressed them above.

Required Disclosures

In Chapter 7, the Study Group concluded that the notes to the general purpose financial statements of private sector rate-regulated enterprises should disclose the regulator(s) and the jurisdiction(s) covered, even if the enterprise no longer qualifies as rate regulated (see General Principle 12 regarding presentation and disclosure). If a GBE's rates are governed by a statute or contract, this should also be disclosed in the notes.

Furthermore, if there is a perception that the regulator is not independent, the enterprise should provide note disclosure of its relationship with the regulator in accordance with *CICA Handbook – Accounting* Section 3840, "Related Party Transactions." Section 3840 establishes measurement and disclosure standards for related party transactions in the financial statements of profit-oriented enterprises.

In the Study Group's view, information about the related parties of a public sector rate-regulated enterprise is of significance to financial statement users. Related parties exist when one party has the ability to exercise, directly or indirectly, control, joint control or significant influence over the other. Two or more parties are related when they are subject to common control, joint control or common significant influence. The degree of influence that one party may exert on another is a major factor in determining whether they are related. In some cases, the degree of influence may be so remote that they need not be considered related. An explanation of how significant influence, joint control or control is exercised between the reporting enterprise and a related party clarifies the nature of their relationship.

SCOPE OF APPLICATION

With respect to the scope of application, some feel that the criteria set out in Section 3465 of the *Handbook – Accounting* for qualifying as a rate-regulated enterprise are too broad because they could apply to many government organizations. For financial reporting purposes, any government organization that is required to follow the *Handbook – Accounting*, or that chooses to do so, could, in their opinion, potentially qualify for such treatment, if it meets the *Handbook – Accounting* criteria. In addressing this concern, the Study Group compared authoritative pronouncements promulgated by the Public Sector Accounting Board (PSAB) 16(49) and the US Governmental Accounting Standards Board (GASB).

Government Business Enterprises (GBEs)

A GBE is different from other types of government organizations. As its principal activity, a GBE sells goods and services to individuals and organizations outside the government reporting entity 17(50) Public Sector Accounting Handbook, "Financial Reporting Entity," paragraph PS1300.07) and its revenues are to a large degree received from outside sources. In the case of government business-type organizations, 18(51) the goods and services are not sold primarily to individual and organizations outside the government and/or it cannot, in the normal course of its business, maintain its operations and meet its liabilities from revenues received from sources outside the government reporting entity. Since revenues adequate to maintain the organization are not derived from third parties, rate regulation does not apply to these government business-type organizations.

By inference, although it is not specifically stated in the *Public Sector Accounting Handbook*, except for GBEs, rate regulation does not apply to the public sector. To determine whether a government organization is a GBE, several factors should be considered:

- the enterprise's history of maintaining its operations and meeting its liabilities;
- whether the enterprise would continue to maintain its operations and meet its liabilities without relying on sales to, or subsidies from, the government reporting entity;
- past, present and future economic conditions within which the enterprise operates; and
- whether the enterprise has realistic and specific plans that show how it expects to maintain its operations and meet its liabilities in the future.

The *Public Sector Accounting Handbook* makes no specific reference to the types of GBEs that should apply the accounting standards set out in the *Handbook – Accounting*. Nonetheless, "Financial Reporting Entity," Section PS1300, paragraph .27, emphasizes that, because a GBE carries on a business, its financial statements should be prepared on the same basis as those of a private sector business. This basis is most appropriate for measuring the government's investment in the organization and the impact it has on the government's financial position and results. This would seem to imply that there should be consistency in application between public and private rate-regulated enterprises unless there are some good reasons for the contrary.

One Study Group member has noted that there are many GBEs in Canada, and that their business covers a broad range of activities, including casino gaming, lotteries, liquor boards, banking, insurance, housing, etc., as well as publicly owned utilities. In common with most public sector boards, most GBE boards are given the legislative authority to set the rates they charge for their products or services. Also, by definition, GBEs are self-sustaining. Therefore, they fully recover their costs. Accordingly, in his opinion, many GBEs would meet the definition of a rate-regulated enterprise and would be entitled to apply the differential treatment for accounting for rate regulation. In his opinion, the public will therefore have great difficulty in understanding why such GBEs are considered rate regulated and why they are allowed to use this differential treatment.

The other nine members of the Study Group question the validity of this argument. In their opinion, there are relatively few GBEs in the public sector that meet the criteria set out in the definition of a rate-regulated enterprise.

The preceding discussion and analysis of public sector pronouncements suggests that General Principle 1 should apply only to GBEs. To assess the feasibility of this approach, in the survey of federal, provincial and territorial comptrollers referred to above, participants were asked the following questions:

- In your jurisdiction, what entities that are included in the federal or provincial government's summary financial statements currently follow GAAP for rate-regulated enterprises as set out in the *Handbook – Accounting*?
- The Study Group is proposing to limit application of the above-noted definition of a "rate-regulated enterprise" to "government business enterprises." In your jurisdiction, would this eliminate any of the entities currently following GAAP for rate-regulated enterprises?
- Is it important that the general purpose financial statements of rate-regulated enterprises in the public sector be prepared on a basis consistent with that in the private sector?

In response, survey participants reported that relatively few rate-regulated enterprises form part of the government reporting entity. Most of these enterprises are electric power utilities and all are GBEs. 19(52) They also felt that it is important that the general purpose financial statements of GBEs be prepared on a basis consistent with that of rate-regulated enterprises in the private sector (survey excerpts are provided in Appendix D of this Research Report).

In the Study Group's view, the application of General Principle 1 should be limited to GBEs that meet the criteria for qualifying as a rate-regulated enterprise. This would include having rates designed to cover the enterprise's cost of providing service, that is, rates set so that, based on expected demand and costs as recognized in the regulatory process, revenues will equal the costs of providing service. In line with existing practice, the Study Group is of the opinion that the *Public Sector Accounting Handbook* Recommendations should specifically recognize that only GBEs may qualify for the differential treatment afforded to rate-regulated enterprises by the *Handbook – Accounting*.

CONCLUSION

In this chapter, the Study Group assessed whether the General Principles set out in Chapter 7 are appropriate for the public sector. After examining the public sector environment in both

Canada and the United States, it considered the need for an independent rate-setting authority and the criteria in General Principle 1, as they relate to the scope of public sector activities that may be considered rate regulated for financial reporting purposes. As part of its assessment, the Study Group considered whether the other General Principles regarding application, recognition, presentation and disclosure should apply equally to all enterprises that meet General Principle 1.

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 that meet the criteria for qualifying as a rate-regulated enterprise. This is consistent with the authoritative pronouncements and current practices in both Canada and the United States. In this regard, *Public Sector Accounting Handbook* Recommendations should specifically recognize that, in the public sector, only GBEs are entitled to qualify as rate-regulated enterprises for financial reporting purposes. For GBEs that do qualify, the accounting recommendations for rate-regulated enterprises contained in the *Handbook – Accounting* should be applied. One Study Group member, however, feels strongly that, 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.

Regarding the need for an independent rate-setting authority, nine of the ten Study Group members are of the view that the first criterion in the definition of a rate-regulated enterprise should remain unchanged: the enterprise's rates for regulated services or products provided to its customers should be established by, or 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. Also, complete independence of the regulator from a public sector enterprise is not required as long as the regulator operates at arm's length from the enterprise. In this respect, guidance is provided on assessing whether the regulator is operating at arm's length and the credibility of the regulatory process.

Should the other General Principles regarding application, recognition, presentation and disclosure apply equally to all enterprises that meet the criteria in General Principle 1? The Study Group consensus is that 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, however, would support this position only if the regulatory agency is independent of both the GBE and the government.

Chapter 9

APPLYING GENERAL PRINCIPLES TO SPECIFIC

ISSUES

Detailed guidance is not essential to recognize the economic impact of rate regulation on the financial reporting of rate-regulated enterprises, but it would help avoid any misunderstanding and, at the same time, illustrate how general principles should be applied in practice.

INTRODUCTION

As noted in Chapter 1, the Study Group determined that it would be prudent to review the financial statement concepts set out in "Financial Statement Concepts," *CICA Handbook – Accounting* Section 1000. In this regard, it has concluded that the current accounting and financial reporting practices of rate-regulated enterprises fall well within that conceptual framework. Furthermore, a differential treatment based on the General Principles presented in Chapter 7 is considered appropriate for rate-regulated enterprises. To supplement those principles, the project terms of reference call for the Study Group to consider, "What additional guidance is needed relating to specific accounting and reporting issues encountered by rate-regulated enterprises?"

In this chapter, the Study Group elaborates on the General Principles and provides guidance on their application to specific issues. The specific issues covered in this chapter are capital assets (including interest capitalized), income taxes and inter-company gains and losses. Also included are other areas significant to rate-regulated enterprises, such as the accounting treatment of employee future benefits. For each of these matters, consideration is given as to when assets or liabilities (and changes in them) that result from rate regulation should be recognized in the financial statements (refer to General Principles 4 to 11) and what information should be disclosed in the notes to the financial statements (refer to General Principles 12 and 13).

Several broad issues of particular relevance to rate-regulated enterprises are also addressed in this chapter: (1) application of general principles; (2) recoverability of assets created by rate regulation; and (3) discontinuation of accounting for the economic impact of rate regulation (refer to General Principle 3).

APPLICATION OF GENERAL PRINCIPLES

GAAP in both Canada and the US encompasses reflecting economic benefits (assets) and economic obligations (liabilities) in the balance sheet, and including changes in such benefits and obligations in the income statement. Although applying GAAP to the general purpose financial statements of rate-regulated enterprises works the same way, in the Study Group's opinion, there is an additional consideration — recognizing regulatory assets and liabilities that result from rate-regulation.

Application of the General Principles would result in a rate-regulated enterprise following all of the standards in the *Handbook*, the same as a non-regulated enterprise would. In addition, a rate-regulated enterprise would recognize the economic impact of rate regulation where that recognition is consistent with the General Principles. This is consistent with the approach usually taken by rate-regulated enterprises in the US.

In applying the General Principles to specific issues, the economic impact of rate regulation is identified; that is, the economic benefit that exceeds the amount that would otherwise be recognized as an asset, or the economic obligation that exceeds the amount that would otherwise be recognized as a liability. This impact is then recognized as a regulatory asset or a regulatory liability to the extent that the General Principles are met. For example, if a regulator allows for the future recovery of costs that would normally be expensed in the current period, the costs would be capitalized if General Principle 4 were met.

In some cases, a regulator may use the cash method (pay-as-you-go) to determine the amount of expenses that are to be recoverable through allowed rates. For example, with regard to accounting for income taxes, many rate-regulated enterprises follow the taxes payable or flow through method, where that method is prescribed by the regulator, and do not follow the method normally required by GAAP, the liability method. Pending further study, the Accounting Standards Board specifically permits the use of the taxes payable or flow-through method in Canada. If this were not the case, and a Canadian rate-regulated enterprise had to record its full tax liability, and also recorded a regulatory asset equal to the expected amount of future income taxes that would be recoverable in future rates, there would be a significant increase in capital taxes and large corporation taxes payable.

In the US, rate-regulated enterprises always use the liability method in preparing their financial statements, even when the regulator prescribes the taxes payable or flow-through method. They record future income tax assets or liabilities on the balance sheet and they also set up a corresponding regulatory asset or liability. The net effect is that income is presented on a taxes payable basis.

Some maintain that there should be an exception to the strict application of the General Principles where a regulator applies the cash method (or some other prescribed method) for determining certain costs to be included in the cost of service. Either the regulatory asset should be netted against the associated liability (or the regulatory liability should be netted against the associated asset) or the rate-regulated enterprise should continue to apply the cash method (or some other prescribed method) of accounting to these specific costs. With either alternative, the end result is that reported income would be the same as if the General Principles were applied.

Although both assets and liabilities would be lower, this impact could be disclosed in the notes to the financial statements, consistent with current practice. More importantly, the base against which capital taxes and large corporation taxes are applied would be reduced, resulting in significant tax savings for the ratepayers or the shareholders of the rate-regulated enterprise. Of the two approaches, those favouring such exceptions prefer the cash method (or some other prescribed method), as opposed to the netting method, with appropriate note disclosure on the netting of assets and liabilities.

Those who argue for strict application of the General Principles believe that tax regulations should not govern the accounting treatment for rate-regulated enterprises. They also note that, unless specifically sanctioned by the *Handbook*, disclosure in the notes to the financial statements *per se* is not a substitute for proper accounting. Likewise, the netting (or offsetting) of GAAP assets / liabilities with regulatory assets / liabilities does not meet GAAP requirements. Under the General Principles set out in Chapter 7, GAAP methods should be applied to all assets and liabilities reported on the balance sheet, and separate regulatory assets and liabilities should be reported, as appropriate, to reflect the economic impact of rate regulation. 1(53)

Those who argue for exceptions maintain that financial reporting must not only strive for conceptual purity, but must also deal with practical realities. With disclosure in the notes to the financial statements, consistent with current practice, strict adherence to the General Principles, in their opinion, would not significantly improve the quality or transparency of financial reporting by rate-regulated enterprises. It would, however, needlessly increase the tax burden, and that burden would be passed on to customers as part of the cost of service. Or, if the regulator did not allow that cost to be recovered in future rates, that burden would be passed on to shareholders.

There is a difference of opinion in the Study Group on this issue. Some believe that there should be a strict adherence to the General Principles set out in Chapter 7, whereas others are of the view that the differential treatment currently permitted in "Income Taxes," *Handbook* Section 3465, which is also current practice among Canadian rate-regulated enterprises, should continue.

For each issue addressed in this chapter, the accounting treatment that would result from strict application of the General Principles is presented. In light of the above-noted differing views, the practical accounting treatment is also described for the issues where regulators use the cash method to determine the amount of expenses to be included in rates.

RECOVERABILITY OF ASSETS CREATED BY RATE REGULATION

General Principle 4 sets out the conditions for recognizing a regulatory asset in the financial statements. To recognize a regulatory asset, it must be likely that the regulator will change future rates by an amount sufficient to provide an economic benefit. This requires an ongoing assessment of the likelihood of recovery of regulatory assets subsequent to their initial recognition.

With respect to the ongoing recognition of regulatory assets, the following hierarchy of evidence may be helpful in establishing the likelihood of future recovery:

- The enterprise has an order from its regulator that addresses and allows the recovery of the specific incurred cost.

- The regulator has treated the specific incurred cost as an allowable cost-of-service item in prior regulatory filings of the enterprise.
- The same regulator has treated the specific incurred cost as an allowable cost in connection with another enterprise's filing. Also, it is the regulator's general policy to allow recovery of this incurred cost.
- The regulator has included a similar incurred cost as an allowable cost in prior regulatory filings of the enterprise.
- The same regulator has treated a similar incurred cost as an allowable cost in connection with another enterprise's filing. Also, it is the regulator's general policy to allow the recovery of this incurred cost.
- The enterprise has obtained an "accounting order" or comparable form of communication from the regulator agreeing with the enterprise's proposed accounting for the specific incurred cost, even though such orders often include a qualifier that the letter guidance is not authoritative for rate-making purposes. In a few jurisdictions, such accounting orders may provide the same degree of assurance as a specific rate order. The level of assurance provided by accounting orders must be assessed on a commission-by- commission basis, with particular focus on legal authority, who signs the accounting order, and historical regulatory practices.
- A significant majority of other regulatory authorities has treated a specific incurred cost (or similar incurred cost) as an allowable cost and the enterprise's regulator has not disallowed that cost.
- Representation letters stating that it is likely that the cost will be allowable in future rates are obtained from outside legal counsel with substantive involvement, informed in-house legal counsel and management.

