# Disclosures by Entities Subject to Rate Regulation — Background Information and Basis for Conclusions

## AcG-19

**Foreword**

The pre-changeover standards in Part V of the CPA Canada Handbook – Accounting, which included this Basis for Conclusions document, have been removed from the Handbook. This Basis for Conclusions was developed to accompany the pre-changeover standard and, since that standard was fully converged with Part II of the Handbook, it remains relevant.

Background Information and Basis for Conclusions documents are primary sources of generally accepted accounting principles, as described in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100. These documents are intended to help readers understand how the AcSB reached its conclusions, but they do not include explanations of requirements or guidance on the application of the relevant Handbook Section or Accounting Guideline.

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### INTRODUCTION

1 This document summarizes considerations that were deemed significant by the members of the Accounting Standards Board (AcSB) in reaching the conclusions in ACCOUNTING GUIDELINE AcG-19, Disclosures by Entities Subject to Rate Regulation. It sets out the reasons the AcSB undertook to develop the Guideline, the process of research and deliberation, the key decisions made and the principal reasons for accepting certain approaches and rejecting others. Individual AcSB members gave greater weight to some factors than to others.

2 Nothing in this document is to be taken as overriding the content of AcG-19. However, the discussion may assist Handbook users in understanding the requirements of the Guideline and the AcSB's intent with respect to its interpretation and application.

### BACKGROUND

#### Need for a Guideline

3 The AcSB has undertaken a project examining the need to modify existing Canadian accounting standards to deal specifically with the unique characteristics of rate-regulated operations. The key issues to be addressed by the project are whether and, if so, under what circumstances, rate regulation may create assets and liabilities meeting the asset and liability definitions of FINANCIAL STATEMENT CONCEPTS, Section 1000, and how such financial statement items

should be measured. The project will also consider how best to meet user needs through disclosures in the general purpose financial statements of entities subject to rate regulation.

4 During the initial phases of the project, the AcSB became aware of a significant diversity in practice in the recognition and measurement of what are generally referred to as "regulatory assets and liabilities". Regulatory assets and liabilities result from the application of the existing North American accounting model for rate-regulated operations, which is intended to reflect the economic effects of the rate-setting process. The accounting prescribed by this model is often referred to as "rate-regulated accounting". As an example of the diversity in applying this model, while some entities require a regulator's rate order before recognizing a regulatory asset or liability, others record these items based on management's expectations about future regulatory actions.

5 A review of the financial statements of Canadian entities subject to rate regulation has also indicated a wide range in the extent and quality of disclosures by entities subject to rate regulation. While the notes to the financial statements refer to the existence of rate regulation, they often provide insufficient information about why and how this has influenced the accounting for certain transactions and events, and the specific financial statement items affected. Further, to the degree this information is present, it is often scattered throughout the notes, making it difficult to find.

6 The AcSB acknowledges that the diversity and deficiencies described above exist, in part, due to the Handbook's limited guidance on rate-regulated operations; indeed, this was a major reason for undertaking the Rate-Regulated Operations Project. While the project will address these issues, it will take some time to complete due to:

(a) the complexity of the issues involved;

(b) their high correlation to issues being addressed in other domestic and international accounting standards projects; and

(c) the need to ensure adequate stakeholder involvement throughout the process.

7 The AcSB recognizes that disclosure is not a substitute for appropriate recognition and measurement. Nonetheless, it decided to issue an Accounting Guideline dealing only with disclosures as an interim measure, pending resolution of the issues described in paragraph 3 above. AcG-19 is intended to ensure that financial statement users are better informed about the existence, nature and economic effects of rate regulation, as well as its financial statement effects under the current accounting model for rate-regulated operations. The AcSB expects the Guideline to be withdrawn upon the completion of the Rate-Regulated Operations Project, and its disclosure requirements reconsidered for possible inclusion in the final standard.

