esma European Securities and Markets Authority

The Chair

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Ms Françoise Flores
European Financial Reporting
Advisory Group (EFRAG)
35 Square de Meeûs
1000 Brussels
Belgium

Ref: The IASB's Discussion Paper *Reporting the Financial Effects of Rate Regulation*

Dear ~~Ms Flores~~, DEAR FRANCOISE,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the EFRAG's due process. ESMA considered the EFRAG's draft comment letter to the IASB's Discussion Paper (DP) *Reporting the Financial Effects of Rate Regulation*. We are pleased to provide you with the following comments with the aim of improving the enforceability of IFRSs and the transparency and decision usefulness of financial statements.

Like EFRAG, ESMA welcomes that the IASB has embarked on a comprehensive project on rate-regulated activities that resulted in the publication of the DP. ESMA considers that reflecting financial effects of rate regulation which meets specific criteria in IFRS financial statements would improve their relevance and information-usefulness for users. In particular, ESMA believes that recognition, separate presentation and disclosure of these effects in financial statements would result in relevant information enhancing the understanding of how rate regulation affects rate regulated activities of the entity and thus increase the usefulness of the information provided in financial statements.

Similar to EFRAG, ESMA agrees that 'a defined type of rate regulation', as defined in the DP, is the appropriate starting point for a discussion as to whether rate regulated-activities could be objectively distinguished from other issuers' business activities and whether rate regulation creates a combination of rights and obligations for which specific accounting guidance might need to be developed. While ESMA agrees with EFRAG that the existence of enforceable rights and obligations is an essential pre-condition for recognition of assets or liabilities and ensures the appropriate scope of application of a potential future standard, we believe that other criteria stated in the DP are also essential pre-conditions, rather than indicators, for activities to be classified as defined rate regulation.

Furthermore, ESMA believes that any approach the IASB decides to develop should first fully consider the interaction with the [revised] Conceptual Framework and existing standards (e.g. IFRS 15 *Revenue from Contracts with Customers*).

In ESMA's view, any deferral accounting balances that are to be recognised in financial statements should meet the definition of an asset and a liability in the [revised] Conceptual Framework. Should the IASB conclude when developing this project further that a full alignment of all of the aspects of the new guidance with the definition of an asset or a liability in the [revised] Conceptual Framework would not result in useful information, we believe that such decision would warrant a clear description and justification why the specific guidance on reporting financial effects on rate regulation goes beyond these [revised] definitions.

At this stage of the project, analogous with EFRAG views, ESMA considers that developing specific accounting guidance for defined rate regulation could best portray the financial effects of rate regulation in IFRS financial statements. Out of the possible approaches to developing accounting guidance described in the DP, ESMA encourages the IASB to further explore and develop the approach based on combining the deferral and acceleration of the recognition of a combination of costs and revenues. Unlike EFRAG, ESMA will not support the cost deferral approach as described in the ED.

Consistent with the ESMA views on the recognition of all leases in the statement of financial position under the Leases project, ESMA believes that disclosure requirements should not be a replacement for appropriate recognition and measurement criteria as a disclosure-only alternative would fail to provide relevant information to users in primary IFRS financial statements. ESMA recalls that results of academic research clearly demonstrate that information provided in the primary financial statements is the main focus of users.

Finally, ESMA is of the view that any future standard on reporting the financial effects of rate regulation should require issuers to provide sufficient explanation of the environment related to any type of rate regulation. Specific disclosure objectives would improve the comparability and enforceability of IFRS financial statements as well as enable users to understand the effects of rate regulation on the financial position, performance and cash flows of an entity.

Our detailed comments on the DP are set out in the Appendix I to this letter. Please do not hesitate to contact us should you wish to discuss all or any of the issues we have raised.

Yours sincerely,

Steven Maijoor
Chair
European Securities and Markets Authority

Appendix I – ESMA's detailed answers to the questions in the DP

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?

1. ESMA welcomes that the IASB has embarked on a comprehensive project on rate-regulated activities that resulted in the publication of this DP. We note that there is a significant interest of market participants in the subject as exemplified by multiple submissions to IFRS Interpretations Committee and by previous IASB's proposals. Thus we encourage the IASB to address the long-standing issue of reporting the financial effects of rate regulation which meet specific criteria comprehensively within this project.