Furthermore, it must be anticipated that the enterprise will request the future recovery no later than that enterprise's next rate case. As well, a determination must be made that the rates, established at levels that would recover the costs, including a fair return on investment, can be charged to and collected from customers.

SPECIFIC ISSUES ADDRESSED IN THE *CICA HANDBOOK – ACCOUNTING*

The following analyses provide guidance for applying the General Principles for rate-regulated enterprises to specific matters covered in the *Handbook*, including the differential treatment for property, plant and equipment, income taxes, and inter-company gains and losses. Guidance is also provided on employee future benefits, foreign currency translation and financial instruments, although differential treatment is not specifically provided in the *Handbook*.

Property, Plant and Equipment

As noted in Chapter 1, accounting for fixed / capital assets (property, plant and equipment) is a significant issue for the natural gas sector and the hydro-electric industry. In a rate-regulated environment, pertinent considerations include: cost and amortization; allowance for funds used during construction (AFUDC); disallowances; future removal and site restoration costs; and disposal of items of property, plant and equipment. The following analyses cover each of these considerations.

Cost and amortization

Accounting Issue

Current accounting standards for profit-oriented enterprises require that property, plant and equipment be recorded at cost and that amortization be recognized in a rational and systematic manner appropriate to the nature of the item of property, plant and equipment with a limited life and its use by the enterprise. The accounting issue is whether a rate-regulated enterprise should record a regulatory asset or liability for the amount by which depreciation for regulatory purposes is different from the amount acceptable under normal GAAP methods.

Accounting Requirements in Canada

"Property, plant and equipment," *Handbook* Section 3061, paragraph .10, states that:

> Rate-regulated property, plant and equipment are items of property, plant and equipment held for use in operations meeting all of the following criteria: 2(54)
>
> (a) the rates for regulated services or products provided to customers are established by or are subject to approval by a regulator or a governing body empowered by statute or contract to establish rates to be charged for services or products;
>
> (b) the regulated rates are designed to recover the cost of providing the services or products; and
>
> (c) it is reasonable to assume that rates set at levels that will recover the cost can be charged to and collected from customers in view of the demand for the services or products and the level of direct and indirect competition. This criterion requires consideration of expected changes in levels of demand or competition during the recovery period for any capitalized costs.

Where the amount by which depreciation for regulatory purposes differs from the amount acceptable under normal GAAP methods, a regulatory asset or liability should be recognized if the related asset meets the *Handbook* definition of rate-regulated property, plant and equipment and the pertinent recognition criteria (General Principles 4 to 7). In assessing the amount of depreciation acceptable under GAAP, professional judgment should be used in choosing the method that allows amortization to be recognized in a rational and systematic manner appropriate to the nature of the item of property, plant and equipment. The amortization method and estimates of the life and useful life of an item of property, plant and equipment should be reviewed on a regular basis (see *Handbook* paragraph 3061.33).

In addition, rate-regulated enterprises should determine the extent to which their regulatory depreciation methods differ from normal GAAP methods and lives and, if the differences are significant, disclose them in the notes to the financial statements (General Principle 13). 3(55)

Allowance for funds used during construction (AFUDC)

Accounting Issue

Current accounting standards for profit-oriented enterprises allow for the capitalization of certain carrying costs, such as interest costs, that are directly attributable to an acquisition, construction or development activity. Often, regulators set the allowance for funds used during construction on the basis of the regulated enterprise's weighted average cost of capital, which would normally exceed the amount otherwise allowed under GAAP because it includes a cost-of-equity component. The accounting issue is whether a rate-regulated enterprise should be allowed to capitalize an allowance for funds used during construction which exceeds the amount otherwise allowed under GAAP, if that is the method used for rate-making purposes.

Accounting Requirements in Canada and the US

Handbook Section 3061, paragraph .23, states that:

> The cost of an item of property, plant and equipment that is acquired, constructed, or developed over time includes carrying costs directly attributable to the acquisition, construction, or development activity such as interest costs when the enterprise's accounting policy is to capitalize interest costs. For an item of rate-regulated property, plant and equipment, the cost includes the directly attributable allowance for funds used during construction allowed by the regulator.

In the United States, *Accounting for the Effects of Certain Types of Regulation*, SFAS 71, paragraph 15, notes that:

> In some cases, a regulator requires an enterprise subject to its authority to capitalize, as part of the cost of plant and equipment, the cost of financing construction as financed partially by borrowings and partially by equity. A computed interest cost and a designated cost of equity funds are capitalized, and net income for the current period is increased by a corresponding amount. After the construction is completed, the resulting capitalized cost is the basis for depreciation and unrecovered investment for rate-making purposes. In such cases, the amounts capitalized for rate-making purposes as part of the cost of acquiring the assets shall be capitalized for financial reporting purposes instead of the amount of interest that would be capitalized in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*. The income statement shall include an item of other income, a reduction of interest expense, or both, in a manner that indicates the basis for the amount capitalized. 4(56)

Application of General Principles

For regulatory purposes, a regulator may require a rate-regulated enterprise to capitalize an allowance for the funds used during construction (AFUDC) at a rate that assumes the project is financed by debt and shareholders' equity. After the construction is completed, the resulting capitalized cost is the basis for depreciation and unrecovered investment for rate-making purposes. As a result, the rate-regulated enterprise recovers the total cost of the plant, including the AFUDC, through depreciation charges that are part of the cost of service to be recovered from customers over the estimated life of the plant.

The full amount of the AFUDC should be capitalized as a regulatory asset if its subsequent depreciation / amortization is likely to be included in allowable costs for rate-making purposes (General Principle 4). The AFUDC is normally divided into two components: the interest component, or the allowance for borrowed funds, and the equity component, or the allowance for equity funds. In addition, rate-regulated enterprises should disclose, in the notes to the general purpose financial statements, how rate regulation affects the reported values of property, plant and equipment on a going-forward basis. They should also provide pertinent information on the AFUDC, as appropriate (General Principle 13). 5(57)

Disallowances

Accounting Issue

The accounting issue is whether a disallowance should be deducted from the reported cost of the plant, and a loss reported, when it becomes likely that part of the cost will be disallowed for rate-making purposes.

Accounting Requirements in Canada and the US

In Canada, there are no specific accounting pronouncements that address the issue of disallowances of plant costs of rate-regulated enterprises. It is encompassed, however, by "write downs" in *Handbook* Section 3061, which states that:

> *When the net carrying amount of an item of property, plant and equipment, less related accumulated provision for future removal and site restoration costs and future income taxes, exceeds the net recoverable amount, the excess should be charged to income.* (paragraph .38)
>
> In determining the net recoverable amount of an item of rate-regulated property, plant and equipment, the enterprise considers the extent to which rates will provide for the recovery of the cost of the asset. (paragraph .46)

In the United States, *Regulated Enterprises — Accounting for Abandonments and Disallowances of Plant Costs*, SFAS 90, paragraph 7, states that:

> When it becomes probable that part of the cost of a recently completed plant will be disallowed for rate-making purposes and a reasonable estimate of the amount of the disallowance can be made, the estimated amount of the probable disallowance should be deducted from the reported cost of the plant and recognized as a loss.

According to SFAS 90, if the probable disallowance results from a cap on the plant's cost for rate-making purposes, the loss should be recognized as soon as it becomes probable that the cap will be exceeded. This calculation should be based on the expected total cost of the plant, including all AFUDC and other overheads that would normally be applied. The excess of this amount over the cap should be discounted to present value using the AFUDC rate. (In other words, the future AFUDC is removed from the expected total plant cost.) This discounted amount should be written off as a loss. If part of the cost is explicitly, but indirectly, disallowed (for example, by an explicit disallowance of return on investment on a portion of the plant), an equivalent amount of cost shall be deducted from the reported cost of the plant and recognized as a loss. Calculation of this amount requires use of the best available information. For instance, if the regulator specifies the equivalent amount of the plants cost that is being disallowed, then that amount should probably be used as the loss. Otherwise, it may be necessary to estimate and use the present value of future cash flows that have been disallowed.

Application of General Principles

When it becomes likely that part of the cost of a plant will be disallowed for rate-making purposes, and a reasonable estimate of the amount of the disallowance can be made, the estimated amount of the disallowance should be deducted from the reported cost of the plant and reported as a loss. When the regulator allows the cost, but reduces or eliminates the return, the recovery of the cost should be discounted and the difference between the discounted amount and the cost of the asset should be written down to that discounted amount. This annual cost must be subtracted from the cash flows to establish the amount available to cover the capital cost, which is what discounting does.

In addition, rate-regulated enterprises should disclose, in the notes to the general purpose financial statements, pertinent information on disallowances, as appropriate (General Principle 13). 6(58)

Future removal and site restoration costs

Accounting Issue

Current accounting standards for profit-oriented enterprises require that a provision be made for future removal and site restoration costs in a rational and systematic manner by charges to income. The accounting issue is whether a rate-regulated enterprise should recognize a regulatory asset or liability when the regulator requires that a different method be followed. For example, the regulator may specify that future rates will provide for the recovery of costs when they are paid.

Accounting Requirements in Canada and the US

Handbook Section 3061 states that:

> *When reasonably determinable, provisions should be made for future removal and site restoration costs, net of expected recoveries, in a rational and systematic manner by charges to income*. (paragraph .35)
>
> Future removal and site restoration costs include costs, net of expected recoveries, for dismantling and abandoning a property. Provisions are needed to accrue the liability for future removal and site restoration costs, when the likelihood of their incurrence is established as a result of environmental law, contract, or because the enterprise has established a policy to restore a site, and when such costs can be reasonably determined. Provisions are recorded as liabilities and are not classified with accumulated amortization. (paragraph .36)
>
> When future removal and site restoration costs cannot be reasonably

determined, a contingent liability may exist. (paragraph .37)

In the US, *Environmental Remediation Liabilities*, AICPA Statement of Position (SOP) 96-1, requires an accrual for environmental clean-up or remediation liabilities. That is, a loss must be accrued by a charge to income if it is both probable and can be reasonably estimated. If the loss is a range, the "reasonably estimated" criterion is met. If no value in the range is more likely than any other, the minimum amount should be accrued. SOP 96-1 also includes benchmarks to aid in the determination of when environmental remediation liabilities should be recognized in accordance with *Accounting for Contingencies*, SFAS 5. *Loss Contingencies Assumed in a Business Combination*, Staff Accounting Bulletin (SAB) 92, sets out the SEC staff position that environmental costs meeting the criteria of SFAS 71, paragraph 9, should be recognized on the balance sheet as a regulatory asset and should not be offset against the liability. *Accounting for Asset Retirement Obligations*, SFAS143, requires the recognition (at fair value) of a liability where there is a legal obligation associated with future removal and site restoration costs. An asset in the same amount will also be established and subsequently allocated to expense using a systematic and rational method over its useful life. SFAS 143 also acknowledges that, for rate-regulated enterprises, there may be a difference in timing for financial reporting and rate-making purposes, and that a regulatory asset or liability may have to be recognized. 7(59)

Application of General Principles

When reasonably determinable, provisions should be made for future removal and site restoration costs in a rational and systematic manner by charges to income. In addition, a regulatory asset would be recorded (General Principles 4 to 7) in those cases where the regulator decides that future rates will provide for the recovery of such costs. When future removal and site restoration costs cannot be reasonably determined, a contingent liability may exist and this should be disclosed in the notes to financial statements (General Principle 13). 8(60)

As discussed earlier in the chapter, it must be acknowledged that some are opposed to the strict application of the General Principles because it would result in an increase in large corporations taxes and capital taxes payable by rate-regulated enterprises, an amount that would generally be passed on to shareholders or customers, depending on whether or not the regulator allows the increased cost to be included in the cost of service. They maintain that, where regulators use the cash method (or some other prescribed method) to determine the amount of expenses to be included in rates, future removal and site restoration costs would be recognized in the period when they are recovered through the regulatory process.

Disposal of capital assets

Accounting Issue

Current accounting standards for profit-oriented enterprises require that the difference between the net proceeds on disposal and the net carrying amount be charged to income in the period when the net carrying amount of an item of property, plant and equipment exceeds the net recoverable amount. The accounting issue is whether a rate-regulated enterprise should be allowed to record a regulatory asset equivalent to the deferral of such differences, if that is the method used for rate-making purposes.

Accounting Requirements in Canada and the US

Handbook Section 3061 states that:

> On disposal of an item of property, plant and equipment, whether by sale, destruction, loss, abandonment or expropriation, the difference between the net proceeds on disposal and the net carrying amount is recognized in income in the period unless there are other aspects of the transaction that would prevent recognition. For example, a sale-leaseback transaction accounted for in accordance with LEASES, Section 3065; and certain transactions more appropriately accounted for as financing arrangements or as cost recoveries. (paragraph .52)
>
> For rate-regulated operations, the regulator may require the difference between net carrying amount and the proceeds on disposal of an item of property, plant and equipment to be considered in the determination of future rates charged to customers. In such circumstances the difference is deferred, provided there is reasonable assurance that:
>
> (a) any excess of net carrying amount over proceeds on disposal will be recovered through future rates; or
>
> (b) any excess of proceeds on disposal over net carrying amount will serve to reduce future rates. (paragraph .53)

In the US, when it becomes probable that a rate-regulated enterprise will abandon an operating asset or an asset under construction, SFAS 90 requires that the cost of the asset be removed from work in progress or plant-in-service. The enterprise would determine the likely recovery of the total costs to be provided from future rates, as permitted by the rate regulator. Only the amounts probable of recovery may be deferred; the remainder is recognized as a loss. *Reasonable Estimation of the Amount of a Loss*, FASB Interpretation 14, provides guidance on estimating the amount of a loss, and *Computation of a Loss on an Abandonment*, Technical Bulletin 87-2, provides guidance on computing the loss.

If the rate regulator permits the enterprise to recover the costs of an abandoned plant over a period of time, the enterprise must consider whether it will be allowed to earn a return on the investment. If it is likely that recovery of cost plus a full return will be granted, SFAS 90 requires that the costs be reported as a separate new asset and amortized in the same manner as used for rate-making purposes. Often the rate regulator does not allow the enterprise to earn a return on its investment in abandoned plant. If no return or a partial return is allowed, only the present value of the future revenues expected to be provided is reported as a separate new asset. Any excess of the total cost of the abandonment over the present value of the estimated future revenues is recorded as a loss.

In the US, *Estimated Future Costs Related to Spent Nuclear Fuel and Nuclear Electric Generating Plants*, SAB Topic 10-B, provides guidance on what disclosures should be made concerning the estimated future costs to decommission nuclear generating plants. The SEC requires that the financial statement notes disclose the estimated costs of dismantling or decontaminating nuclear generating plants and whether provision for these costs is being made in current operations and recognized in rates. If such expected costs are not being provided for currently, utilities should disclose any difference between current and expected future costs and the potential impact on the financial statements or future operations.

