Hong Kong Institute of
Certified Public Accountants
香港會計師公會

Our Ref.: C/FRSC

Sent electronically through the IASB Website (www.ifrs.org)

5 February 2015

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sirs,

IASB Discussion Paper of Reporting the Financial Effects of Rate Regulation

The Hong Kong Institute of Certified Public Accountants is the only body authorised by law to promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong. We are grateful for the opportunity to provide you with our comments on this Discussion Paper (DP). We had also previously responded to:

- IASB Exposure Draft on Regulatory Deferral Accounts (ED/2013/5) (http://www.hkicpa.org.hk/file/media/section6_standards/standards/FinancialReporting/submission-pdf/2013/sub_rda.pdf).
- IASB Request for Information on Rate Regulation (http://www.hkicpa.org.hk/file/media/section6_standards/standards/FinancialReporting/submission-pdf/2013/sub_rate.pdf).
- IASB Exposure Draft on Rate-regulated Activities (ED/2009/8) (http://www.hkicpa.org.hk/file/media/section6_standards/standards/FinancialReporting/submission-pdf/2009/sub-rate-regulated-activities.pdf).

We welcome the IASB's comprehensive project on rate-regulated activities and support the IASB in considering the need for specific accounting guidance or requirements to account for the combination of rights and obligations that arise in defined rate regulations. We are mindful that IFRS is a principles-based standard and the IASB has a policy to avoid developing industry specific standards. Nevertheless, we support the IASB's focus on a defined type of rate regulation as a first step of the research project to provide a common starting point before moving to the next stage of the project, which hopefully, is to determine whether rights and obligations exist in the context of a broader regulated environment.

While we broadly support the description of defined rate regulation as highlighted in the DP, we have provided certain suggestions so that it can be improved. In addition, we consider the defined regulatory period is an important feature that would support the argument that there is a combination of rights and obligations created by defined rate regulation.

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As mentioned in our comments to the IASB 2009 ED on Rate-regulated Activities, we are concerned whether the recognition of regulatory deferral account balances would meet the definitions of assets and liabilities in the *Conceptual Framework*. Therefore, we suggest the IASB conduct a full analysis of the rights and obligations arising from rate regulation and whether they can meet the definitions of assets and liabilities contained in *Conceptual Framework*, which is currently under revision before moving to the next stage of the project. Otherwise, the lack of conceptual basis for the recognition of regulatory deferral accounts as assets or liabilities might lead us to creating exceptions to IFRS.

If the IASB concludes that the regulatory assets and liabilities meet the definition of assets and liabilities, we support the approach of developing specific IFRS guidance or requirements for rate-regulated activities, which considers deferring or accelerating the recognition of a combination of costs and revenue. Users of financial statements are familiar with this approach as it has been adopted in the US GAAP and has the advantage of aligning the timing of recognition for regulatory purpose with IFRS financial reporting purpose.

Our responses to the questions raised in the DP are set out in the Appendix for your consideration.

If you have any questions regarding the matters raised in this letter, please contact Ben Lo, our Associate Director of Standard Setting at ben@hkicpa.org.hk.

Yours faithfully,

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CN/BL

Encl.

Hong Kong Institute of CPAs

Comment on IASB Discussion Paper of Reporting the Financial Effects of Rate Regulation

Question 1

(a) What information about the entity's rate-regulated activities and the rate-regulatory environment do you think preparers of financial statements need to include in their financial statements or accompanying documents such as management commentary?

Please specify what information should be provided in:

(i) the statement of financial position;

(ii) the statement(s) of profit or loss and other comprehensive income;

(iii) the statement of cash flows;

(iv) the note disclosures; or

(v) the management commentary.

(b) How do you think that information would be used by investors and lenders in making investment and lending decisions?

We understand that users of financial statements need information regarding the financial effects of rate regulation. However, except for IFRS 14 which provides guidance about how to account for regulatory deferral accounts and is only applicable to first-time adopters of IFRS, there is no guidance for existing IFRS users on this respect.