2. ESMA considers that reflecting financial effects of rate regulation which meets specific criteria in IFRS financial statements (i.e. defined rate regulation) would improve their relevance and information-usefulness for users. We believe that financial statements should provide all relevant information related to the impact of rate regulation on financial position, performance and cash-flows of an issuer that is subject to rate regulation.

3. ESMA considers that if some type of rate regulation results in separate enforceable rights and obligations, the effects of this rate regulation should be recognised in financial statements. ESMA believes that recognition, separate presentation and disclosure in financial statements, would result in relevant information enhancing the understanding of how rate regulation affects rate regulated activities of the entity and thus enhance the usefulness of the information provided in IFRS financial statements. ESMA also believes that such an approach could provide users of financial statements with high-quality financial information that is understandable, comparable, enforceable and globally accepted.

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?

4. ESMA agrees that 'a defined type of rate regulation' is the appropriate starting point for a discussion as to whether rate regulated-activities could be objectively distinguished from other issuers' business activities and whether rate regulation creates a combination of rights and obligations for which specific accounting guidance or requirements might need to be developed.

5. ESMA agrees that the focus of the project should be on rate-regulated activities rather than rate regulated entities, as IFRS should require a similar accounting treatment for transactions with similar economic characteristics rather than attempt to create industry specific standards applicable only to a subset of entities.

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?***

6. ESMA agrees that characteristics of 'market rate regulation' do not result in an economic environment that differs significantly from the environment in which other commercial activities are undertaken. As commercial activities of issuers subject to 'market rate regulation' are sufficiently similar to other commercial activities, existing recognition and measurement requirements in other IFRSs result in faithful representation of these activities in financial statements.

7. ESMA is of the view that the objective of any future standard on reporting the financial effects of rate regulation should be to require issuers to provide sufficient explanation of the environment related to any type of rate regulation (including 'market rate regulation') in a particular regulatory regime. This would enable users to understand the effects of rate regulation on the financial position, performance and cash flows of an entity. In our view, the existing requirements of paragraph 112(c) of IAS 1

Presentation of Financial Statements require an entity to provide information in the notes that is not presented elsewhere in the financial statements, but which is relevant to an understanding of them. However, specific disclosure objectives for rate regulated activities would improve the comparability and enforceability of IFRS financial statements.

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.

8. ESMA agrees with the description of defined rate regulation in the DP. However, ESMA is of the view that the existence of enforceable rights and obligations is the most important characteristic of defined rate regulation that allows it to be distinguished from issuers' other business activities. Accordingly, the existence of enforceable rights and obligations is an essential pre-condition for recognition of assets or liabilities and ensures the appropriate scope of application of a potential future standard.

9. ESMA believes that in addition to the existence of enforceable rights and obligations all of the following criteria stated in the DP are essential pre-conditions as well for activities to be classified as defined rate regulation:

   - low demand risk, characterised by low level of price elasticity of demand and low substitution risk, meaning that the probability of sale is high and determinable as customers have little choice, if any, to purchase the good or service;

- no effective competition to supply, together with the existence of formal enforceable requirements to maintain availability and quality of supply, meaning that the rate regulated entity has no choice but to provide the good or service in a specific quality or availability; and

- existence of formal rate setting mechanism providing regulatory protections whose objective are to provide stability of prices for customers and ensuring financial viability of rate-regulated entities through setting a revenue requirement and a regulated rate.

10. ESMA believes that fulfilment of all these pre-conditions ensures that the scope of defined rate regulation is properly defined for recognition of financial effects of rate regulation in the IFRS financial statements.

Question 6

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?***

11. ESMA believes that that the IASB has identified the appropriate combination of rights and obligations that arise in defined rate regulation for which specific accounting requirements should be developed in order to improve the relevance of IFRS financial statements and the understanding of the effect of rate regulated activities on issuers financial position, performance and cash-flows.