Application of General Principles

Losses would generally be reported by rate-regulated enterprises in the period when it becomes probable that they would not be recovered from customers (General Principle 11). Nonetheless, a regulatory asset should be recorded for losses on disposals and write-downs of rate-regulated assets if the regulator permits these losses to be recovered from future rates (General Principles 4 to 7). 9(61) In addition, rate-regulated enterprises should disclose, in the notes to the general purpose financial statements, pertinent information on disposal of items of property, plant and equipment, as appropriate (General Principle 13). 10(62)

Income Taxes

Accounting Issue

Current accounting standards require that profit-oriented enterprises report the expected income tax liability associated with the income that they have recognized, whether or not those taxes are currently payable. The taxes paid in the period, plus the change in the tax liability, are reported as income tax expense. This results in future income taxes being recognized in the period that the associated income is recognized. In many cases, however, the rates of regulated enterprises are based on the flow-through method, whereby the taxes recovered in rates equal the taxes currently payable as a result of the income earned in the period. Generally, it is expected that the future income taxes will become recoverable through allowed rates once they become payable. The accounting issue is whether a rate-regulated enterprise should recognize the economic benefit associated with the expectation that it will collect future income taxes through future allowed rates.

Accounting Requirements in Canada and the US

"Income Taxes," *Handbook* Section 3465, establishes standards for the recognition, measurement, presentation and disclosure of income and refundable taxes in an enterprise's financial statements, with limited application for certain rate-regulated enterprises. Section 3465 replaced the concept of **timing differences** with the concept of **temporary differences**. In addition, it replaced deferred tax debits and credits with future income tax assets and future income tax liabilities. 11(63)

Handbook Section 3465 states that:

> *A rate regulated enterprise need not recognize future income taxes in accordance with the Recommendations of this Section to the extent that future income taxes are expected to be included in the approved rate charged to customers in the future and are expected to be recovered from future customers. If future income taxes are not recognized in accordance with the Recommendations of this Section, the rate regulated enterprise should disclose the following, in addition to the information to be disclosed in accordance with paragraphs 3465.91 and 3465.92:*
>
> *(a) the reason why future income tax liabilities and future income tax assets have not been recognized; and*
>
> *(b) the amount of future income tax liabilities, future income tax assets and future income tax expense that have not been recognized. (paragraph .102)*

Pending further study of accounting for rate regulated enterprises as a whole, rate regulated enterprises are not required to record future income taxes for temporary differences that arise from assets and liabilities relating to their rate regulated activities to the extent that these future income taxes will be included in the rates charged to customers in the future and will be recoverable at that time as set out in paragraph 3465.102. (paragraph .103)

Future income taxes would be recognized in accordance with the remainder of this Section to the extent that future income taxes are not expected to be included in the rates charged to customers in the future. In addition, a rate regulated enterprise that chooses to recognize future income taxes despite the expectation that they will be included in the rates charged to customers in the future would recognize all future income tax liabilities and future income tax assets in accordance with the requirements of this Section. (paragraph .104)

In the US, when it was originally issued, SFAS 71, paragraph 18, noted that:

> Items of revenue and expense are sometimes taxable or deductible in periods other than the periods in which those items are recognized for

> financial reporting purposes. In some cases, a regulator does not include the income tax effect of certain transactions in allowable costs in the period in which the transactions are reported but includes income taxes related to those transactions in allowable costs in the period in which the taxes become payable. In such cases, if it is probable that income taxes payable in future years because of net reversal of timing differences will be recovered through rates based on taxes payable at that time, the enterprise shall record neither the deferred income taxes that result from those timing differences nor the related asset (the probable future benefits that will result from payment of the taxes). However, the enterprise shall disclose the cumulative net amount of income tax timing differences for which deferred income taxes have not been provided. That disclosure supplements the requirements of paragraph 63 of Opinion 11 for disclosure of operating loss carryforwards, significant amounts of other unused deductions or credits, and reasons for significant variations in the customary relationships between income tax expense and pretax accounting income. Except as provided in this paragraph, regulated enterprises shall apply the requirements of Opinion 11.

This, however, was replaced by the following when *Accounting for Income Taxes*, SFAS 109 was issued:

> A deferred tax liability or asset shall be recognized for the deferred tax consequences of temporary differences in accordance with FASB Statement No. 109, Accounting For Income Taxes (SFAS 109 paragraph 288 (v))

Historically, most public utilities used the flow-through method of accounting for certain temporary differences. Under this method, income tax expense was recognized on the basis of taxes paid or payable. A small number of differences were accorded deferred tax treatment (commonly called normalization, from a regulatory standpoint), primarily because of tax regulations. Normalization generally results in higher operating expenses for utilities and, therefore, higher revenue requirements. SFAS 71 allowed flow-through accounting to be used for financial reporting if certain criteria were met.

With the required adoption of SFAS 109, utilities changed the way deferred taxes are calculated and use the liability method to record deferred taxes on temporary differences, regardless of their regulatory treatment. In addition, the definition of temporary differences encompasses the equity component of the AFUDC, which utilities historically recorded on a net-of-tax basis. SFAS 109 prohibits recording of net-of-tax amounts and requires that those amounts be grossed up. Many regulators may continue to require flow-through accounting for income taxes for rate-making purposes. If flow-through accounting is prescribed by the regulator and deferred taxes not currently provided under that method meet the recovery criteria set forth in SFAS 71, the differences between the flow-through method and the liability method would be recorded as regulatory assets or liabilities on the balance sheet. In determining the amount of deferred taxes to be established, SFAS 109 focuses on the probable future revenue to be recovered through rates. SFAS 109 recognizes that the future revenues will include recovery of the tax expense generated on the revenues as well as the deferred tax liability. The tax-on-tax item is recorded as a regulatory asset on the balance sheet, with the offset to the deferred tax liability.

Application of General Principles

Profit-oriented enterprises are required to report the expected income tax liability associated with the income that they have recognized, whether or not those taxes are currently payable. The taxes paid in the period plus the change in the tax liability are reported as income tax expense. This results in future income taxes being recognized in the period that the associated income is recognized. In many cases, however, the rates of regulated enterprises are based on the flow-through method, whereby the taxes recovered in rates are set equal to the taxes currently payable as a result of the income earned in the period. Generally, it is expected that the future income taxes will become recoverable through allowed rates once they become payable.

Application of the General Principles set out in Chapter 7 would result in financial reporting similar to what is required in the US. A rate-regulated enterprise should follow the Recommendations in *Handbook* Section 3465, whether or not rates are based on the flow-through method. That means that the enterprise would report a liability equal to the expected income taxes payable on the income recognized in the current period. Where it is likely that any amount of future income taxes (not necessarily the full amount of future income taxes) would be included in the calculation of future allowed rates, and those rates would be chargeable and collectible from customers, such amounts would be recognized as a regulatory asset. The income tax expense recognized in the period would then be reduced or increased by the change in this regulatory asset (General Principles 4 to 7).

As discussed earlier in this chapter, some are opposed to the strict application of the General Principles because it would result in an increase in large corporations taxes and capital taxes payable by rate-regulated enterprises, an amount that would generally be passed on to shareholders or customers, depending on whether or not the regulator allows the increased cost to be included in the cost of service. They maintain that the current approach used in practice and permitted by the *Handbook* should continue to be used; that is, where rates are based on the flow-through method, this method should also be allowed for financial reporting purposes, with appropriate disclosure in the notes to the financial statements.

In addition, rate-regulated enterprises should disclose, in the notes to the general purpose financial statements, the economic impact of rate-regulation on income taxes on a going-forward basis (General Principle 13). Such disclosures, as required by *Handbook* Section 3465, paragraphs .91, .92 and .102, would be cross-referenced to pertinent information provided in other notes. 12(64)

Intercompany Gains and Losses

Accounting Issue

Current accounting standards for profit-oriented enterprises require that intercompany gains or losses be eliminated in preparing a consolidated income statement. The accounting issue is whether a rate-regulated enterprise should be allowed to realize intercompany gains and losses to the extent that the transfer price is recognized for rate-making purposes.

Accounting Requirements in Canada and the US

"Consolidated Financial Statements," *Handbook* Section 1600, deals with the preparation of consolidated financial statements. To the extent that transactions between the parent and its subsidiaries (intercompany transactions) result in intercompany gains or losses, such gains or losses normally would be eliminated in preparing a consolidated income statement. With regard to rate-regulated enterprises, however, *Handbook* Section 1600, paragraph .29, states that:

> Where a parent or subsidiary manufactures or constructs facilities for a regulated public utility in the consolidated group, any intercompany gain or loss is deemed to have been realized to the extent that the transfer price on such facilities is recognized for rate-making purposes by a government regulatory body.

In the United States, SFAS 71, paragraphs 16 and 17, note that:

> Profit on sales to regulated affiliates shall not be eliminated in general-purpose financial statements if both of the following criteria are met:
>
> (a) the sales price is reasonable.
>
> (b) it is probable that, through the rate-making process, future revenue approximately equal to the sales price will result from the regulated affiliate's use of the products.
>
> The sales price usually shall be considered reasonable if the price is accepted or not challenged by the regulator that governs the regulated affiliate. Otherwise, reasonableness shall be considered in light of the circumstances. For example, reasonableness might be judged by the

return on investment earned by the manufacturing or construction operations or by a comparison of the transfer prices with prices available from other sources.

Application of General Principles

It is important for rate-regulated enterprises to consider whether regulatory agencies will permit any intercompany gains or losses to be included in future rates. Applying the General Principles set out in Chapter 7 (in particular General Principle 11), such enterprises would not eliminate intercompany profits on sales to regulated affiliates if it is likely that, through the rate-making process, future revenues in amounts approximately equal to the intercompany transfer price will be provided. That revenue would result from inclusion of the intercompany profits in the amount used by the regulator as allowable costs for purposes of depreciation and return on investment.

In such cases, a regulated enterprise should recognize profits on sales to a regulated affiliate to the extent that the profits are included in allowable costs in the rate-making process because the profits are validated by the rate actions of the regulator. The regulator's acceptance of the transfer price provides evidence of recoverability. For rate-making purposes, the intercompany profits would be included in the depreciation used as an allowable cost, and the undepreciated amount would be included in the investment on which a return is provided as an allowable cost.

Employee Future Benefits

In an August 1999 survey of rate-regulated enterprises (discussed in Chapter 1), respondents stated that there should be some consideration given to ensuring that accounting requirements — such as "Employee Future Benefits," *Handbook* Section 3461 — do not negatively affect customer rates or investor return.

Accounting Issue

Current accounting standards for profit-oriented enterprises require that an entity recognize the cost of retirement benefits and certain post-employment benefits over the periods in which employees render services to the entity in return for the benefits. The accounting issue is whether a rate-regulated enterprise should recognize a regulatory asset or liability when the regulator requires that the pay-as-you-go (cash method) or some other prescribed method be used to determine rates. For example, the regulator may specify that future rates will provide for the recovery of costs when they are paid or the regulator may specify that costs will be recovered prior to the period in which they would normally be expensed.

Accounting Requirements in Canada and the US

Handbook Section 3461 establishes standards for the recognition, measurement and disclosure of the cost of employee future benefits, including pension and other retirement benefits, post-employment benefits, compensated absences and termination benefits. Generally, an entity must recognize the cost of retirement benefits and certain post-employment benefits over the periods in which employees render services to the entity in return for the benefits. Other post-employment benefits are recognized when the event that obligates the entity occurs. The standard is in harmonization with the US standard on this subject.

In the US, SFAS 71, paragraph 48, notes that *Accounting for Compensated Absences*, SFAS 43, "specifies criteria for accrual of a liability for employees' compensation for future absences. For rate-making purposes, compensation for employees' absences may be included in allowable costs when the compensation is paid." According to SFAS 71, paragraph 49:

> the liability, if any, would be accrued in accordance with SFAS 43 because rate actions of the regulator cannot eliminate obligations that were not imposed by the regulator. ... By including the accrued compensation in future allowable costs on an as-paid basis, the regulator provides reasonable assurance of the existence of an asset. The asset is the probable future benefit (increased revenue) that will result from the regulatory treatment of the subsequent payment of the liability ... . Accordingly, the enterprise also would record the asset that results from the regulator's actions.

In *Accounting for OPEB Costs by Rate Regulated Enterprises*, EITF Issue 92-12, the task force reached consensus on several issues. For plans providing postretirement benefits other than pensions (OPEB plans), the task force ched a consensus that a regulatory asset related to costs covered by *Employers' Accounting for Postretirement Benefits Other Than Pensions*, SFAS 106:

> should not be recorded if the regulator continues to include OPEB costs in rates on a pay-as-you-go basis. ... For a continuing plan a rate-regulated enterprise should recognize a regulatory asset for the difference between SFAS 106 costs and OPEB costs included in the enterprise's rates if the enterprise (1) determines that it is probable that future revenue in an amount at least equal to the deferred cost (regulatory asset) will be recovered in rates, and (2) meets *all* of the [specified] criteria.

The task force also reached a consensus that:

> a rate-regulated enterprise should disclose in its financial statements a description of the regulatory treatment of OPEB costs, the status of any

pending regulatory action, the amount of any SFAS 106 costs deferred as a regulatory asset at the balance sheet date, and the period over which the deferred amounts are expected to be recovered in rates.

In addition, the task force concluded in *Accounting for Regulatory Assets*, EITF Issue 93-4, that if a rate-regulated entity initially fails to meet the regulatory asset recognition requirements of the consensus developed in EITF Issue 92-12, but meets those requirements in a subsequent period, a regulatory asset for the cumulative difference between SFAS 106 costs and OPEB costs included in rates since the date of adoption of SFAS 106 should be recognized in the period the requirements are met.

Application of General Principles

Following a strict application of the General Principles, a rate-regulated enterprise should recognize the cost of retirement benefits and certain post-employment benefits over the periods in which employees render services to the entity in return for the benefits in accordance with *Handbook* Section 3461. In addition, the difference between the net periodic pension cost, as recognized in accordance with GAAP, and the amounts of pension cost considered for rate-making purposes would be recognized as a regulatory asset or a regulatory liability (General Principles 4 to 10). The actions of the regulator do not affect the recognition of pension liabilities or assets; what they do is create a regulatory asset or liability in addition to the pension liability or asset. The same applies to the recognition of other postemployment benefits costs and liabilities. In addition, rate-regulated enterprises should disclose, in the notes to the general purpose financial statements, the economic impact o rate-regulation on employee future benefits on a going-forward basis (General Principle 13). Such disclosures, as required by *Handbook* Section 3461, paragraphs .150 to .163 should be cross-referenced to pertinent information provided in other notes. 13(65)

As discussed earlier in this chapter, some are opposed to the strict application of the General Principles because it would result in an increase in large corporations taxes and capital taxes payable by rate-regulated enterprises, an amount that would generally be passed on to shareholders or customers, depending on whether or not the regulator allows the increased cost to be included in the cost of service. They maintain that, where regulators use the pay-as-you-go (cash method) or some other prescribed method to determine the amount of expenses to be included in rates, the costs of employee future benefits would be recognized in the period when they are recovered through the regulatory process. In addition, the notes to the financial statements would disclose the liability relating to the employee future benefits and the expectation of recovery thereof.

Foreign Currency Translation

According to the August 1999 survey of rate-regulated enterprises (discussed in Chapter 1), respondents stated that there should be some consideration given to ensuring that accounting requirements in "Foreign Currency Translation," *Handbook* Section 1650, and proposed changes in those requirements do not negatively affect customer rates or investor return.

Accounting Issue

Current accounting standards for profit-oriented enterprises require that exchange gains and losses on long-term monetary items be included immediately in income. The accounting issue is whether a rate-regulated enterprise should recognize a regulatory asset for exchange gains and losses on long-term monetary items that are deferred and amortized or recovered in rates when realized for rate-making purposes.