We are informed that users of existing IFRS financial statements need information regarding the risks that entities face as a result of rate regulation. In particular, qualitative information about the rate-setting mechanism that adjusts for over-billings and under-billings, how the relevant rate regulation operates and is enforced, risks associated with the recovery of regulatory balances and expected period of recovery are considered as important.

In terms of financial performance, users would like to know how reported earnings in financial statements be reconciled to the earnings permitted by the rate regulation. In terms of financial position, as some of the rate-regulated activities would be able to generate a reasonable return based on a certain percentage of rate-regulated entities' net asset, information on future investment plans of rate-regulated entities would also be considered as useful for users in assessing the future prospects if they would like to invest in shares in those rate-regulated entities.

Question 2

Are you familiar with using financial statements that recognise regulatory deferral account balances as regulatory assets or regulatory liabilities, for

example, in accordance with US generally accepted accounting principles (GAAP) or other local GAAP or in accordance with IFRS 14? If so, what problems, if any, does the recognition of such balances cause users of financial statements when evaluating investment or lending decisions in rate-regulated entities that recognise such balances compared to:

(a) non-rate-regulated entities; and

(b) rate-regulated entities that do not recognise such balances?

Hong Kong fully adopted IFRS in 2005 (word for word) and issued HKFRS 14 *Regulatory Deferral Accounts*, the equivalent of IFRS 14. We are not aware of any entities in Hong Kong that are eligible to apply HKFRS 14 as it is only applicable to first-time adopters that recognise regulatory deferral account balances in their financial statements in accordance with previous GAAP.

Question 3

Do you agree that, to progress this project, the IASB should focus on a defined type of rate regulation (see Section 4) in order to provide a common starting point for a more focused discussion about whether rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed (see paragraphs 3.6-3.7)? If not, how do you suggest that the IASB should address the diversity in the types of rate regulation summarised in Section 3?

We are mindful that IFRS is a principles-based standard and the IASB has a policy to avoid developing industry specific standard. Nevertheless, we support the IASB's focus on a defined type of rate regulation as a first step of the research project to provide a common starting point before moving to the next stage of the project, which hopefully, is to determine whether rights and obligations exist in the context of a broader regulated environment. We suggest that the IASB widen the scope of the project if the comments received on this DP indicate that there are some other activities which create rights and obligations similar to that of defined rate regulation.

Question 4

Paragraph 2.11 notes that the IASB has not received requests for it to develop special accounting requirements for the form of limited or 'market' rate regulation that is used to supplement the inefficient competitive forces in the market (see paragraphs 3.30-3.33).

(a) Do you agree that this type of rate regulation does not create a significantly different economic environment and, therefore, does not require any specific accounting requirements to be developed? If not, why not?

(b) If you agree that this type of rate regulation does not require any specific accounting requirements, do you think that the IASB should, alternatively, consider developing specific disclosure requirements? If so, what would you propose and why?

We agree that market regulation as mentioned in paragraphs 3.30-3.33 of the DP does not require any specific accounting requirements to be developed. Unlike the defined rate regulation in the scope of this DP, which may create a combination of rights and obligations, we do not believe market regulation has characteristics that differ significantly from other commercial activities.

Moreover, existing IFRS, such as paragraphs 138 and 112(c) of IAS 1 *Presentation of Financial Statements*, already require disclosure of information relating to the nature of the entity's operations or otherwise that is relevant to the understanding of the financial statements. Accordingly, entities that are subject to 'market regulation' would be expected to explain the type of regulatory environment that the reporting entity is engaged in.

Question 5

Paragraphs 4.4-4.6 summarise the key features of defined rate regulation. These features have been the focus of the IASB's exploration of whether defined rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might be developed in order to provide relevant information to users of general purpose financial statements.

(a) Do you think that the description of defined rate regulation captures an appropriate population of rate-regulatory schemes within its scope? If so, why? If not, why not?

(b) Do you think that any of the features described should be modified in order to include or exclude particular types of rate-regulatory schemes or rate-regulated activities included within the scope of defined rate regulation? Please specify and give reasons to support any modifications to the features that you suggest, with particular reference to why the features may or may not give rise to circumstances that result in particular information needs for users of the financial statements.

