

Adoption of IFRSs by Entities with Rate-regulated Activities — Amendment to Introduction to Part I — Background Information and Basis for Conclusions

Foreword

In October 2010, the Accounting Standards Board (AcSB) amended the Introduction to Part I of the CICA Handbook – Accounting. The AcSB has approved for publication the contents of this document setting out its rationale for this amendment.

Background Information and Basis for Conclusions documents are intended to help readers understand how the AcSB reached its conclusions. They do not include guidance on the application of the Handbook.

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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 their conclusions in developing the amendment to the Introduction to Part I of the Handbook in respect of the adoption of International Financial Reporting Standards (IFRSs) by entities with rate-regulated activities. It sets out the reasons the AcSB undertook to amend the Introduction, the process of research and deliberation, the key decisions made, and the principal reasons for adopting the positions taken 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 requirements of the Introduction to Part I. However, the discussion may help readers understand how the AcSB reached its conclusions in developing the amendment and the AcSB's intent with respect to its interpretation and application.

BACKGROUND

- 3 Currently, IFRSs provide no specific guidance on accounting for rate-regulated activities. In December 2008, the International Accounting Standards Board (IASB) decided to undertake a project to develop a standard on rate-regulated activities. Any final standard resulting from the project would have a fundamental effect on Canadian entities with such activities. The project continued until September 2010, at which time it was removed from the IASB's active agenda.
- 4 The AcSB observed that changes in the work plan for, and the ultimate suspension of, the IASB's activities in this area have created significant uncertainty for this group of publicly accountable enterprises in terms of their ability to adopt IFRSs by January 1, 2011. Accordingly, the AcSB decided to provide qualifying entities with rate-regulated activities the option to defer their adoption of IFRSs for the first time until interim and annual financial statements relating to annual periods beginning on or after January 1, 2012. The remainder of this document provides details of the circumstances leading to the AcSB's decision. It also describes the factors influencing the AcSB's decisions on the length and scope of the deferral, as well as related disclosures.

NEED FOR, AND LENGTH OF, A DEFERRAL

- 5 In July 2009, the IASB issued an Exposure Draft, "Rate-regulated Activities," addressing the recognition, measurement and disclosure of regulatory assets and regulatory liabilities. The standard proposed by the IASB would have permitted

the recognition of regulatory assets and regulatory liabilities in some circumstances, similar to pre-changeover Canadian practice. However, a significant number of the comment letters received by the IASB challenged the fundamental principle that the effects of rate regulation could result in the creation of assets and liabilities meeting the definitions of those elements in the IASB's conceptual framework. When considering the results of preliminary staff research on that issue in July 2010, the IASB decided that its staff should undertake more work to explore the issue. It also decided that the project would not proceed as quickly as previously planned because of the heavy workload from other projects of higher priority. The plan was to issue a final standard in late 2011 and not to develop an interim standard to assist countries moving to IFRSs in the near future.

- 6 For some time, entities in Canada with rate-regulated activities have been unclear about whether assets and liabilities they have recognized as a result of the effects of rate regulation (i.e., regulatory assets and regulatory liabilities) could be included in their IFRS opening balance sheets, and about their continued ability to recognize similar assets and liabilities going forward. In light of this uncertainty and the IASB's project schedule, the AcSB had received a number of requests for a deferral of the mandatory IFRS changeover date for publicly accountable enterprises with rate-regulated activities. After the IASB's July 2010 meeting, the AcSB decided that a deferral was warranted given the IASB's stated intention of developing a standard on rate-regulated activities, and the probability that such a standard would not be published in time for the mandatory adoption of IFRSs for interim and annual financial statements relating to annual periods beginning on or after January 1, 2011.
- 7 In July 2010, the AcSB issued an Exposure Draft, "Adoption of IFRSs by Entities with Rate-regulated Activities," proposing an optional two-year deferral of the mandatory date for first-time adoption of IFRSs by qualifying entities with rate-regulated activities. The AcSB's proposal was based on the assumption that the IASB's active project would result in a final standard on rate-regulated activities in 2011, to take effect at a later date but with early adoption permitted. The AcSB thought that a two-year deferral would provide entities sufficient time to meet the requirements of any such new IFRS.
- 8 In early September 2010, as the AcSB prepared to redeliberate the proposals in its July 2010 Exposure Draft based on the comments received, it learned that the IASB was meeting shortly thereafter to consider new staff proposals on its Rate-regulated Activities project. The IASB staff did not recommend that the project proceed with the development of a final standard. Instead, the staff recommended that the IASB bring the project to a close, issue an explicit prohibition of the recognition of regulatory assets and regulatory liabilities under existing IFRSs, incorporate issues relating to rate-regulated activities into a future comprehensive project on intangible assets, and possibly develop a disclosure standard in the meantime.
- 9 These recommendations invalidated the fundamental assumption underlying the AcSB's proposed two-year deferral. However, the AcSB decided that relief for this sector was still warranted. If the IASB decided to end its Rate-regulated Activities project, the uncertainty about how to reflect the effects of rate regulation in accordance with IFRSs would continue. The AcSB thought entities with rate-regulated activities, especially small government business enterprises, might need additional time to prepare themselves and users of their financial statements for IFRSs. The AcSB proceeded to redeliberate its proposals in light of these new considerations.
- 10 The majority of responses to the AcSB's July 2010 proposals were in favour of a deferral. However, some respondents requested a longer deferral period, perhaps one tied to the completion of IASB activities on this topic. Other respondents suggested that instead of a deferral, the relief the AcSB intended for this sector should take the form of new Handbook guidance requiring entities with rate-regulated activities to adopt IFRSs as originally planned, except for a prescribed treatment for the effects of rate regulation. In most cases, this prescribed treatment would allow entities to retain on their balance sheets the regulatory assets and regulatory liabilities they had recognized previously, and to continue with the rate-regulated accounting practices they were following under pre-changeover Canadian GAAP.
- 11 The AcSB observed that the proposed new Handbook guidance described in paragraph 10 would be a hybrid GAAP of sorts comprising IFRSs and additional guidance permitting the recognition of regulatory assets and regulatory liabilities in some circumstances. The IFRS component could change automatically as Part I of the Handbook changes for new or amended standards issued by the IASB. In contemplating the component comprising additional guidance for rate-regulated activities, the AcSB observed that it could be developed using either or a combination of the following primary sources of US and Canadian GAAP pertaining specifically to rate-regulated activities:
 - (a) the US Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation" (SFAS 71) and standards issued subsequently that have amended, interpreted or supplemented the provisions of SFAS 71; and
 - (b) the guidance contained in a limited number of Sections in the pre-changeover standards in Part V of the Handbook specifying the application of the Section to entities with rate-regulated activities.Alternatively, it could be based on the proposals in the IASB's July 2009 Exposure Draft, with or without adjustments for comments received by the IASB. Such guidance, in effect a "Part VI" of the Handbook, would remain in place until issues relating to rate-regulated activities had been appropriately resolved by the IASB.
- 12 The AcSB rejected the suggestion of developing a "Part VI" to the Handbook for the following reasons:
 - (a) In the event that the IASB did not reactivate its Rate-regulated Activities project or deal with the issues relating to rate-regulated activities in some other manner, a "Part VI" for this sector would represent a potentially