Accounting Requirements in Canada and the US

According to *Handbook* Section 1650, exchange gains and losses arising on translation or settlement of a foreign currency transaction (except those that are (1) related to certain intercompany transactions or (2) transactions designated as, and effective as, economic hedges of net investments and foreign currency commitments) should be included in the determination of net income for the current period. The Canadian standard is in harmonization with the US standard on this subject. 14(66)

In the US, foreign currency transaction gains and losses should be included in the determination of income for the period in which the exchange rate changes except those that are (1) related to certain intercompany transactions, (2) certain amounts related to a derivative instrument that is a cash flow hedge of a forecasted foreign-currency-denominated transaction or a forecasted intercompany foreign-currency-denominated transaction, and (3) an intercompany balance for which settlement is not planned or anticipated in the foreseeable future and that is considered to be part of the net investment in a foreign operation (refer to *Foreign Currency Translation*, SFAS 52, *Accounting for Derivative Instruments and Hedging Activities*, SFAS 133, and *Accounting for Certain Derivative Instruments and Certain Hedging Activities: an amendment of FASB Statement No. 133*, SFAS 138).

Application of General Principles

A rate-regulated enterprise should include exchange gains and losses on long-term monetary items in the determination of net income in accordance with the requirements of *Handbook* Section 1650. A regulatory asset or a regulatory liability, however, would be recognized if such gains and losses are deferred and amortized or recovered when realized for rate-making purposes (General Principles 4 to 10). In addition, rate-regulated enterprises should disclose, in the notes to the general purpose financial statements, the economic impact of rate-regulation on exchange gains and losses on a going-forward basis (General Principle 13).

As discussed earlier in this chapter, some are opposed to the strict application of the General

Principles because it would result in an increase in large corporations taxes and capital taxes payable by rate-regulated enterprises, an amount that would generally be passed on to shareholders or customers, depending on whether or not the regulator allows the increased cost to be included in the cost of service. They maintain that, where regulators use the cash method, or some other prescribed method, to determine the amount of gains and losses to be included in rates, foreign exchange gains and losses would be recognized in the period when they are included in rates, and appropriate disclosure would be provided in the notes to the financial statements.

Financial Instruments

According to the August 1999 survey of rate-regulated enterprises (discussed in Chapter 1), respondents stated that there should be some consideration given to ensuring that accounting requirements in "Financial Instruments," *Handbook* Section 3860, and proposed changes in those requirements, do not negatively affect customer rates or investor return.

Proposal for a comprehensive fair value model

In January 2001, the Canadian Accounting Standards Board and accounting standard setters in nine other international jurisdictions, including the US and IASC, issued an "Invitation to Comment" on proposals for a comprehensive fair value model to account for financial instruments and similar items. The proposals differ from *Accounting for Derivative Instruments and Hedging Activities*, SFAS 133, and *Financial Instruments: Recognition and Measurement*, IAS 39 (the principal two existing accounting standards on the subject), but they build on the same general principles, while avoiding much of the complexity of the interim steps in those standards. The Accounting Standards Board believes that existing Canadian accounting standards for recognition and measurement of financial instruments are inadequate and that the *status quo* cannot continue.

Application of General Principles

If accounting standards were to be issued by the Accounting Standards Board with regard to applying a "fair value" model to financial instruments, such standards would apply to rate-regulated enterprises. In their case, however, a regulatory asset or a regulatory liability would be recognized when the increase or decrease in "fair value" is deferred and amortized for rate-making purposes (General Principles 4 to 10). In addition, rate-regulated enterprises would disclose, in the notes to the general purpose financial statements, the economic impact of rate-regulation on financial instruments on a going-forward basis (General Principle 13).

As discussed earlier in this chapter, some are opposed to the strict application of the General Principles because it would result in an increase in large corporations taxes and capital taxes payable by rate-regulated enterprises, an amount that would generally be passed on to shareholders or customers, depending on whether or not the regulator allows the increased cost to be included in the cost of service. They maintain that, where regulators use the cash method to determine the gains and losses to be included in rates, the increase or decrease in the "fair value" of financial instruments would be recognized in the period when they are included in rates, and appropriate disclosure would be provided in the notes to the financial statements.

SPECIFIC ISSUES ADDRESSED IN THE UNITED STATES

A brief commentary on the following specific issues covered in SFAS 71 is set out below with a view to providing useful guidance and to serve as the basis for eliminating significant differences in GAAP between Canada and the United States:

- intangible assets;
- accounting changes;
- recovery of costs without return on investment;
- early extinguishment of debt;
- contingencies;
- leases;
- revenue collected subject to refund;
- refunds to customers;
- alternative revenue programs.

Intangible Assets

In Canada, accounting by rate-regulated enterprises for intangible assets is governed by "Goodwill and Other Intangible Assets," *Handbook* Section 3062, which states that an intangible asset should be initially recognized and measured at cost, and amortized over its useful life, unless that life is determined to be indefinite, in which case it will not be amortized until its life is determined to be finite. Intangible assets should be reviewed or tested periodically for impairment. 15(67)

The United States, in *Goodwill and Other Intangible Assets*, SFAS 142, has similar requirements. SFAS 71, paragraph 29, has been amended to note that SFAS 142 states that goodwill shall not be amortized and shall be tested for impairment in accordance with that Statement. Paragraph 29 also notes that, for rate-making purposes, a regulator may permit an enterprise to amortize purchased goodwill over a specified period. In other cases, a regulator may direct an enterprise not to amortize goodwill or to write off that goodwill.

According to SFAS 71, paragraph 30 (as amended):

> if the regulator permits all or a portion of goodwill to be amortized over a specific time period as an allowable cost for rate-making purposes, the regulator's action provides reasonable assurance of the existence of a regulatory asset. ... That regulatory asset would then be amortized for financial reporting purposes over the period during which it will be allowed for rate-making purposes. Otherwise, goodwill shall not be amortized and shall be accounted for in accordance with SFAS 142.

Rate-regulated enterprises should recognize a regulatory asset in their financial statements in accordance with General Principles 4 to 7, to the extent that the amount to be recovered in future rates (ignoring return on the intangible asset) exceeds the amount that would be capitalized by a non-regulated enterprise. Professional judgment should be used in choosing the method that allows amortization to be recognized in a rational and systematic manner appropriate to the nature of the intangible asset. The amortization method should be reviewed on a regular basis. Furthermore, rate-regulated enterprises should disclose, in the notes to the general purpose financial statements, how rate regulation affects the reported values of intangible assets on a going-forward basis (General Principle 13). Rate-regulated enterprises should determine the extent to which their regulatory amortization methods differ from normal GAAP methods and lives and, if the differences are significant, consider disclosing them in the financial statements.

Accounting Changes

"Accounting Changes," *Handbook* Section 1506, establishes standards for the accounting treatment of a change in accounting policy as well as a change in an accounting estimate and a correction of an error relating to prior period financial statements and prior period adjustments.

It is important to note that the appropriate treatment of accounting changes depends not only on the nature of the change, but also on its treatment as prescribed by the regulator. In interpreting GAAP requirements for rate-regulated enterprises, reference is often made to SFAS 71 for guidance. SFAS 71, paragraph 32, offers the following clarification regarding the treatment of accounting changes by a regulated enterprise:

> If a regulated enterprise changes accounting methods and the change does not affect costs that are allowable for rate-making purposes, the regulated enterprise would apply the change in the same manner as would an unregulated enterprise. ... If a regulated enterprise changes accounting methods and the change affects allowable costs for rate-making purposes, the change generally would be implemented in the way that it is implemented for regulatory purposes.

As a result, if a change in accounting policy does not affect costs allowable for rate-making purposes, the rate-regulated enterprise should account for the change in accordance with the Recommendations in *Handbook* Section 1506 (that is, using retroactive restatement, except in specific circumstances). Capitalization of leases with no income statement effect is an example of that type of change.

If a change in accounting policy affects allowable costs for rate-making purposes, however, the change generally would be implemented in the way that it is implemented for regulatory purposes. 16(68) A change in the method of accounting for research and development costs, either from a policy of capitalization and amortization to one of charging those costs to expense as incurred or *vice versa*, is an example of that type of change.

Recovery of Costs without Return on Investment

In Canada, no specific accounting pronouncements address the issue of accounting by rate-regulated enterprises for the recovery of costs without return on investment. In the United States, however, SFAS 71, paragraph 33, states that, "in some cases, a regulator may approve rates that are intended to recover an incurred cost over an extended period without a return on the unrecovered cost during the recovery period." According to SFAS 71, paragraph 34, "the regulator's action provides reasonable assurance of the existence of an asset. ... Accordingly, the regulated enterprise would capitalize the cost and amortize it over the period during which it will be allowed for rate-making purposes. That cost would not be recorded at discounted present value."

If material, appropriate disclosures as specified in SFAS 71, paragraph 20, would be provided, as follows:

> In some cases, a regulator may permit an enterprise to include a cost that would be charged to expense by an unregulated enterprise as an allowable cost over a period of time by amortizing that cost for rate-making purposes, but the regulator does not include the unrecovered amount in the rate base. That procedure does not provide a return on investment during the recovery period. If recovery of such major costs is provided without a return on investment during the recovery period, the enterprise should disclose the remaining amounts of such assets and the remaining recovery period applicable to them.

An expenditure should be recognized as an asset if it meets the *Handbook* definition of a rate-regulated capital asset and the pertinent recognition criteria (General Principles 4 to 7). The regulated enterprise would capitalize an incurred cost and amortize it over the period during which it will be allowed for rate-making purposes. That cost would not be recorded at discounted present value because it will be recovered without a return on investment. Furthermore, rate-regulated enterprises should disclose, in the notes to the general purpose financial statements, how rate regulation affects the reported values of capital assets on a going-forward basis (General Principle 13).

Early Extinguishment of Debt

In Canada, no specific accounting pronouncements address the issue of accounting for the early extinguishment of debt. In the United States, however, SFAS 71, paragraphs 35-37, note that *Early Extinguishment of Debt*, AICPA Accounting Principles Board Opinion 26, "requires recognition in income of a gain or loss on an early extinguishment of debt in the period in which the debt is extinguished. For rate-making purposes, the difference between the enterprise's net carrying amount of the extinguished debt and the reacquisition price may be amortized as an adjustment of interest expense over some future period."

According to SFAS 71, paragraphs 36 and 37:

> If the debt is reacquired for an amount in excess of the enterprise's net carrying amount, the regulator's decision to increase future rates by amortizing the difference for rate-making purposes provides reasonable assurance of the existence of an asset. ... Accordingly, the regulated enterprise would capitalize the excess cost and amortize it over the period during which it will be allowed for rate-making purposes.
>
> If the debt is reacquired for an amount that is less than the enterprise's net carrying amount, the regulator's decision to reduce future rates by amortizing the difference for rate-making purposes imposes a liability on the regulated enterprise. ... Accordingly, the enterprise would record the difference as a liability and amortize it over the period during which permitted rates will be reduced.

With regard to accounting for the early extinguishment of debt, the difference between the rate-regulated enterprise's net carrying amount of the extinguished debt and the reacquisition price should be recognized as a regulatory asset or liability (depending on the nature of that difference) in accordance with General Principles 4 and 8, respectively, provided it is treated as such for rate-making purposes. 17(69) Furthermore, rate-regulated enterprises should disclose in the notes to the general purpose financial statements, how rate regulation affects the reported values of debt on a going-forward basis (General Principle 13).

Contingencies

In Canada, accounting for contingencies is governed by "Contingencies," *Handbook* Section 3290.

In the United States, SFAS 71, states that:

> [*Accounting for Contingencies*, SFAS 5] specifies criteria for recording estimated losses from loss contingencies. A regulator may direct a regulated enterprise to include an amount for a contingency in allowable costs for rate-making purposes even though the amount does not meet the criteria of SFAS 5 for recording. For example, a regulator may direct a regulated enterprise to include an amount for repairs of expected future uninsured storm damage. (paragraph 38)
>
> If the regulator requires the enterprise to remain accountable for any amounts charged pursuant to such rates and not yet expended for the intended purpose, the resulting increased charges to customers create a liability ... . If a cost to repair storm damage is not subsequently incurred, the increased charges will have to be refunded to customers through future rate reductions. Accordingly, the regulated enterprise would recognize the amounts charged pursuant to such rates as liabilities rather than as revenues. If a cost to repair storm damage is subsequently incurred, the enterprise would charge that cost to expense and reduce the liabilities at that time by recognizing income in amounts equal to the cost. (paragraph 39)

With regard to accounting for estimated losses from loss contingencies, the increased charges to customers create a liability if the conditions set out in General Principle 8 are met. Furthermore, rate-regulated enterprises should disclose in the notes to the general purpose financial statements how rate regulation affects the reported contingencies on a going-forward basis (General Principle 13).

Leases

In Canada, accounting for leases is governed by "Leases," *Handbook* Section 3065. The survey of current practices referred to in Chapter 3 and reported in Appendix B, indicates that five of 25 survey companies provided information on leases in the notes to the financial statements.

In the United States, SFAS 71, paragraph 40, notes that:

> [*Accounting for Leases*, SFAS 13] ... specifies criteria for classification of leases and the method of accounting for each type of lease. For rate-making purposes, a lease may be treated as an operating lease even though the lease would be classified as a capital lease under the criteria of Statement 13. In effect, the amount of the lease payment is included in allowable costs as rental expense in the period it covers. (paragraph 40)
>
> For financial reporting purposes, the classification of the lease is not

> affected by the regulator's actions. The regulator cannot eliminate an obligation that was not imposed by the regulator ... . Also, by including the lease payments as allowable costs, the regulator sets rates that will provide revenue approximately equal to the combined amount of the capitalized leased asset and interest on the lease obligation over the term of the lease and, thus, provides reasonable assurance of the existence of an asset ... . Accordingly, regulated enterprises would classify leases in accordance with Statement 13 ... . (paragraph 41)
>
> The nature of the expense elements related to a capitalized lease (amortization of the leased asset and interest on the lease obligation) is not changed by the regulator's action; however, the timing of expense recognition related to the lease would be modified to conform to the rate treatment. Thus, amortization of the leased asset would be modified so that the total of interest on the lease obligation and amortization of the leased asset would equal the rental expense that was allowed for rate-making purposes. (paragraph 42)
>
> The Board notes that generally accepted accounting principles do not require interest expense or amortization of leased assets to be classified as separate items in an income statement. For example, the amounts of amortization of capitalized leased nuclear fuel and interest on the related lease obligation could be combined with other costs and displayed as "fuel cost." However, the disclosure of total interest cost incurred, required by [*Capitalization of Interest Cost*], Statement 34, would include the interest on that lease obligation; and the disclosure of the total amortization charge, required by Statement 13, would include amortization of that leased asset. (paragraph 43)

With regard to accounting for leases, the classification of the lease is not affected by the regulator's actions. The regulator cannot eliminate an obligation that was not imposed by the regulator. Nonetheless, the timing of expense recognition related to the lease would be modified to conform to the rate treatment and related regulatory asset or liability recognized in the financial statements if the conditions set out in General Principles 4 or 8, respectively, are met. Furthermore, rate-regulated enterprises should disclose, in the notes to the general purpose financial statements, how rate regulation affects the reported values of leases on a going-forward basis (General Principle 13).

As discussed earlier in this chapter, some are opposed to the strict application of the General Principles because it would result in an increase in large corporations taxes and capital taxes payable by rate-regulated enterprises, an amount that would generally be passed on to shareholders or customers, depending on whether or not the regulator allows the increased cost to be included in the cost of service. They maintain that, where regulators use the cash method, expenses related to the lease would be recognized in the period when they are included in rates and appropriate disclosure would be provided in the notes to the financial statements.