8 While the majority of respondents to the Draft Guideline issued for public comment in October 2004 agreed with the need to improve disclosures, some felt that any new disclosure requirements should be incorporated (along with any new recognition and measurement requirements) into a final standard on rate-regulated operations, rather than issued in advance as an Accounting Guideline. The AcSB did not see this as a viable option in view of the fact that, as noted above, the project will take some time to complete. Improvements in disclosure are achievable in the meantime and likely to be of significant benefit to financial statement users.

**Consideration of US disclosure requirements**

9 Some respondents to the Draft Guideline expressed the view that the Guideline should incorporate all of the disclosure requirements of FASB Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" (FAS 71), and other US accounting standards directly relevant to rate-regulated operations. The AcSB rejected this approach as being inappropriate in the circumstances. The US requirements are based on well-established recognition and measurement requirements for rate-regulated operations, as set out in the aforementioned accounting standards. In Canada, such a set of recognition and measurement requirements does not yet exist. Moreover, the AcSB has not endorsed FAS 71 and other relevant US pronouncements as a suitable model for the development of a Canadian standard. In addition, the majority of the US disclosure requirements relate to narrowly defined topics and do not lend themselves well to the AcSB's objective of establishing a generic, principles-based set of disclosure requirements that can be applied to any specific issue and can accommodate the variety of accounting treatments found in Canadian practice. The AcSB noted that once entities have complied with the Guideline, there is nothing to prevent them from disclosing additional information required under US GAAP if they so desire.

## PURPOSE AND SCOPE

10 The AcSB decided against including a definition for rate-regulated enterprises in the Guideline. The definition for this term currently included in certain Sections of the Handbook inherently includes an assumption that rate-regulated accounting is appropriate in certain circumstances, as well as a determination of who should use it and when. While the project must reconsider the appropriateness of this definition, this falls outside the scope of the Guideline. The AcSB concluded that the Guideline's disclosure requirements should apply to all entities with regulated rates, and decided to communicate this in paragraph 1 of the Guideline, rather than through the inclusion of a broad definition of entities subject to its requirements, which would necessarily differ from the definition included elsewhere in the Handbook.

## PRINCIPLES

11 Rate regulation can materially affect the economic reality of certain entities, and is therefore an important consideration in evaluating their financial performance. The AcSB determined that all entities with regulated rates should disclose sufficient information to permit such evaluations. Even when rate regulation has not affected the manner in which an

entity accounts for transactions and events, general information about the rate-setting process and the operations affected will help financial statement users understand the entity's economic performance as reflected in the financial statements. When an entity uses rate-regulated accounting, it is also important to disclose how rate regulation has affected the accounting choices made, and its effect on the financial statements.

**GENERAL INFORMATION ON RATE REGULATION AND ITS ECONOMIC EFFECTS**

12 The AcSB decided that entities subject to rate regulation should describe their relationship with the rate-setting authority when it is a related party under RELATED PARTY TRANSACTIONS, Section 3840, as this information might be useful to some financial statement users. The question of whether the relationship between an entity and its rate regulator(s) should affect the entity's ability to use rate-regulated accounting is an issue to be considered within the context of the overall project, rather than the Guideline.

13 With respect to the degree of detail sought under paragraph 6(b)(ii) of the Guideline, AcSB members were in agreement that the intention is to give financial statement readers a basic understanding of the process by which an entity's rates are approved (rather than the derivation of rates for various services or customer classes). The Guideline provides examples illustrating the type of information expected for various rate-setting methodologies.

**ADDITIONAL INFORMATION ON THE FINANCIAL STATEMENT EFFECTS OF RATE REGULATION**

14 The Draft Guideline included a number of references to possible differences between the accounting policies selected by an entity subject to rate regulation and those otherwise applicable under generally accepted accounting principles. Respondents to the Draft Guideline objected to this wording as implying that entities subject to rate regulation do not follow generally accepted accounting principles. The AcSB agreed that the references in question should be reworded to remove any such implication. The final Guideline acknowledges that rate regulation may cause an entity to account for a transaction or event differently than it would in the absence of rate regulation, and paragraph 7 refers to Handbook Sections requiring or permitting such differences.