indefinite exception to the AcSB's strategy that all publicly accountable enterprises should adopt IFRSs. The AcSB judged this to be unacceptable.

- (b) Entities applying "Part VI" would be unable to make the explicit and unreserved statement of compliance with IFRSs required by IFRS 1 *First-time Adoption of International Financial Reporting Standards*. As a result, they could only state compliance with Canadian GAAP for entities with rate-regulated activities. Again, this would be inconsistent with the AcSB's IFRS strategy and, for entities, would entail all the burdens of an IFRS conversion with none of the benefits.
 - (c) Because entities would not be able to state compliance with IFRSs as required by IFRS 1, "Part VI" would have to include a standard virtually identical to IFRS 1 without that requirement but complete with the exemptions included in that IFRS. Entities would apply that standard on initial adoption of "Part VI." When ultimately adopting IFRSs, they would be required to apply IFRS 1 itself. Such repeated application of the requirements and elections in IFRS 1 would be potentially costly and confusing for entities, the users of their financial statements and their auditors.
 - (d) Regardless of the approach taken to building "Part VI," it would be a time-consuming and unwieldy process. In particular, the AcSB would need to follow its normal due process of debating the material in detail and exposing it for public comment.
 - (e) The "Part VI" alternative creates complications for securities regulators and reporting issuers. The Canadian Securities Regulators would need to amend their regulations to permit the use of "Part VI," a process that would take some time. Entities applying "Part VI" that are registrants with the US Securities and Exchange Commission would be required to continue providing a reconciliation to US GAAP because they would be unable to claim compliance with IFRSs. The AcSB noted that there would probably be more differences between "Part VI" and US GAAP than between Part V and US GAAP, at least until the converged standards being developed by the IASB and FASB take effect in the future. Stakeholders have told the AcSB that eliminating the reconciliation requirement is an important factor underlying their support of the transition to IFRSs.
 - (f) The creation of a "Part VI" for entities with rate-regulated activities might be viewed as a precedent for other industries with concerns about particular IASB conclusions.
 - (g) Creating such a hybrid GAAP would very likely be regarded globally in the same negative light as the "carve-outs" of IAS 39 *Financial Instruments: Recognition and Measurement* undertaken in Europe and similar alterations to IFRSs in other jurisdictions, calling into question Canada's commitment to full adoption.
- 13 Having rejected a "Part VI" solution, the AcSB had to consider whether the timing of developments in the IASB's Rate-regulated Activities project had jeopardized the ability of Canadian entities in this sector to meet the mandatory IFRS adoption date of January 1, 2011. Specifically, the AcSB was concerned that entities had factored a two-year deferral providing time to implement a final rate-regulated activities standard into their IFRS conversion plans and activities. The AcSB observed that this was likely and decided that a deferral was appropriate.
- 14 The AcSB also decided that the deferral should last one year only, regardless of future activities of the IASB on this topic. It concluded that an additional year should provide sufficient time for entities to complete their preparations for adopting IFRSs, even if such preparations had been delayed temporarily pending the outcome of the IASB's project. It should also provide entities and their auditors sufficient time to determine how the effects of rate regulation are reflected in accordance with IFRSs in the absence of a standard on this topic. Alternatively, registrants with the US Securities and Exchange Commission could decide to adopt US GAAP in place of IFRSs.
- 15 The AcSB rejected the originally proposed two-year deferral as it was now considered to be highly unlikely that the IASB could reactivate a project on rate-regulated activities and produce a final standard, or resolve the contentious issues relating to rate-regulated activities in another manner, within that time. The AcSB also rejected a longer, perhaps indefinite, deferral until the IASB indicated the actions it would or would not take on this topic, as this would result in the inappropriate continued use of Part V. The AcSB had previously decided not to maintain Part V to permit entities to focus on the adoption of one of the new Parts of the Handbook. As a result, that Part is becoming increasingly obsolete with the completion of major joint projects of the IASB and FASB.