Revenue Collected Subject to Refund

In Canada, no specific accounting pronouncements address the issue of accounting by rate-regulated enterprises for revenue collected subject to refund. In the United States, however, SFAS 71 (paragraph 44) notes that, "in some cases, a regulated enterprise is permitted to bill requested rate increases before the regulator has ruled on the request." In other words, regulated enterprises are granted temporary rate increases by a regulatory authority, subject to the condition that all or a portion of the additional revenues may be refundable to customers. If the rates finally authorized are lower than the temporary rates, usually the utility is required to refund the excess revenues.

According to SFAS 71, paragraph 45, the provisions of *Accounting for Contingencies*, SFAS 5, determine whether a provision for estimated refunds should be accrued for this loss contingency. Generally, a regulated enterprise records a liability to refund revenues previously collected from customers when it is probable that a refund will be due and the amount of the refund is reasonably determinable. In practice, these conditions are often met only when the regulator issues an order for a refund. In some circumstances, however, the conditions of SFAS 5 may be met before a formal rate order is issued. SFAS 71 does not permit refunds to be recognized as prior-period adjustments. Instead, refunds must be recognized in the accounting period in which the requirements of SFAS 5 are met. The enterprise must disclose the effect of the refund on net income of the current year and indicate the years when the refunded revenue was recognized.

With regard to accounting for revenue collected subject to refund, a regulatory liability should be recognized in the financial statements if the conditions set out in General Principle 8 are met. Furthermore, rate-regulated enterprises should disclose, in the notes to the general purpose financial statements, how rate regulation affects the reported values of liabilities on a going-forward basis (General Principle 13).

Refunds to Customers

In Canada, no specific accounting pronouncements address the issue of accounting by rate-regulated enterprises for refunds to customers. In the United States, however, SFAS 71, paragraph 46, notes that *Prior Period Adjustments*, SFAS 16, "limits prior period adjustments (other than those that result from reporting accounting changes) to corrections of errors, and adjustments related to prior interim periods of the current fiscal year."

According to SFAS 71, paragraph 47, "in accordance with Statement 16, estimated refunds that were not previously accrued would be charged to income in the first period in which they meet the criteria for accrual (paragraph 8, Statement 5). If the amounts are material, the disclosures specified in paragraph 19 of [SFAS 71] would be furnished." That is, for refunds that are recognized in a period other than the period in which the related revenue was recognized and that have a material effect on net income, the enterprise should disclose the effect on net income and indicate the years in which the related revenue was recognized. Such effect may be disclosed by including it, net of related income taxes, as a line item in the income statement. It should not be presented as an extraordinary item.

With regard to accounting for refunds to customers, a regulatory liability should be recognized in the financial statements if the conditions set out in General Principle 8 are met. Furthermore, rate-regulated enterprises should disclose in the notes to the general purpose financial statements, how rate regulation affects the reported values of such liabilities on a going-forward basis (General Principle 13).

Alternative Revenue Programs

In Canada, no specific accounting pronouncements address the issue of accounting by rate-regulated enterprises for alternative revenue programs. In the United States, *Accounting by Rate-Regulated Utilities for the Effects of Certain Alternative Revenue Programs*, EITF Issue 92-7, the consensus of the task force was that once specified events occur that permit billing of additional revenues due to weather abnormalities or to compensate the utility for demand-side management initiatives or reward the utility for achieving certain objectives, the regulated utility should recognize the additional revenues if all of the following conditions are met:

1. The program is established by an order from the utility's regulatory commission that allows for automatic adjustment of future rates. Verification of the adjustment to future rates by the regulator would not preclude the adjustment from being considered automatic.
2. The amount of additional revenues for the period is objectively determinable and is probable of recovery.
3. The additional revenues will be collected within 24 months following the end of the annual period in which they are recognized.

With regard to accounting for alternative revenue programs, a regulatory asset should be recognized in the financial statements if the conditions set out in General Principle 4 are met.

DISCONTINUING ACCOUNTING FOR THE EFFECTS OF RATE REGULATION

General Principle 3 states: "When an enterprise that has regulated operations no longer meets the criteria set out in Principle 1, it should discontinue reporting the economic impact of rate regulation and reflect the effects of discontinuation in its general purpose financial statements."

Whether a rate-regulated enterprise is in the private sector or the public sector, it must be mindful of circumstances that may indicate the need to discontinue accounting for the effects of rate regulation.

In Canada, no specific accounting pronouncements address the issue of discontinuation of accounting for the economic impact of rate regulation. 18(70) In the United States, the FASB issued *Regulated Enterprises — Accounting for the Discontinuation of Application of FASB Statement No. 71*, SFAS 101, in 1988. SFAS 101 specifies that an entity that ceases to meet the criteria for application of SFAS 71 should report that event in its general purpose financial statements.

It is possible for an enterprise to continue to be regulated (and meet the first criterion) and not be able to meet one or both of the other two criteria (cover the costs of providing services through the established rates and recover those costs from customers). As a result, the enterprise would continue to have its rates established by the regulator and would follow regulatory requirements, but would not be able to recognize the impact of the regulator's actions in its general purpose external financial statements.

Changing regulatory practices and alternative forms of rate regulation may raise questions about an enterprise's ability to continue to meet the second criterion. When a regulator departs from the traditional rate-making model, the regulated enterprise must assess whether the new rate regulation is designed to recover the costs of providing the regulated services or products. In this respect, General Principle 3 calls for an ongoing assessment of the likelihood of recovery of regulatory assets subsequent to their initial recognition. At each balance sheet date, management should ensure that sufficient evidence exists to support a recorded regulatory asset. Evidence should be available to demonstrate that the costs in question continually meet the "probable" criteria for creating and continuing to record regulatory assets.

Reporting the Effects of Discontinuation

When an enterprise discontinues accounting for the economic impact of rate regulation, it should eliminate from its balance sheet the effects of any actions of regulators that had been recognized as assets and liabilities, but would not have been recognized as such by business enterprises in general. In accordance with GAAP, the carrying amounts of plant, equipment and inventory would not be adjusted, however, unless their value is impaired. Similarly, an example of a legal liability that would not be written off is an obligation for rate refunds to be distributed to customers based on past sales.

The net income effect of these adjustments would be recognized in the period in which discontinuation occurs. It would be reported as an extraordinary item because it is not in the normal course of operations. As well, the notes to general purpose financial statements would disclose pertinent information regarding the discontinuation of accounting for the effects of rate regulation (refer to General Principle 12 and 13 regarding note disclosures).

Application to Separable Portions of a Business

General Principle 2 states: "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." Accordingly, the discontinuation would be applied to a separable portion of operations within a jurisdiction if the enterprise can establish that its other operations within the jurisdiction continue to meet the established criteria.

This is consistent with the approach taken in the United States, where SFAS 71 applies to separable portions of a regulated enterprise's operations (paragraph 6). SFAS 101 also applies to separable portions of operations, such as a customer class or a functional group of assets within a jurisdiction. In *Deregulation of the Pricing of Electricity — Issues Related to the Application of FASB Statements No. 71 and 101*, Issue 97-4, the EITF considered when an enterprise should cease applying SFAS 71 to a separable portion of its business whose pricing is being deregulated. The consensus was that the appropriate time is when the enterprise can reasonably determine how the transition plan will affect the portion of the business being deregulated. The related regulatory assets and liabilities should be evaluated on the basis of the source of the cash flows that will realize or settle them. SEC staff requires assurance that such regulatory assets have been specifically provided for *via* he collection of regulated cash flows.

CONCLUSION

Chapter 7 of this Research Report sets out General Principles for accounting and financial reporting by rate-regulated enterprises. While detailed guidance is not essential to recognize the economic impact of rate regulation on the financial reporting of rate-regulated enterprises, in the Study Group's opinion 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 provides specific guidance on accounting issues that are considered of interest to the regulatory community, with emphasis given to those areas that may have a material impact on general purpose financial statements. Also addressed are general considerations with respect to the recording of regulatory assets and liabilities, demonstrating the ongoing recoverability of assets created by rate regulation, and recognizing when it is time to discontinue accounting for the effects of rate regulation.

Appendix A

CONCEPTUAL FRAMEWORKS OF CANADA AND THE UNITED STATES

The accounting standards boards of Canada and the United States have issued conceptual framework statements to create a basis for the development and application of accounting standards. Although the frameworks vary significantly in structure and detail, there are few fundamental differences between them.

The Canadian framework, "Financial Statement Concepts," is set out in Section 1000 of the *CICA Handbook – Accounting*. The US framework is set out in separate, but interrelated, FASB Concepts Statements — *Objectives of Financial Reporting by Business Enterprises, Qualitative Characteristics of Accounting Information, Elements of Financial Statements, Objectives of Financial Reporting by Nonbusiness Organizations, Recognition and Measurement in Financial Statements of Business Enterprises*, and *Using Cash Flow Information and Present Value in Accounting Measurements*.

The Canadian and US frameworks specifically state that the concepts do not, in themselves, establish standards or generally accepted accounting principles but are the tools for solving accounting and reporting problems and for developing standards. In this regard, the Canadian framework notes that the concepts are "to be used by preparers of financial statements and accounting practitioners in exercising their professional judgment as to the application of generally accepted accounting principles and in establishing accounting policies in areas in which accounting principles are developing." 1(71)

The frameworks in the two countries indicate that their purpose is to present concepts that are relevant to the preparation and presentation of financial statements. The Canadian framework applies to general purpose **financial statements**, whereas the US framework applies to general purpose **financial reporting**. Both frameworks identify what is normally included in a set of financial statements: a balance sheet (a statement of financial position), an income statement, a statement of retained earnings (a statement of changes in stockholders' equity) and a statement of changes in financial position (a cash flow statement). The frameworks limit the items recognized in the financial statements to those based on past transactions and events. They also note that the information provided often results from approximate, rather than exact, measures. The US framework further notes that financial reporting is only one source of information needed by users to make economic decisions.

Objective and Users of Financial Statements

In Canada and the United States, the conceptual frameworks state that the objective of **financial statements** is to provide information to users about an entity's financial position and results of operations. 2(72) They emphasize providing information that is useful in making investment, credit and other decisions and in assessing management stewardship.

Specifically, *CICA Handbook – Accounting* Section 1000, "Financial Statement Concepts," states (in paragraph 1000.15) that:

> The objective of financial statements is to communicate information that is useful ... in making ... resource allocation decisions and/or assessing management stewardship. Consequently, financial statements provide information about:
>
> (a) an entity's economic resources, obligations and equity / net assets;
>
> (b) changes in an entity's economic resources, obligations and equity / net assets; and
>
> (c) the economic performance of the entity.

In the United States, FASB Concepts Statement 1, *Objectives of Financial Reporting by Business Enterprises*, sets out objectives and concepts for use in developing standards of financial accounting and reporting. The discussion begins with a broad focus on information that is useful in investment and credit decisions (paragraph 34). It then narrows that focus to investors' and creditors' primary interest in the prospects for receiving cash from their investments in, or loans to, business enterprises and the relation of those prospects to an enterprise's cash flow prospects (paragraph 37). Finally, the discussion focuses on information about the economic resources of an enterprise, the claims to those resources, and the effects of transactions, events and circumstances that change resources and claims to those resources (paragraph 40).

According to FASB Concepts Statement 1, financial reporting should provide the following:

- information about an enterprise's economic resources, obligations, and owners' equity;
- information about an enterprise's performance and earnings;
- information about an enterprise's liquidity, solvency and funds flows;
- information about management's stewardship and performance;
- management's explanations and interpretations.

In both countries, the focus is on users and their information needs. In Canada, the users of general purpose financial statements include those identified in the *CICA Handbook – Accounting* (paragraph 1000.09 lists investors, creditors and their advisers) and in the *CICA Public Sector Accounting Handbook* (PS 1400.09 lists the public, legislators, investors and analysts). Although investors (shareholders) and creditors are considered to be the primary users, it is stated that other users will find the information in financial statements generally useful.

Investors and creditors of profit oriented enterprises are interested, for the purpose of making resource allocation decisions, in predicting the ability of the entity to earn income and generate cash flows in the future to meet its obligations and to generate a return on investment. Investors and creditors also require information about how the management of an entity has discharged its stewardship responsibility to those who have provided resources to the entity.

FASB Concepts Statement 1 identifies the following potential users of financial information: "owners, lenders, suppliers, potential investors and creditors, employees, management, directors, customers, financial analysts and advisors, brokers, underwriters, stock exchanges, lawyers, economists, taxing authorities, regulatory authorities, legislators, financial press and reporting agencies, labour unions, trade associations, business researchers, teachers and students, and the public" (paragraph 24). Except for management, and to some extent directors, these potential users are "external users" and the focus is on the external aspect of financial reporting.

Among external users, taxing and regulatory agencies have statutory authority to require specific information needed to fulfill their functions. Similarly, some present or potential investors and creditors may be able to require an enterprise to provide specified information as a condition to entering into a particular transaction. This Research Report is concerned primarily with the needs of external users who lack the authority to prescribe the financial information they want from an enterprise and, therefore, must use the information that management communicates to them. This does not mean that regulatory agencies are not users, in the sense of having a legitimate interest in the general purpose financial reporting of enterprises they regulate. Inasmuch as they can prescribe the financial information they require, however, they do not have the same reliance on general purpose financial statements as external users who lack that authority.

Certain government-owned and operated rate-regulated enterprises are equivalent to private-sector businesses. In fact, some may consider them to be business enterprises and regard contributors, customers and citizens as the equivalent of investors in those enterprises. Furthermore, many of those enterprises sell bonds to the public and, hence, have at least some investors in the usual sense of the word; all of those enterprises have creditors.

Qualities and Characteristics of Useful Information

The qualities and characteristics that make information useful for decision making are the criteria for selecting preferable accounting choices from among available alternatives. Both conceptual frameworks refer to *understandability, relevance, reliability, predictive and feedback value, materiality, representational faithfulness, neutrality, conservatism (prudence), completeness, comparability, consistency, timeliness, the benefit versus cost constraint*, and *verifiability* as qualities and characteristics that have an impact on the usefulness of information provided in the financial statements. The emphasis given to some of those qualities and characteristics varies between the two countries, and there are some minor differences in the definition or interpretation of some of those listed.

For example, the US framework sets out a hierarchy that distinguishes between primary and other accounting qualities. It notes, however, that the hierarchy is an exploratory device, whose purpose is to clarify certain relationships rather than assign relative weights or importance to specific qualities. The Canadian framework notes four principal characteristics (understandability, relevance, reliability and comparability) and identifies other qualities that have an impact on these principal characteristics. It notes that, in practice, a trade-off between qualitative characteristics often is necessary.

The Canadian framework also refers to *substance over form* as a characteristic of financial information, whereby transactions are accounted for and presented in a manner that conveys their substance rather than necessarily their legal form. The US framework notes that this is rather a vague idea that defies precise definition. It considers that *representational faithfulness* leaves no room for accounting representations that subordinate substance to form. Furthermore, the US framework stresses that accounting standards cannot be phrased in such a way that their application can suit all circumstances; therefore, judgmental choices must be made.

Underlying Assumptions

Two basic underlying assumptions are noted in the frameworks: the *accrual basis* and *going concern*. The *accrual basis* recognizes the effect of transactions and other events and circumstances in the period in which they occur, regardless of whether there has been a receipt or payment of cash or its equivalent. The frameworks note that accrual accounting also encompasses *deferrals* (cash payments and receipts that occur prior to fulfilling the criteria for recognition of expense or revenue). *Going concern* relates to the assumption that an entity will continue in operation for the foreseeable future and will be able to realize assets and discharge liabilities in the normal course of operations, unless there is evidence to the contrary.