(c) Are there any additional features that you think should be included to establish the scope of defined rate regulation or would you omit any of the features described? Please specify and give reasons to support any features that you would add or omit.

We believe the description of defined rate regulation generally captures an appropriate population. However, we are of the view that the following features, most or all of which are mentioned in various parts of the DP, should be emphasised in the key features of defined rate regulation:

(a) A rate-setting framework that is legally enforceable that governs the operations and financial affairs of the rate-regulated entities for an agreed period of time;

(b) The existence of an external rate regulator (such as a government) whose role and authority, established in legislation or other formal regulations, are to enforce the rate-regulated entity's rights and obligations created by a defined rate regulation; and

(c) A rate-setting mechanism that allows the recovery of costs and required rate of return.

In addition, we are of the view that the element of defined regulatory period should be included as a feature of defined rate regulation. In Hong Kong, electricity generation, distribution and supply is considered as a type of industry which is subject to rate regulation by means of a Scheme of Control Agreement (SCA) between the government of Hong Kong and the two power companies. Based on the SCA, the regulatory period is usually shorter than the useful lives of assets invested by the power companies. In order to safeguard a change implemented by the Hong Kong government to the electricity supply market structure that would cause material impact to the power companies, a provision is included in the SCA that entitles rate-regulated entities to recover from the market stranded costs. Under the SCA, the amounts of stranded costs and recovery mechanism are to be agreed between the Government and the regulated companies.

Based on the above fact pattern, we consider the element of defined regulatory period is an important provision which ensures the recovery of investment and return beyond the regulatory period. This provision also supports the argument that there is a combination of rights and obligations created by defined rate regulation that the IASB should consider developing guidance or requirements.

We consider that these features mentioned in the paragraphs directly above would also be good indicators to illustrate the principles/guidance for determining whether rights and obligations exist in the context of a regulated environment, should the IASB considers to develop principles/guidance for rate-regulated entities that are broader than the scope considered in the DP.

If the IASB decides to develop specific accounting guidance or requirements for rate-regulated activities, we also recommend that the features listed in paragraph 4.4(a) - (d) of the DP are considered as factors rather than criteria for determining whether an entity falls within the scope of this project. This approach would be consistent with IFRS as a principles-based standard.

<u>Question 6</u>

Paragraphs 4.62-4.72 contain an analysis of the rights and obligations that arise from the features of defined rate regulation.

(a) Are there any additional rights or obligations that you think the IASB should consider? Please specify and give reasons.

(b) Do you think that the IASB should develop specific accounting guidance or requirements to account for the combination of rights and obligations described? Why or why not?

We are not aware of any other rights or obligations that have not been identified in this DP and we support the IASB in developing specific accounting guidance or requirements to account for the combination of rights and obligations as described in the DP. We think that existing IFRS does not prescribe specific accounting requirements to provide relevant and useful information for understanding the financial effects of rate-regulated entities.

<u>Question 7</u>

Section 5 outlines a number of possible approaches that the IASB could consider developing further, depending on the feedback received from this Discussion Paper. It highlights some advantages and disadvantages of each approach.

(a) Which approach, if any, do you think would best portray the financial effects of defined rate regulation in IFRS financial statements and is most likely to provide the information that investors and lenders consider is most relevant to help them make their investing and lending decisions? Please give reasons for your answer?

(b) Is there any other approach that the IASB should consider? If so, please specify and explain how such an approach could provide investors and lenders with relevant information about the financial effects of rate regulation.

(c) Are there any additional advantages or disadvantages that the IASB should consider before it decides whether to develop any of these approaches further? If so, please describe them.

If commenting on the asset/liability approach, please specify, if it is relevant, whether your comments reflect the existing definitions of an asset and a liability in the *Conceptual Framework* or the proposed definitions suggested in the *Conceptual Framework* Discussion Paper, published in July 2013.