15 A respondent to the Draft Guideline suggested that entities subject to rate regulation should be required to disclose not only when they have accounted for a transaction or event differently than they would have in the absence of rate regulation, but also when they haven't, and it might be argued that failure to do so is inappropriate under the current accounting model for rate-regulated operations. The AcSB agreed that, from a conceptual viewpoint, entities applying the model should do so thoroughly and consistently, taking care to reflect all of the economic effects of rate regulation rather than only some. However, AcSB members concluded that the question of whether entities subject to rate regulation are applying the model appropriately is a recognition and measurement issue falling outside the scope of the Guideline, and that the Guideline requirement to disclose the financial statement effects of rate regulation should not be expanded to include instances where it might be argued rate regulation should have had an effect on the accounting for a transaction or event even when it didn't.

16 A small number of respondents to the Draft Guideline disagreed with the fundamental concept of disclosing the additional information required by paragraph 8 of the Guideline. Others objected only to the proposed requirement to quantify the current and cumulative financial statement effect of differences between the manner in which an entity has accounted for a transaction or event and how it would have been treated in the absence of rate regulation. Both groups were of the view that the requirements in question would, unjustifiably, raise doubts about the reliability and integrity of the entity's financial statements. The AcSB disagreed that this was the likely outcome. The required disclosures are intended to make the financial statements more understandable, thus enhancing, rather than impairing, their credibility. The revised wording referred to in paragraph 14 above should also alleviate respondent concerns that the Guideline could unfavourably influence financial statement users' perceptions.

17 The second group of respondents further argued that it would often be impracticable to determine the required cumulative financial statement effect, and provided examples (the one most often cited being allowance for funds used during construction, which includes both an interest and an equity component and is capitalized as part of property, plant and equipment, thus affecting depreciation). The AcSB acknowledged that, due to the varying nature of financial statement items affected by rate regulation, the required information was more easily ascertainable in some cases than in others. It concluded that:

(a) when rate regulation has only partially affected the reported balance of a financial statement item, it is often impracticable to isolate this effect and entities should be required to disclose only the additional information required by paragraphs 8(a)-(b) of the Guideline; and

(b) when a separate asset or liability has been recognized solely as a result of the effects of rate regulation, entities should also disclose the additional information required under paragraph 8(c) of the Guideline. This information includes the income statement effect of such recognition for the current period (the cumulative effect is evident from the reported balance of the asset or liability).

The Illustrative Example provides examples of both of these cases.

18 A small number of respondents to the Draft Guideline suggested that it be clarified to specify that the requirement to disclose additional information on specific financial statement items affected by rate regulation applies only to material items. The AcSB decided against such a change, since it believes the concept of materiality and how it applies in the preparation of financial statements is adequately explained in the Introduction to Accounting Standards and in

FINANCIAL STATEMENT CONCEPTS, Section 1000. This is consistent with the approach taken in other areas of the Handbook.

19 The AcSB decided that financial statement users would benefit from knowing how long regulatory assets and liabilities recognized by an entity are likely to continue to affect its financial results. Accordingly, paragraph 8(c)(iii) of the Guideline requires the disclosure of the expected recovery or settlement period for each regulatory asset or liability. When the regulator has not yet specified the recovery or settlement period, management should provide its best estimate, considering factors such as proposals included in the entity's rate applications and past regulatory actions.

20 The AcSB also decided that the Guideline should include a requirement for entities to describe the regulatory risks and uncertainties affecting the eventual recovery or settlement of the regulatory asset or liability and its timing (see Guideline paragraph 8(c)(iv)). Such risks and uncertainties introduce a degree of uncertainty regarding the measurement of regulatory assets and liabilities, i.e., the amount at which they have been recognized in the financial statements. MEASUREMENT UNCERTAINTY, Section 1508, requires disclosure of the nature of a measurement uncertainty when it is material, even when the carrying amount of the financial statement item is not revised.