Elements of Financial Statements

CICA Handbook – Accounting Section 1000 (paragraph 1000.25) states that:

> Elements of financial statements are the basic categories of items portrayed therein in order to meet the objective of financial statements. There are two types of elements: those that describe the economic resources, obligations and equity / net assets of an entity at a point in time, and those that describe changes in economic resources, obligations and equity / net assets over a period of time. Notes to the financial statements ... are not considered to be an element.

Both frameworks identify *assets* and *liabilities*, *equity*, *income (revenues)* and *expenses*, *gains* and *losses*, and *performance (profit* or *earnings)* as the elements of financial statements. Although the wording differs somewhat, the various elements may generally be described as follows:

- *Assets* are the economic resources obtained or controlled by an entity as a result of past transactions or events, from which future benefits may be obtained (see *CICA*

Handbook – Accounting paragraph 1000.29).

- *Liabilities* are obligations arising from past transactions and events that may result in future sacrifices of economic benefits through transfer or use of assets or provision of services to other entities (see *CICA Handbook – Accounting* paragraph 1000.32).
- *Equity* is the residual (ownership) interest in the assets of an entity after deducting its liabilities (see *CICA Handbook – Accounting* paragraph 1000.35). 3(73)
- *Income (revenues)* refers to increases in economic resources, by way of inflows or enhancement of assets, or reductions of liabilities, resulting from the ordinary activities of an entity (see *CICA Handbook – Accounting* paragraph 1000.37). 4(74)
- *Expenses* refer to decreases in economic resources, by way of outflows or reduction of assets, or incurrences of liabilities, resulting from the ordinary activities of an entity (see *CICA Handbook – Accounting* paragraph 1000.38). 5(75)
- *Gains* are increases in equity resulting from peripheral or incidental transactions and events of an entity, and from other events, transactions and circumstances affecting the entity, except those resulting from revenues or investments by owners (see *CICA Handbook – Accounting* paragraph 1000.39).
- *Losses* are decreases in equity resulting from peripheral or incidental transactions and events of an entity, and from other events, transactions and circumstances affecting the entity, except those resulting from expenses or distributions to owners (see *CICA Handbook – Accounting* paragraph 1000.40).
- *Performance (profit or earnings)* is a measure of the residual amount after expenses and losses are deducted from revenues and gains during a period.

In addition, the US framework defines "other comprehensive income" as the change in equity from all transactions and other events other than transactions with owners and distinguishes it from earnings in that certain classes of gains and losses are included in comprehensive income that are excluded from earnings.

Recognition and Measurement

Recognition is defined as the process of incorporating an item in the financial statements of an entity. It consists of the amount and a narrative description of the item, with the amount being included in a financial statement total. *Recognition* cannot be substituted with notes, disclosure or other similar types of information.

The general criteria for recognition noted in both frameworks are that there is a reliable and relevant basis of measurement and that a reasonable estimate can be made. The US framework specifically states that the item must meet the definition of an element of financial statements and that recognition is subject to a cost-benefit constraint 6(76) and a materiality 7(77) threshold. These are implied in other parts of the Canadian framework.

The criteria for recognition of *revenues, expenses, gains* and *losses* are covered in both frameworks. Again, the wording differs, but the criteria generally are as follows:

- *Revenues* are recognized when performance is completed. The Canadian framework also refers to reasonable assurance regarding measurement and collectibility.
- *Expenses* are recognized when an expenditure does not have a future economic benefit.
- *Gains* are recognized when realized. The US framework also permits recognition when realizable.
- *Losses* are recognized when a previously recognized asset does not have a future economic benefit. The US framework also refers to the situation in which a liability has been incurred or increased without associated economic benefits.

Measurement is the process of determining the amount at which an item is recognized in the financial statements. There are a number of bases on which an amount can be measured, but financial statements are prepared primarily using the *historical cost* basis of measurement, whereby transactions and events are recognized in financial statements at the amount of cash or cash equivalents paid or received or the fair value ascribed to them when they took place.

Other bases of measurement include: current cost — United States; current market value — US; net realizable (settlement) value — US; present (or discounted) value of future cash flows — Canada and US; realizable value — Canada; and replacement cost — Canada. These measurement alternatives can be used in limited circumstances only. Although some of these alternatives are not specifically mentioned in the conceptual frameworks, they are being used in Canada and the United States.

Both frameworks mention the financial capital maintenance concept in the preparation of financial statements, stipulating that capital maintenance should be measured in nominal terms. The concept of capital maintenance affects measurement because income in an economic sense exists only after the capital of an enterprise has been maintained. Therefore, income is the increase or decrease in the amount of capital at the end of the period over the amount at the beginning of the period, excluding the effects of capital contributions and distributions.

Appendix B

SURVEY OF FINANCIAL STATEMENT DISCLOSURES BY INDUSTRY

Chapter 4 of the Research Report provides an analysis of the current state of accounting and financial reporting by rate-regulated enterprises in Canada. To supplement that analysis, this Appendix presents the results of a survey of financial statement disclosures in corporate annual reports for 1999 or 2000. The survey covers 25 regulated enterprises in four industries — electric, natural gas distribution and transmission, telecommunications and transportation. A list of the survey companies is provided below followed by a schedule of disclosures provided in their general purpose financial statements.

Electric enterprises	**Year**
1. British Columbia Hydro and Power Authority	2000
2. Canadian Utilities Limited	2000
3. Emera Inc.	2000
4. Epcor Utilities Inc.	2000
5. Hydro One Inc.	1999
6. Hydro Québec	2000
7. New Brunswick Power Corporation	2000
8. Newfoundland and Labrador Hydro	1999
9. Newfoundland Power Inc.	2000
10. Saskatchewan Power Corporation	2000

Natural gas distribution and transmission enterprises	**Year**
11. ATCO Ltd.	2000
12. BC Gas Utility Ltd.	2000
13. Enbridge Inc.	2000
14. Pacific Northern Gas Ltd.	2000
15. The Consumers' Gas Company Ltd.	2000
16. TransCanada Pipelines Limited	2000
17. Westcoast Energy Inc.	2000

Telecommunications enterprises	**Year**
18. Aliant Inc.	2000
19. Bell Canada	2000
20. Manitoba Telecom Services Inc.	2000
21. Saskatchewan Telecommunications Holding Corporation	1999
22. Télébec ltée	2000

23. Telus Corporation	2000
Transportation enterprises	**Year**
24. NAV Canada	2000
25. Halifax-Dartmouth Bridge Commission	2000

RATE-REGULATED ENTERPRISES IN CANADA

Survey of Disclosures in Notes to Financial Statements

Appendix C

ILLUSTRATIVE FINANCIAL STATEMENT DISCLOSURES

This appendix provides examples of disclosures presented in the notes to the general purpose financial statements of selected rate-regulated enterprises. The examples are drawn from the published annual reports of survey companies listed in Appendix B to this Research Report.

The examples are intended to reflect current practices in Canada. Variations may be necessary to meet the requirements of differing circumstances and other typical reporting situations that are not represented in these examples.

Regulator / Impact of Rate Regulation

- Epcor Utilities Inc. — pages 136-137
- Hydro One Inc. — page 138
- Newfoundland Power Inc. — pages 139-141
- Westcoast Energy Inc. — page 142
- Teleses ltée — page 143

Accounting for Capital Assets

- British Columbia Hydro and Power Authority — pages 144-145

- Enbridge Inc. — page 146

Accounting for Income Taxes

- TransCanada Pipelines Limited — pages 147-149

You will require Adobe Acrobat Reader to view the following. Should you require it, click here to install the program.

Financial Statements

Epcor Utilities Inc.

Hydro One Inc.

Newfoundland Power Inc.

Westcoast Energy Inc.

Télébec ltée

British Columbia Hydro and Power Authority

Enbridge Inc.

TransCanada Pipelines Limited

Appendix D

SURVEY OF PUBLIC SECTOR PRACTICES

With regards to the public sector in Canada, the Study Group is proposing that the application of General Principle 1 should be limited to "government business enterprises." General Principle 1 defines a "rate-regulated enterprise" as an enterprise (i.e., a separate legal entity) that has regulated operations meeting 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.
- 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.

To assess the feasibility of this proposal, the Study Group undertook a survey of the current financial reporting practices of the federal and provincial governments in Canada. Survey participants were asked the following questions:

- In your jurisdiction, what entities that are included in the federal or provincial government's summary financial statements currently follow GAAP for rate-regulated enterprises as set out in the *CICA Handbook*?
- Do the entities that currently following GAAP for rate-regulated enterprises meet all of the criteria set out in the above-noted definition of a "rate-regulated enterprise?" Which entities do not have rates established by, or subject to approval by, an

independent, third party regulator?

- The Study Group is proposing to limit application of the criteria for qualifying as a "rate-regulated enterprise" to "government business enterprises" because their financial statements should be prepared on the same basis as private sector businesses (refer to Public Sector Handbook, paragraph PS 1300.27). In your jurisdiction, would this eliminate any of the entities currently following GAAP for rate-regulated enterprises?
- Is it important that the general purpose financial statements of rate-regulated enterprises in the public sector be prepared on a basis consistent with that in the private sector?

The following excerpts are drawn from the responses to the survey.

Government of Canada

None of the organizations within the Government of Canada reporting entity fit the definition of a rate-regulated enterprise.

British Columbia

In addition to British Columbia Hydro and Power Authority (BC Hydro), there are several other organizations that meet the definition of rate-regulated, but do not follow GAAP for rate-regulated enterprises. If a new set of guidelines / recommendations come out for rate-regulated enterprises, some of these organizations or their auditors may determine that they should be following rate-regulated GAAP. We note that the definition of rate-regulated is not just that rates be established by an independent, third-party regulator, but that they may be established by the organization's own governing board.

Any accounting treatment determined to be appropriate for rate-regulated enterprises should be applicable to both private sector and public sector enterprises alike. It is important that the general purpose financial statements for rate-regulated enterprises in the public sector be prepared on a basis consistent with that of rate-regulated enterprises in the private sector.

Alberta

The Alberta Government does not have any rate-regulated enterprises that form part of the reporting entity. In general, we agree that the financial statements of rate-regulated enterprises in the public sector should be consistent with those in the private sector.

Saskatchewan

Saskatchewan's largest Crown corporations, SaskEnergy Incorporated (SaskEnergy), Saskatchewan Power Corporation (SPC), and Saskatchewan Telecommunications Holding

Corporation (SaskTel), follow rate-regulated GAAP. All three of the Crown corporations meet the definition of a government business enterprise.

SaskTel is regulated by the Canadian Radio-television and Telecommunications Commission (CRTC). It does not appear that SaskTel would meet the second or third criterion of the proposed definition, as local telephone access is subsidized and, therefore, the rates would not recover the enterprises's costs for that service. As a result, SaskTel would not be considered rate-regulated by the proposed definition. It is likely that this will affect all phone companies regulated by CRTC.

SaskEnergy and SPC's rates are subject to review by the Saskatchewan Rate Review Panel. The rates are then subject to approval by the Crown's Board of Directors, the Crown Investments Corporation's Board and, ultimately, Saskatchewan Cabinet. This rate-approval process meets the proposed definition as the Boards and Cabinet are empowered by statue or policy to establish rates that bind customers. Therefore, SaskEnergy and SPC would be considered rate-regulated. However, this might be an issue of further debate in Saskatchewan. In order to be consistent and comparable to other companies in the same industry, it is important that Crown corporations are allowed to follow rate-regulated accounting.

The main focus of developing financial reporting policies for rate-regulated enterprises is to ensure companies in the same industry have comparable reporting practices. If an accounting treatment is accepted by industry, it should be accepted by all similar companies regardless of who owns the company (i.e., government versus private sector). Therefore, it is important for similar organizations to follow similar accounting policies, whether they are public or private.

Ontario

In the past, Ontario Hydro was the only Crown agency to prepare its general purpose financial statements in accordance with GAAP for rate-regulated enterprises. Prior to the electricity restructuring, the activities of Ontario Hydro were not reflected in the Province's books as the Province had no access to the "retained earnings" of the agency under the Power Corporations Act. With the restructuring, the Province now includes in its accounts, on a modified equity basis, the activities of HYDRO1 and Ontario Power Generation. HYDRO1 meets the definition of a "rate-regulated enterprise" for financial reporting purposes as its rates are established by the Ontario Energy Board (an agency of the Crown whose members are appointed by OIC but operate independently of these enterprises and the government), their rates are designed to recover the costs of providing the regulated services or products, and it is reasonable to assume that their rates can be charged to and collected from customers.

New Brunswick

In New Brunswick, NB Power is the only organization in the government reporting entity that uses rate-regulated accounting. NB Power meets the definition of a rate-regulated enterprise. By legislation, it has the authority to increase rates by up to 3% in any year on its own — subject to interest coverage rate limits. Any increase outside of this must be approved by the Public Utilities Board, which acts independently but is appointed by government. 1(78) NB Power is a government business enterprise (GBE) so, if rate-regulated enterprises have to be GBEs, it will not have an impact on us. It is important for public sector and private sector rate-regulated operations to be accounted for on a consistent basis.

Nova Scotia

Nova Scotia has two rate-regulated entities that are reported in the Province's summary financial statements, Halifax-Dartmouth Bridge Commission and Highway 104 Western Alignment Corporation. Both of these entities prepare their statements according to GAAP. They are Government Business Enterprises. Therefore, their results are included in the Province's summary statements using the modified equity basis. The toll rates of the Halifax-Dartmouth Bridge Commission are subject to approval of the Nova Scotia Utility and Review Board. The toll rates of Highway 104 are set in the agreement with the bondholders and agreed to by the corporation and the Province, but are not regulated by an independent third party, such as the Nova Scotia Utility and Review Board. We agree that rate-regulated enterprises in the public sector should be prepared on a basis consistent with those of the private sector to accommodate the needs and expectations of other users of their financial statements.

Northwest Territories and Nunavut

The GNWT includes the financial statements of the NWT Power Corporation. The assets of this entity are shared by the Government of the NWT and the Government of Nunavut. The NWT Power Corporation was established after the GNWT purchased the Northern Canada Power Commission and is still trying to align rate structure / revenue requirements with the associated costs within the various rate zones. In addition, the GNWT also provides a direct subsidy to residential and commercial consumers in all rate zones outside Yellowknife. This unique situation would prevent us from meeting all the criteria until we complete realignment of revenues to costs. General Rate Applications are submitted and approved by an independent Public Utilities Board. Limiting application to "government business enterprises" would not prevent NWT Power Corporation from qualifying as a rate-regulated enterprise.

Appendix E

RATE REGULATION IN THE ELECTRIC POWER INDUSTRY

Public utilities are often described as businesses so affected with the public interest that they must be regulated by government regarding entry into and exit from the market, rate charges to customers, rate of return allowed to owners, and for the requirement to serve all customers within their area of operation. 1(79) With very few exceptions, rate regulation has been imposed on both publicly-owned and privately-owned utilities, or example, in the electric power industry.