Section 5 of the DP provides a detailed discussion regarding the debate on whether regulatory deferral account balances would meet the definitions of assets and liabilities under the existing *Conceptual Framework* and the definitions proposed by the *Conceptual Framework* discussion paper. However, no definite conclusions were drawn at the end of this section. As mentioned in our comments to the IASB 2009 ED on Rate-regulated Activities, it is unclear whether the recognition of regulatory deferral account balances would meet the existing definitions of assets and liabilities and we believe it is fundamental to have a proper debate on this.

As the project on *Conceptual Framework* is still in progress, we recommend that the IASB provides additional guidance on the concepts of 'control', 'past events' and 'present obligation' so that it would be easier to determine if regulatory assets and liabilities would meet the definition of assets and liabilities under IFRS. Otherwise, the lack of conceptual basis for the recognition of regulatory assets and liabilities would create exceptions to IFRS and result in comparability issues.

We note, however, that some of our constituents operating in regulated industries in Hong Kong would support the approach to report using regulatory accounting as it would facilitate the interpretation and understanding by investors and shareholders. One of these key constituents thinks that this approach would also reduce the efforts in preparing two sets of financial statements.

Accordingly, while we believe IFRS should be principles-based and we do not support the creation of exceptions to IFRS, we suggest the IASB conduct a full analysis of the rights and obligations arising from rate regulation and whether they can be recognised as assets and liabilities under the *Conceptual Framework* project to provide a conceptual basis for the package of rights and obligations to be recognised to provide decision-useful information for users. In the event that the IASB cannot provide a conceptual justification for the recognition of regulatory account balances, the IASB should consider prescribing disclosure that would provide relevant information to users.

If the IASB conclude that the recognition of regulatory account balances meet the definition of assets and liabilities, we would support the approach of developing specific IFRS guidance or requirements for rate-regulated activities that considers deferring or accelerating the recognition of a combination of costs and revenue. We were informed that users of financial statements are familiar with this approach as it has been adopted in the US GAAP. This approach has the advantage of aligning the timing of the recognition for regulatory purpose with IFRS financial reporting purpose.

We are not aware of any other approach that the IASB should consider and we believe that the IASB has provided a detailed discussion regarding the advantages and disadvantages for respective approach identified in this DP.

Question 8

Does your organisation carry out activities that are subject to defined rate regulation? If so, what operational issues should the IASB consider if it decides to develop any specific accounting guidance or requirements?

This question is not applicable to us as the Institute is a body authorised by law to promulgate financial reporting standards for professional accountants in Hong Kong.

Question 9

If, after considering the feedback from this Discussion Paper and the *Conceptual Framework* project, the IASB decides to prohibit the recognition of regulatory deferral account balances in IFRS financial statements, do you think that the IASB should consider developing specific disclosure-only requirements? If not, why not? If so, please specify what type of information you think would be relevant to investors and lenders in making their investing or lending decisions and why.

If the IASB decides to prohibit the recognition of regulatory deferral account balances in IFRS financial statements, we recommend the IASB should consider developing specific disclosure requirements for rate-regulated activities as users of financial statements would like to understand the economic impacts of rate-regulation (such as information about the rate-setting mechanism, risks associated with rate regulation and how would it affect the entity's financial position, financial performance and cash flows).

However, the IASB should be careful to avoid disclosure overload that will add complexity to users. This is why our preferred approach is as per our response to question 7. That is, we would prefer the IASB to find a way within the conceptual framework which allows the recognition of regulatory assets and liabilities, as we believe this would provide decision-useful information in a less confusing manner than a disclosure-only approach.

<u>Question 10</u>

Sections 2 and 6 discuss some of the information needs of users of general purpose financial statements. The IASB will seek to balance the needs of users of financial statements for information about the financial effects of rate regulation on an entity's operations with concerns about obscuring the understandability of financial statements and the high preparation costs that can result from lengthy disclosures (see paragraph 2.27).

(a) If the IASB decides to develop specific accounting requirements for all entities that are subject to defined rate regulation, to what extent do you think the requirements of IFRS 14 meet the information needs of investors and lenders? Is there any additional information that you think should be required? If so, please specify and explain how investors or lenders are likely to use that information.