21 Paragraph 8(d) of the Guideline requires entities subject to rate regulation to state when and why accounting for the effects of rate regulation has been discontinued since the last financial statements issued, and to identify the operations affected. Under US GAAP, FASB Statement of Financial Accounting Standards No. 101, "Accounting for the Discontinuation of Application of FASB Statement No. 71," requires that the net effect of adjustments required as a result of the discontinuation of rate-regulated accounting be included in income of the period in which the discontinuation occurs, and classified as an extraordinary item. The AcSB decided against expanding paragraph 8(d) to specify how the discontinuance of rate-regulated accounting should be presented in the financial statements, noting that EXTRAORDINARY ITEMS, Section 3480, provides guidance on whether a transaction or event has resulted in an extraordinary item and, if so, how it should be presented and disclosed.

22 Paragraph 9 of the Guideline addresses the manner in which the information required by the Guideline should be communicated within the notes to the financial statements. It is intended to ensure that financial statement users can easily find all of the required information when it is contained in more than one note, thus enhancing its understandability and avoiding the disjointed disclosures sometimes seen in current practice. The AcSB noted that the inclusion of this requirement is consistent with the principles outlined in GENERAL STANDARDS OF FINANCIAL STATEMENT PRESENTATION, paragraph 1400.07.

23 In determining how best to achieve the coherent presentation of the required information, the AcSB also considered an alternative approach under which entities would be required to disclose all of the required information in one or two notes to the financial statements. Respondents to the Draft Guideline, as well as the AcSB, rejected this approach as being overly prescriptive and not allowing for the appropriate exercise of professional judgment.

**PRESENTATION**

24 The AcSB decided that entities subject to rate regulation should be subject to the same GAAP requirements relating to the offsetting of assets and liabilities as all other entities, despite arguments to the effect that, since rate regulators usually permit the recovery or settlement of regulatory assets or liabilities in rates on a net basis, these financial statement items should be allowed to be offset for general purpose balance sheet presentation purposes. The AcSB noted that decisions on offsetting taken by regulators for rate-setting purposes are irrelevant for financial reporting purposes.

**TRANSITIONAL PROVISIONS**

25 Since the Guideline affects only disclosures by entities subject to rate regulation, and not their accounting, these entities should not find its requirements onerous. Nonetheless, the AcSB decided that the Guideline should be effective for fiscal years ending on or after December 31, 2005, thus not requiring entities with calendar year ends to develop the necessary disclosures for the interim periods of 2005 following the issuance of the Guideline. The AcSB noted that entities should refer to INTERIM FINANCIAL STATEMENTS, Section 1751, in determining the effect of the Guideline on interim financial statements in years following the one in which the Guideline becomes effective.

26 Recognizing the greater effort involved in obtaining the information required by paragraph 8(c)(ii) of the Guideline for comparative periods upon the Guideline's initial application, the AcSB decided to provide transitional relief with respect to this requirement only. Accordingly, paragraph 12 permits, but does not require, this information to be disclosed for comparative periods prior to the effective date of the Guideline.

**ILLUSTRATIVE EXAMPLE**

27 The AcSB decided that an Illustrative Example should be included to assist entities in applying paragraph 8 of the Guideline. The items chosen for illustration are representative both of cases in practice in which rate regulation has resulted in the recognition of a separate asset or liability (for example, purchased power cost variances), and those in which it has not (for example, income taxes). They also demonstrate that rate regulation may affect the accounting for non-recurring events or transactions (for example, storm costs), as well as those that are ongoing and require the selection of an accounting policy (for example, gains and losses on debt retired prior to maturity).

28 The AcSB decided that the Illustrative Example need not be expanded to illustrate the application of the requirements of paragraph 6 of the Guideline (in addition to those of paragraph 8). Board members view the information required under paragraph 6 as less in need of, and also less suited to, illustration.