Development of the electric power industry in Canada involved a mix of politics, economics, geography and technology. In the early 20th century, demand for electric power was being met by many isolated electric generating plants, both thermal and hydro. Because of the sophisticated technology and significant capital investment, the electric utilities evolved quickly into monopolies. With the growing importance of electricity as a basic need for commerce, industry and domestic life, and the apparent economies offered by large-scale integrated systems, there was a need to make some fundamental choices. Were essential services to be provided by private enterprise or publicly-owned utility? How, and to what extent, were they to be regulated? Depending on such factors as political will, population density and vested interests, intervention by way of government regulation came at different times and in different ways in each province and territory. This is illustrated, in part, by developments in Québec and Ontario.

In Québec, much of the electric power industry was under private control. In 1918, only 20 of the 119 power plants were owned and operated by municipalities. In 1940, five private companies supplied 90 per cent of the power. Largely in response to growing consumer dissatisfaction over high rates, the Québec Hydro-Electric Commission (Hydro-Québec) was created in 1944. It was to supply power to municipalities and commercial enterprises at the lowest possible rate and to generate, transmit and distribute electricity throughout the province. In 1963, a political decision was made to nationalize existing utilities and Hydro-Québec quickly acquired most privately-owned suppliers. By 1984, it had become one of the 10 largest public utilities in North America.

Unlike Québec, most of Ontario's early 20th century history is dominated by a publicly-owned utility. Many municipalities and boards of trade in southern Ontario felt that cheap power was essential to economic growth. In response to public pressure, the Hydro-Electric Power Commission of Ontario (Ontario Hydro) was incorporated in 1905. Ontario Hydro was given the legal authority to control the rates charged for electricity and the right to generate and distribute electrical energy. As a wholesaler of power to municipalities, it also controlled the rates they charged. By 1930, Ontario Hydro was supplying electric power to 550 communities. Despite massive expansion, it needed more power. Additional input came from nuclear-powered thermal generating plants, developed in conjunction with Atomic Energy of Canada Limited.

In Canada, the provinces have jurisdiction over property and, therefore, the electric power industry could not be regulated on a national level. Each province reacted differently to a technology that demanded the creation of a monopoly. As provincial and interprovincial integration became necessary to achieve maximum efficiency through diversification of load and supply, regulation became more important, and the distinction between private and public utilities became blurred. Today, a variety of approaches continue to exist, with some provinces dominated by a public utility (for example, Ontario and Québec), some having mixed private and public utilities (for example, Alberta and Newfoundland), and one province dominated by a private utility (Prince Edward Island).

Of the major electric utilities in Canada today, eight are provincially owned, seven are investor owned, four are privately-owned and two are territorial Crown corporations. In addition, there are a number of municipally owned utilities, particularly in Ontario. Pubic sector enterprises and private sector enterprises each represent about half of the 21 major electric utilities. According to the Statistics Canada publication *Electric Power Generation, Transmission and Distribution 1998*, however, public utilities generate about 83% of the power in Canada and private utilities about 17%. 2(80) Public utilities account for 90% of the total net fixed assets of $124 billion and about 95% of the total long-term debt of $91 billion. In addition, the account for 87% of the total annual operating revenues of approximately $40 billion.

In contrast to the Canadian environment, where there are a few, relatively large rate-regulated enterprises (e.g., hydro utilities) owned by the provincial governments, the US environment is characterized by many, relatively small rate-regulated enterprises of state and local governments. According to the American Public Power Association's *2000 Annual Directory and Statistical Report*, there are 3,170 electric utilities in the United States. Of these, 2,009 (63%) are publicly owned utilities, 239 (8%) are investor owned utilities, 912 (29%) are cooperatives and 10 (less than 1%) are federal power agencies.

There is no connection, however, between the type of ownership and the capacity to serve the ultimate customers. Although investor-owned utilities comprise only 8% of the total number of utilities, they generate approximately 75% of the power and service approximately 75% of the ultimate customers (1998 revenues exceeded $168 billion). On the other hand, publicly-owned utilities comprise 63% of the total number of utilities, but they generate only 12% of the power and service less than 15% of the ultimate customers (1998 revenues were $30 billion).

In summary, there are relatively few publicly-owned electric power utilities in Canada, but they generate the majority of the total power. This contrasts sharply with the situation in the United States which has many publicly-owned electric power utilities, but they generate only a small fraction of the total power. Nevertheless, both public and private sector utilities are similar in that they carry on a business and prepare their general purpose financial statements in accordance with GAAP for private sector enterprises. This similarity is highlighted by a move in recent years towards unbundling services provided by electric utilities, leading to more and more deregulated or market-oriented rates for the generation services, with transmission and distribution rates remaining regulated.

GLOSSARY

The following terms are used in the Research Report or are commonly used in the regulatory community and may be useful to the reader. Terms in bold within definitions are separately defined in the Glossary. 1(81)

Allowance for funds used during construction (AFUDC)

AFUDC is the amount that a **rate-regulated enterprise** is allowed to earn to recover its cost of financing assets under construction. It is equal to the average cost of the construction work in process, times a financing rate, which is usually equal to the enterprise's **cost of capital** rate. AFUDC is included in the cost of the related assets and recovered in future periods through the depreciation charge. AFUDC is similar to "Interest During Construction" for unregulated industries, except that the **cost of equity** capital is normally taken into account.

Allowed rate of return

The rate of return a regulated enterprise is allowed the opportunity to earn. When applied to the **rate base**, the allowed rate of return provides an amount equal to the forecast cost of financing the investment required for regulated operations. The financing costs include both the **cost of debt** and the **cost of equity**.

Argument

A submission to a regulatory authority at the end of a hearing that summarizes a party's position. Argument may be presented on behalf of the regulated enterprise, each intervenor and, in some cases, the regulator's staff. Argument is usually presented by the party's counsel and draws on the evidence presented in the hearing and legal precedent. At the regulator's discretion, arguments may be presented either orally or in writing, though written submissions are more common.

Avoidable cost

A cost that would be avoided if the cost object did not exist. Avoidable costs will generally be the same as the direct and variable indirect costs.

Capital asset pricing model

A method for estimating the **cost of equity** in which that cost equals a risk-free rate plus a risk premium. The yield on government bonds is usually used as the risk-free rate. The risk premium is equal to the market risk premium times a "Beta" factor, the Beta factor being a measure of the enterprise's risk in relation to the market.

Capital structure

The manner in which an enterprise is financed, which usually includes debt, equity and deferred income tax credits.

Cash working capital

Cash working capital is the investment required by the difference in time between when cash operating expenses are paid and when the cash to cover the expenses is eventually recovered from customers.

Comparable earnings method
A method for estimating the **cost of equity**. The cost of equity is determined based on the realized return on investments of similar risk to that of the regulated enterprise.

Construction work in process (CWIP)
CWIP refers to the capital assets under construction by a regulated enterprise for its future use. It may or may not be included in the regulated enterprise's **rate base**.

Cost-based pricing
A basis for determining how the **cost of service** will be recovered through individual rates. Rates for each type of service are set to reflect the cost of providing the service.

Cost object
Whatever is being costed, such as a product or service, activity, operating division, etc.

Cost of capital
The cost of financing the **rate base**. It is equal to the weighted average cost of each component in the capital structure. The weight for each component equals the percentage of the total capital structure represented by the component.

Cost of debt
The costs associated with debt financing, including interest payments, plus amortization of issuance expense, any purchase discount / premium and any foreign-exchange losses / gains.

Cost of equity
The cost to equity investors of investing their funds in a regulated enterprise. In regulatory proceedings, it is generally determined in relation to what could be earned on investments of similar risk in unregulated companies.

Cost of service
The total cost of providing service, including operating and maintenance expenses, depreciation, amortization, taxes and cost of capital. The cost of service is also referred to as "**revenue requirements**."

Cost of service study
A study to determine the **cost of service** by class of service and/or customer. These studies are used to help determine how the **revenue requirements** are to be allocated among the rates for the various services / customers.

Cross-subsidization
Increasing the rates for one service or class of customers so that the rates for another

service or class of customers can be reduced below cost.

Current cost
The cost of acquiring an asset or service at current prices.

Deemed capital structure
A capital structure used for rate-making purposes that differs from an enterprise's actual **capital structure**. A regulator may deem a capital structure for an enterprise when it considers its actual capital structure inappropriate.

Deferral account
An account that records the deferral of a cost or revenue until a future date. A deferred asset account records a cost that would normally be expensed and recovered in the current period, but is to be expensed or recovered in a future period. A deferred liability account records an amount recovered in the current period to cover costs of providing service in a future period.

Direct cost
A cost incurred for one specific cost object.

Discounted cash flow method
The discounted cash flow method is one of the methods used for estimating the **cost of equity** using market data. Using this method, the cost of equity is equal to the expected dividend yield (the expected dividend divided by current share price), plus the expected dividend growth rate.

Embedded cost
See "**Historical cost**."

Financial viability
Ability to meet financial obligations.

Fixed cost
A cost that doesn't vary with the provision of a cost object (which would be the same whether or not the cost object existed).

Historical cost
The amount originally paid for assets and services.

Incentive regulation
A form of **rate regulation** where the regulated enterprise has financial incentives to improve its efficiency or achieve other goals. Incentives can include financial rewards for exceeding targets and financial penalties for failing to achieve them. Incentive rate regulation is also referred to as "**performance-based regulation**."

Indirect cost

A cost incurred for two or more cost objects.

Interest coverage
A measure of an enterprise's ability to meet interest charges, this is income available to cover interest charges, divided by interest charges. Income to cover interest charges equals net income plus interest charges and income tax expense.

Information requests
Questions posed to those who provide evidence in a hearing. Information requests and their responses are made prior to the hearing, in writing, and become evidence in the hearing. Information requests are also referred to as "**interrogatories**."

Interrogatories
See "**Information requests**."

Lead-lag study
A lead-lag study is used for estimating **cash working capital**. It is an analysis of the average number of days between the time payment is made for operating expenditures and the time the amounts are collected from customers to recover these costs. The resulting time delay is divided by the number of days in the year, then multiplied by the estimated amount of cash operating expenses to determine the amount of necessary cash working capital.

Negotiated settlement
An agreement between a regulated enterprise and its customers (or their representatives) dealing with allowed rates or an issue that affects their determination. Generally, negotiated settlements must be approved by the regulator.

Non-avoidable cost
A cost that would not be avoided if the cost object did not exist. Non-avoidable costs are generally the same as fixed indirect costs.

Performance-based regulation
See "**Incentive regulation**."

Price-cap regulation
A form of **rate regulation** where the focus is on the prices that can be charged. Limits are set on initial prices and a formula is put in place to allow for future increases in the maximum prices that can be charged.

Purchase premium
An amount paid for assets, or an entire enterprise, in excess of original cost, less depreciation.

Rate-regulated enterprise

For financial reporting purposes, a "rate-regulated" enterprise is an organization which 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.
- 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.

Rate base

The amount of investment in regulated operations on which a regulated enterprise is allowed to earn a return. It usually consists of the depreciated value of the plant in service required for regulated operations, plus an allowance for working capital and deferred assets.

Rate regulation

The restriction in the setting of prices that can be charged to customers for services or products. Under rate regulation, an enterprise's rates are established by, or are subject to approval by, a regulator.

Rates

The prices at which regulated services are provided.

Rebuttal evidence

Evidence submitted in a hearing in response to evidence provided by another party. Such evidence may address only the evidence that has been submitted by the other party, not a new area.

Reply argument

A submission to a regulatory body addressing another party's argument. A reply argument may address only the other party's previously submitted argument, not a new area.

Return on rate base regulation

A form of **rate regulation** where the focus is on the allowed earnings, in particular the allowed return per dollar of investment (rate base). Under this form of rate regulation, total revenue requirements are set equal to the expected cost of providing service. This expected cost is equal to the operating costs, plus an allowed return where that return is set equal to the allowed rate base times the allowed rate of return.

Revenue requirements
See "**Cost of service**."

Risk premium method
A method for estimating the **cost of equity** using market data. The cost of equity is determined as the sum of the yield on a debt security (usually the yield on government bonds or the enterprise's bonds), plus an estimate of the equity risk premium (i.e., the required return on the enterprise's equity over the required return on the debt security).

Social contract regulation
A form of **rate regulation** whereby allowed rates are the result of an agreement between the regulated enterprise and the regulatory authority. It is an imprecise form of regulation since it can be argued that almost any form of rate regulation qualifies as social contract regulation.

Test period
The operating period selected to evaluate the **cost of service** and whether proposed rates are adequate to cover costs without providing an excess return. Although the test period is usually a prospective 12-month period, other periods, including historical periods, have been used.

Value-of-service pricing
A basis for determining how the **cost of service** will be recovered through individual rates that reflects the perceived value of the services without regard to the cost of providing them.

Working capital
For regulatory purposes, working capital represents the investment required to finance inventory, plus **cash working capital**.

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Endnotes

1 (Popup - Popup)

1. Where the Research Report presents the views, opinions or conclusions of the Study Group, it refers to the majority of the members and not necessarily to the entire Study Group.

2 (Popup - Popup)

1. The questions were initially raised in May 1999 when the Accounting Standards Board (AcSB) reviewed a draft project proposal on accounting for rate-regulated enterprises. In addition, the Public Sector Accounting Board (PSAB) raised questions about the application to public sector enterprises (see Chapter 8).

3 (Popup - Popup)

2. Chapter 6 examines the criteria that an enterprise must meet to qualify as a rate-regulated enterprise for financial reporting purposes. In short, the rates must be subject to regulation, they must be designed to recover the costs of providing service, and they must be chargeable and collectible from customers.

4 (Popup - Popup)

3. As noted in Chapter 3, there are differing views on the extent to which specific guidance for rate-regulated enterprises should be provided.

5 (Popup - Popup)

4. The survey was undertaken, on the CICA's behalf, by Peggy Coady, Memorial University of Newfoundland.

6 (Popup - Popup)

5. Where the Research Report presents the views, opinions or conclusions of the Study Group, it refers to the majority of the members and not necessarily to the entire Study Group.

7 (Popup - Popup)

1. Appendix E to this Research Report provides a brief overview of rate regulation in the electric power industry in Canada.

8 (Popup - Popup)

2. Circumstances may differ between the public sector and the private sector. Issues of particular relevance to rate-regulated enterprises in the public sector — such as the independence of the regulator and self-regulation — are addressed in Chapter 8 of this Research Report.

9 (Popup - Popup)

1. Statement of Financial Concepts, No. 3, paragraph 85, Financial Accounting Standards Board. A similar view is expressed in "Financial Statement Concepts," *CICA Handbook – Accounting*, paragraph 1000.46.

10 (Popup - Popup)

2. *CICA Handbook – Accounting*, paragraph 1500.06; Exposure Draft "Generally Accepted Accounting Principles" (July 2001), paragraph 19.

11 (Popup - Popup)

1. It is important to understand that Statements issued subsequent to SFAS 71 may amend, interpret, supplement or otherwise affect the provisions of that Statement.

12 (Popup - Popup)

2. It should also be noted that SFAS 71, "Basis for Conclusions," paragraph 64 indicates that this criterion was specifically modified by the Board so as not to preclude application by government-owned utilities with rates set by their own governing board.

13 (Popup - Popup)

3. SFAS 143 is effective for fiscal years commencing after June 15, 2002, although earlier application is encouraged.

14 (Popup - Popup)

4. *Accounting for Regulation in UK Utilities* (London: The Research Board of The Institute of Chartered Accountants in England and Wales, 1994).