(b) Do you think that any of the disclosure requirements of IFRS 14 could be omitted or modified in order to reduce the cost of compliance with the requirements, without omitting information that helps users of financial statements to make informed investing or lending decisions? If so, please specify and explain the reasons for your answer.

As mentioned in our comments to the IASB's ED of Regulatory Deferral Accounts, we believe the disclosure requirements contained in IFRS 14 provide decision-useful information and the cost of obtaining such information is considered reasonable. Moreover, we are aware that users need other information such as those mentioned in our response to Question 1 of this letter.

While we believe some of the disclosure requirements of IFRS 14 could be modified in order to be consistent with other IFRSs, we do not think any of the disclosure requirements contained in IFRS 14 should be omitted. However, as IFRS 14 is considered as an interim standard and the disclosures focus on allowing users to understand diverse accounting practices across jurisdictions, the IASB should therefore re-evaluate the disclosure requirements once an accounting model on rate-regulated activities is developed.

<u>Question 11</u>

IFRS 14 requires any regulatory deferral account balances that have been recognised to be presented separately from the assets and liabilities recognised in the statement of financial position in accordance with other Standards. Similarly, the net movements in regulatory deferral account balances are required to be presented separately from the items of income and expense recognised in the statement(s) of profit or loss and other comprehensive income.

If the IASB develops specific accounting requirements that would apply to both existing IFRS preparers and first-time adopters of IFRS, and those requirements resulted in the recognition of regulatory balances in the statement of financial position, what advantages or disadvantages do you envisage if the separate presentation required by IFRS 14 was to be applied?

If there was no longer a difference under IFRS between those entities which had been able to adopt IFRS 14 as first time adopters and those entities which had not, then we do not consider that the regulatory account balances and their movements should continue to be presented separately from other amounts related to that regulated business in the manner required by IFRS 14.

Instead, we consider it would be more meaningful to regard the regulated business as a separate segment, if the entity was involved in both regulated business and non-regulated business to a material extent. Separate presentation in such cases would enable users to compare information between entities that have a mix of rate-regulated and non-regulated activities (for example, rate-regulated entities that are conglomerates) from those entities that solely engage in rate-regulated activities.

Having said that, whether separate presentation is needed would depend on the accounting approach being developed by the IASB based on the comments received on this DP.

Question 12

Section 4 describes the distinguishing features of defined rate regulation. This description is intended to provide a common starting point for a more focused discussion about whether this type of rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements should be developed.

Paragraph 4.73 suggests that the existence of a rate regulator whose role and authority is established in legislation or other formal regulations is an important feature of defined rate regulation. Do you think that this is a necessary condition in order to create enforceable rights or obligations, or do you think that co-operatives or similar entities, which operate under self-imposed rate regulation with the same features as defined rate regulation (see paragraphs 7.6-7.9), should also be included within defined rate regulation? If not, why not? If so, do you think that such co-operatives should be included within the scope of defined rate regulation only if they are subject to formal oversight from a government department or other authorised body?

As mentioned in our response to Question 5, we believe the existence of a rate regulator (such as a government) whose role and authority are established in legislation or by other formal regulations is an important feature of defined rate regulation as this form of regulator is responsible for enforcing the rights and obligations under a regulatory pricing framework.

We are aware and are concerned that co-operatives or similar entities that are self-regulated would cover a wide range of activities, which might not be the target of the IASB. Accordingly, we suggest that the IASB does not include those forms of entities within the scope of defined rate regulation. Moreover, we believe that the accounting for defined rate regulation should only be developed for entities that supply essential goods or services with limited competition. The existence of a rate regulator provides certainty on the enforcement of the rights and obligations arising from defined rate regulation while such a certainty does not exist for those self-imposed schemes.

Question 13

Paragraphs 7.11-7.22 highlight some of the issues that the IASB may consider if it continues to progress this project.

Do you have any comments or suggestions on these or any other issues that may or may not have been raised in this Discussion Paper that you think the IASB should consider if it decides to develop proposals for any specific accounting requirements for rate-regulated activities?

We agree that the IASB should consider the interaction with other standards that are mentioned in paragraphs 16-17 and B7-B28 of IFRS 14.