SCOPE

- 16 The AcSB's July 2010 Exposure Draft proposed that a qualifying entity is an entity that:
- (a) has activities subject to rate regulation as defined in GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section 1100 in Part V of the Handbook; and,
 - (b) in accordance with ACCOUNTING GUIDELINE AcG-19, Disclosures by Entities Subject to Rate Regulation, also in Part V of the Handbook, discloses that it has accounted for a transaction or event differently than it would have in the absence of rate regulation (i.e., that it has recognized regulatory assets and regulatory liabilities).
- 17 The requirement in paragraph 16(b) was included to ensure that any deferral would apply only to those entities requiring relief (i.e., entities that have recognized regulatory assets or regulatory liabilities on their balance sheets and must determine the treatment of those items upon transition to IFRSs). The AcSB decided that entities that have been

- providing general information about the nature and economic effects of rate regulation in accordance with AcG-19 but that account for their transactions and events in the same manner as other publicly accountable enterprises, do not need additional time to prepare for the first-time adoption of IFRSs.
- 18 In response to comments received, the AcSB decided to amend the qualifying criteria slightly to make clearer its intent on the point discussed in paragraph 17 and the fact that the criterion in paragraph 16(a) must be met as of the beginning of what would otherwise have been an entity's transition period (i.e., as of January 1, 2011).
- 19 One respondent thought a deferral should not be made available to an entity with only a minimal level of exposure to rate regulation, even if the entity had been making the disclosures required by AcG-19. The respondent recommended that the AcSB include implementation guidance on this point. The AcSB disagreed with this recommendation. Any such implementation guidance would necessarily include "bright lines", which the AcSB does not consider appropriate.
- 20 Some respondents raised issues about the application of the qualifying criteria proposed by the AcSB to a consolidated group of companies. Most of those respondents wished the deferral to be made available to all entities in a consolidated group regardless of whether an individual entity meets the qualifying criteria, in order to avoid some entities in the group having to adopt IFRSs earlier than others.
- 21 The AcSB decided that the deferral should apply not only to individual entities meeting the qualifying criteria but also to the consolidated financial statements of their parent companies (and to entities with investments in qualifying entities that are accounted for under the equity method of accounting). When it issued its July 2010 Exposure Draft, the AcSB understood the difficulty of delineating the entities it was attempting to assist with its proposal and that parent companies with holdings in qualifying entities would also receive the benefit of the deferral even when those holdings do not represent the most significant part of their operations.
- 22 However, the AcSB decided that the deferral should not extend to the separate financial statements of any subsidiaries in the consolidated group that do not themselves qualify to use the deferral. As noted in paragraph 17, the AcSB intends the deferral to assist a particular type of entity. It is not intended to facilitate the consolidation process. The AcSB noted that paragraph D17 of IFRS 1 is intended to provide relief when a parent company adopts IFRSs for the first time later than its subsidiary.
- DISCLOSURES**
- 23 The AcSB's July 2010 Exposure Draft proposed that entities electing to defer their IFRS changeover date be required to disclose that fact and when they would first present financial statements in accordance with IFRSs.
- 24 One respondent recommended that entities choosing to use the deferral be required to disclose explicitly that they continue to apply the pre-changeover standards in Part V, rather than simply stating compliance with Canadian GAAP. This is in order to avoid confusion with entities applying IFRSs. In accordance with paragraph I.12 of the Introduction to Part I, such entities are permitted to state compliance with Canadian GAAP as well as with IFRSs. The AcSB decided such a requirement was unnecessary. An entity disclosing that it has not prepared its financial statements in accordance with IFRSs must still be applying the pre-changeover standards in Part V.
- 25 Some respondents objected to the proposal for entities electing the deferral to disclose when they will first present financial statements in accordance with IFRSs. Respondents pointed out that an entity's expectations of when it will first produce IFRS-compliant financial statements would be shaped largely by the timing and outcome of the IASB's activities on this topic. Some respondents also observed that the requirement in question was likely to produce boilerplate disclosures that would be of little benefit. The AcSB decided to remove this requirement. With the adoption of a one-year deferral instead of the proposed two-year deferral, the timing of an entity's first presentation of IFRS financial statements is self-evident.
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