15 (Popup - Popup)

5. The observations were drawn from papers presented at a conference, "Accounting for Regulation – A Comparative Assessment," sponsored by the Centre for the Study of Regulated Industries (CRI) of the University of Bath, that took place at the London School of Economics on September 23, 1999. The papers are titled "Reconciling Generally Accepted Accounting Practice (GAAP) and Regulatory Accounts – The Lessons of Reporting in GAS," by M. Duthie; "A

Comprehensive Accounting Model For Regulation," by P. Vass, and "Statements of Recommended Practice (SORPs) – Role and Rules for Development," by Andrew Lennard, Assistant Technical Director, UK ASB.

16 (Popup - Popup)

6. Refer to "Financial Statement Concepts, " *Handbook* Section 1000, and "General Standards of Financial Statement Presentation," *Handbook* Section 1500. As stated in paragraph 1000.02, Section 1000 is to be used in establishing accounting policies in areas in which accounting principles are developing.

17 (Popup - Popup)

1. The rate-setting processes and methodologies are discussed in Chapter 2 of this Research Report.

18 (Popup - Popup)

2. As noted in Chapter 1, in July 2001, the Accounting Standards Board issued an Exposure Draft of a proposed new *Handbook* Section on "Generally Accepted Accounting Principles." The material in this Section is based on that Exposure Draft. Reference should therefore be made to the new *Handbook* Section once it is issued.

19 (Popup - Popup)

3. Financial statement concepts are discussed in Appendix A of this Research Report.

20 (Popup - Popup)

4. "Contingencies," *Handbook* Section 3290, paragraph .06, states that the uncertainty relating to the occurrence of a future event can be expressed by a range of probabilities that provide a basis for establishing the appropriate accounting treatment. The three main areas of this range are likely, unlikely and not determinable.

21 (Popup - Popup)

5. For a liability to be recognized, however, it must be probable that an outflow of resources embodying economic benefits will be required to settle the obligation (paragraph 1000.44). This effectively disqualifies the recognition of most equitable obligations and some constructive obligations.

22 (Popup - Popup)

1. Note that some enterprises carry on both rate-regulated and non-rate-regulated activities.

23 (Popup - Popup)

2. See Appendix A of this Research Report for a comparison of the conceptual frameworks in Canada and the US.

24 (Popup - Popup)

3. As noted later in this chapter, only a subset of an enterprise's operations may be subject to rate regulation. For example, the transmission and distribution activities in the electric power industry may be subject to rate regulation but the power-generating activities may not (see Appendix E for an overview of rate regulation in the electric power industry).

25 (Popup - Popup)

4. For example, NAV Canada is given the exclusive right to provide certain services under the 1996 *Civil Air Navigation Services Commercialization Act* and is empowered by the *Act* to set and collect user charges for air navigation services.

26 (Popup - Popup)

5. Circumstances may differ in the public sector, however, and issues of particular relevance to rate-regulated enterprises in the public sector — such as the independence of the regulator and self-regulation — merit further consideration. These are addressed separately in Chapter 8 of this Research Report.

27 (Popup - Popup)

6. In Chapter 2, it was noted that there are a number of basic regulatory methodologies and, within each basic methodology, there can be different applications that vary with the regulatory authority.

28 (Popup - Popup)

7. Rate regulators usually consider a fair return on investment to be a cost recoverable through rates.

29 (Popup - Popup)

8. Refer to the definition of a liability, *CICA Handbook – Accounting*, paragraph 1000.32.

30 (Popup - Popup)

1. With regard to the "benefit versus cost" constraint, the Study Group maintains that the benefits expected to arise from providing information in financial statements should exceed the cost of doing so. This constraint is also a consideration in the preparation of financial statements in accordance with GAAP (for example, in considering disclosure of information beyond that required by the standards). The benefits and costs may accrue to different parties and, therefore, the evaluation of the nature and amount of benefits and costs is substantially a judgmental process.

31 (Popup - Popup)

2. Materiality is the term used to describe the significance of financial statement information to decision makers. An item of information, or an aggregate of items, is material if it is probable that its omission or misstatement would influence or change a decision. Materiality is a matter of professional judgment in the particular circumstances.

32 (Popup - Popup)

3. It is assumed that any change in regulatory assets or liabilities would not be associated with a gain or loss as a result of a contribution or distribution of equity / net assets.

33 (Popup - Popup)

4. Appendix A compares the conceptual accounting frameworks of Canada and the United States, including users and their general information needs.

34 (Popup - Popup)

5. Appendix B summarizes the disclosure practices of 25 rate-regulated enterprises.

35 (Popup - Popup)

1. In this regard, the terms of reference for this project ask the Study Group to consider the following:

- Should rate regulation over private sector enterprises be distinguished from rate regulation over public sector enterprises? If so, what are the distinguishing criteria?
- What is the nature of rate regulation and to what degree must it be independent of the enterprises being regulated?

36 (Popup - Popup)

2. *PSAB Handbook*, "Introduction to Public Sector Accounting Recommendations," paragraphs

.03 and .04.

37 (Popup - Popup)

3. A government business has all the following characteristics:
(a) it is a separate legal entity with the power to contract in its own name and that can sue and be sued;
(b) it has been delegated the financial and operational authority to carry on a business;
(c) it sells goods and services to individuals and organizations outside of the government reporting entity as its principal activity; and
(d) it can, in the normal course of operations, maintain its operations and meet its liabilities from revenues received from sources outside of the government reporting entity.
(PSAB Handbook, PS 1300.21)

38 (Popup - Popup)

4. A government business-type organization has all of the following characteristics:
(a) it is a separate legal entity with the power to contract in its own name and that can sue and be sued;
(b) it has been delegated the financial and operational authority to carry on a business; and
(c) it sells goods and services to individuals and organizations as its principal activity. (PSAB Handbook, Introduction .10)

39 (Popup - Popup)

5. Appendix 2 of the "Introduction to Public Sector Accounting Recommendations" states that government organizations should adhere to "Solid Waste Landfill Closure and Post-Closure Liability, *PSAB Handbook* PS 3270, regarding accounting for solid waste landfill closure and post-closure liability, and "Government Assistance — application of *CICA Handbook* Section 3800," *PSAB Handbook* PS 3800, regarding accounting for government assistance.

40 (Popup - Popup)

6. A fund is defined as a fiscal and accounting entity with a self-balancing set of accounts recording cash and other financial resources, together with all related liabilities and residual equities or balances, and changes therein, which are segregated for the purpose of carrying on

specific activities or attaining certain objectives in accordance with special regulations, restrictions or limitations.

41 (Popup - Popup)

7. Statement No. 34 (paragraph 67) notes that enterprise funds are those whose principal revenue sources are from activities for which a fee is charged to external users for goods and services. Activities are *required* to be reported as enterprise funds if any one of the following criteria is met:

- The activity is financed with debt that is secured solely by a pledge of the net revenues from fees and charges of the activity.
- Laws or regulatons require that the activity's costs of providing services, including capital costs (such as depreciation or debt service), be recovered with fees and charges, rather than with taxes or similar revenues.
- The pricing policies of the activity establish fees and charges designed to recover its costs, including capital costs (such as depreciation or debt service).

42 (Popup - Popup)

8. This viewpoint is strongly supported by one member of the Study Group, who is a legislative auditor.

43 (Popup - Popup)

9. It should be noted, however, that the first criterion is just one of three criteria for meeting the definition of a rate-regulated enterprise and that all three criteria must be met. Also, meeting the definition of a rate-regulated enterprise does not necessarily mean that the enterprise would recognize any regulatory assets or liabilities. It means that, if there is an economic impact, the enterprise would be entitled to apply the principles for recognizing regulatory assets and liabilities.

44 (Popup - Popup)

10. Some public sector rate-regulated enterprises, however, do have publicly traded debt.

45 (Popup - Popup)

11. This viewpoint is supported by nine of the ten Study Group members.

46 (Popup - Popup)

12. For example, rates may be set to maintain essential services, to effect economies of scale and/or to prevent discriminatory pricing.

47 (Popup - Popup)

14. The Ontario Energy Board and the New Brunswick Public Utilities Board were cited as examples of regulators that operate at arm's length from both the government and the enterprises that they regulate.

48 (Popup - Popup)

15. One of the ten members expressly stated that he did not agree with the other members on this issue.

49 (Popup - Popup)

16. The CICA has authorized the Public Sector Accounting Board to issue Recommendations and guidance with respect to matters of accounting in the public sector.

50 (Popup - Popup)

17. A government reporting entity comprises the organizations that are accountable for the administration of their financial affairs and resources either to a minister of the government or directly to the legislature, or local government council, and are owned or controlled by the government. (*Public Sector Accounting Handbook*,"Financial Reporting Entity," paragraph PS1300.07)

51 (Popup - Popup)

18. See footnote 4 for a definition of this type of organization.

52 (Popup - Popup)

19. For an overview of rate regulation in the electric power industry, see Appendix E to this Research Report.

53 (Popup - Popup)

1. This complements the Accounting Standards Board initiative to harmonize Canada / US GAAP (see Chapter 3).

54 (Popup - Popup)

2. The criteria set out in the definition of rate-regulated property, plant and equipment is essentially the same as the definition of a rate-regulated enterprise in Handbook Section 3465, paragraph .09.

55 (Popup - Popup)

3. The survey of current practices presented in Appendix B shows that all 25 survey companies disclosed, in the significant accounting policies note, the basis of valuation of property, plant and equipment (items of rate-regulated property, plant and equipment were valued at cost) and the basis of depreciation. Additional disclosures in other notes included the depreciation rate(s) and expense for the period (23 companies), accumulated depreciation (25 companies) and net book value (15 companies).

56 (Popup - Popup)

4. SFAS 90 adds a restriction that the AFUDC may be capitalized only if its subsequent inclusion in allowable costs for rate-making purposes is probable. It further limits capitalization of the AFUDC to that recorded during construction or as part of a qualifying phase-in plan.

57 (Popup - Popup)

5. The survey of current practices presented in Appendix B shows that 20 of 25 survey companies disclosed, in the significant accounting policies note, the accounting treatment of the AFUDC. Of these, 16 companies provided additional information on construction work in progress and four provided additional information on the AFUDC in other notes to the financial statements.

58 (Popup - Popup)

6. The survey of current practices showed that none of the survey companies reported disallowances.

59 (Popup - Popup)

7. SFAS 143 is effective for fiscal years commencing after June 15, 2002, although earlier application is encouraged.

60 (Popup - Popup)

8. The survey of current practices presented in Appendix B shows that 15 of 25 survey companies provided information on site restoration and future removal costs in the significant accounting policies note to the financial statements. Seven companies provided additional disclosures on environmental costs in other notes.

61 (Popup - Popup)

9. In practice, losses on disposal are applied to accumulated depreciation unless they are considered extraordinary.

62 (Popup - Popup)

10. The survey of current practices presented in Appendix B shows that 19 of 25 survey companies provided information regarding the treatment of gains or losses on disposal of fixed / capital assets in the significant accounting policies note to the financial statements. Two companies provided additional disclosures on write-offs and three companies provided additional disclosures on decommissioning of capital assets.

63 (Popup - Popup)

11. Since 1992, *Accounting For Income Taxes*, SFAS 109, has required the use of the future income tax asset / liability approach in dealing with interperiod income tax allocation.

64 (Popup - Popup)

12. The survey of current practices presented in Appendix B shows that 18 of 25 survey companies disclosed information on income taxes in the significant accounting policies note to the financial statements (some were exempt from paying income taxes). Twenty-two companies provided additional information disclosures in other notes to the financial statements.

65 (Popup - Popup)

13. According to the survey of current practices presented in Appendix B, 21 of 25 survey companies provided information on pensions and 19 companies provided information on other postemployment benefits in the signification accounting policies note to the financial statements. As well, 24 companies disclosed additional information in other notes to the financial statements.

66 (Popup - Popup)

14. Prior to the new standard being approved in July 2001, exchange gains or losses related to a foreign currency monetary item with a fixed or ascertainable life extending beyond the end of the following fiscal year were required to be deferred and amortized over the remaining life of the monetary item.

67 (Popup - Popup)

15. This new standard is effective for years commencing on or after January 1, 2002, with earlier

adoption permitted in certain circumstances.

68 (Popup - Popup)

16. The survey of current practices presented in Appendix B shows that five if the 25 survey companies disclosed information in the notes to the financial statements about accounting changes such as future income taxes and employee future benefits.

69 (Popup - Popup)

17. This assumes that the enterprise is required to amortize the difference for regulatory purposes and, if it were not regulated, it would have to recognize the difference in the period that the debt was extinguished.

70 (Popup - Popup)

18. Nonetheless, many telecommunications companies have ceased to apply accounting for the economic impact of rate regulation for external reporting. The notes to the general purpose financial statements of such companies disclose that they are still subject to rate regulation and are required to maintain regulatory records.

71 (Popup - Popup)

1. Refer to *CICA Handbook – Accounting*, paragraph 1000.02.

72 (Popup - Popup)

2. Two 1991 CICA publications, *Information to be Included in the Annual Report to Shareholders* (Chapters 2 and 3) and Interim Financial Reporting: A Continuous Process (Chapter 2) discuss the objectives of financial reporting, assess the uses of annual and interim reports and identify users and their information needs.

73 (Popup - Popup)

3. While equity of a profit oriented enterprise in total is a residual, it includes specific categories of items, for example, types of share capital, contributed surplus and retained earnings.

74 (Popup - Popup)

4. Revenues of entities normally arise from the sale of goods, the rendering of services or the use by others of entity resources yielding rent, interest, royalties or dividends.

75 (Popup - Popup)

5. *CICA Handbook – Accounting* (paragraphs 1000.50 and 1000.51) state that expenses that are not linked with specific revenues are related to a period on the basis of transactions or events occurring in that period or by allocation. Expenses that are linked to revenue generating activities in a cause and effect relationship are normally matched with the revenue in the accounting period in which the revenue is recognized.

76 (Popup - Popup)

6. With regard to the "benefit versus cost" constraint, the benefits expected to arise from providing information in financial statements should exceed the cost of doing so. This constraint is also a consideration in the preparation of financial statements in accordance with GAAP (for example, in considering disclosure of information beyond that required by the standards). The benefits and costs may accrue to different parties and, therefore, the evaluation of the nature and amount of benefits and costs is substantially a judgmental process.

77 (Popup - Popup)

7. Materiality is the term used to describe the significance of financial statement information to decision makers. An item of information, or an aggregate of items, is material if it is probable that its omission or misstatement would influence or change a decision. Materiality is a matter of professional judgment in the particular circumstances.

78 (Popup - Popup)

1. All rates are, however, subject to approval by Cabinet.

79 (Popup - Popup)

1. Businesses engaged in the production and distribution of electricity, the distribution of natural gas, the distribution of water, telecommunications (particularly telephone service), and pipelines (gas, oil and commodities) are generally considered public utilities. In earlier times, railways, grain elevators, ferries and privately owned bridges were also considered public utilities. In the future, highways may be considered public utilities, especially if governments are contractually obligated to take ownership after an elapsed period of time under private ownership.

80 (Popup - Popup)

2. Statistics Canada compiles data on the supply and disposition of electric energy by approximately 200 producers in Canada. It publishes reports on those statistics in addition to the financial and operating statistics of the major electric utilities.

81 (Popup - Popup)

Canadian Accounting and Assurance Reference Service (CAARS)

1. The terms and definitions used in this Glossary were drawn primarily from *Basics of Canadian Rate Regulation*, John Browne and Charles Perron (Toronto, Deloitte & Touche, 1997), and *Introduction to Public Utility Accounting* (Washington, DC, American Gas Association / Edison Electric Institute, 1992).