12. We understand that the IASB in paragraphs 4.62-4.72 of the DP analyses individual features of defined rate regulation schemes in order to ascertain whether development of specific accounting guidance is required for any of them individually or any combination thereof. While ESMA agrees with the reasoning of each individual assessment, we would encourage the IASB to clarify the nature and purpose of this analysis if it is included in a future Exposure Draft (ED).

Question 7

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.

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.

13. ESMA believes that any approach the IASB decides to develop in a future ED should first fully consider the interaction with the [revised] *Conceptual Framework* and existing standards (notably IFRS 15 *Revenue from Contracts with Customers*, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and IFRIC 12 *Service Concession Arrangements*).

14. In ESMA's view, any deferral accounting balances that are to be recognised in the primary financial statements should meet the definition of an asset and a liability in the [revised] Conceptual Framework. Should the IASB conclude when developing this project further that a full alignment of all of the aspects of the new guidance with the definition of an asset or a liability in the [revised] Conceptual Framework would not

provide useful information, we believe that such decision would warrant a clear description and justification why the specific principles on reporting financial effects on rate regulation goes beyond these [revised] definitions. Indeed, ESMA expects that a future ED would provide clear explanations and rationale for any such deviations from the [revised] Conceptual Framework.

15. At this stage of the project, ESMA considers that developing specific accounting guidance for defined rate regulation could best portray the financial effects of rate regulation in IFRS financial statements. Out of the proposed approaches, ESMA encourages the IASB to further explore and develop the approach based on combining the deferral and acceleration of the recognition of a combination of costs and revenue described in the DP.

16. This approach is supported by the argumentation made in paragraph 5.52 of the DP. ESMA concurs with the IASB that as the underlying business activities of rate regulated entities are, in general, accounted for in the same way as similar business activities undertaken by entities that are not subject to rate regulation, the specific requirements to be developed need to focus on reflecting the financial effects of rate regulation.

17. At this stage, ESMA believes that the other approaches presented in the DP do not meet the objective of providing high-quality and understandable financial information.

18. ESMA agrees with the arguments against the recognition of the package of rights and obligations as a single intangible asset provided in paragraphs 5.35 – 5.46 of the DP. In particular, in ESMA view, any approach that may result in the recognition of a negative intangible asset is incompatible with the *Conceptual Framework* and IAS 38 *Intangible Assets.*

19. Any possibility to use regulatory accounting requirements would endanger comparability of IFRS financial statements across various jurisdictions and regulatory frameworks and introduce into IFRSs elements that are potentially inconsistent with the Conceptual Framework and established accounting conventions.

20. Finally, subject to the arguments included in paragraph 14 of this comment letter, the disclosure-only approach for defined rate regulation would retain the existing situation that is not satisfactory as it fails to provide relevant information to users in the primary financial statements for many issuers with activities subject to defined rate regulation. This is consistent with ESMA's views on the recognition of all leases in the statement of financial position under the Leases project[1]. Furthermore, as the results of academic research[2] clearly demonstrate that information provided in the primary financial statements is the primary focus of users and increases transparency, ESMA continues

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[1] Comment Letter, The IASB's Exposure Draft Leases, ESMA, Paris, September 2013, ESMA/2013/1244
[2] E.g., Ahmed, A.S., Kilic, E., Lobo, G.J., 2006. Does Recognition versus Disclosure Matter? Evidence from Value-Relevance of Banks' Recognized and Disclosed Derivative Financial Instruments. *The Accounting Review*, Vol. 81, No. 3, pp. 567-58.

to believe that disclosure requirements cannot be a replacement for appropriate recognition and measurement criteria.

Question 10

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.

21. ESMA believes that notwithstanding which approach or specific accounting guidance for defined rate regulation the IASB ultimately proposes in a future ED, IFRS financial statements should also include relevant disclosures that enable users to understand how an issuer is impacted by rate regulation.

22. While at this stage of the project it might be too early to comment on specific disclosure proposals, ESMA is of the view that in addition to general disclosure objectives, a future ED should also include specific disclosure requirements, building on the requirements currently included in IFRS 14 *Regulatory Deferral Accounts*.

Question 11

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?

23. ESMA believes that the separate presentation of regulatory deferral account balances (similar to the one currently required in IFRS 14 *Regulatory Deferral Accounts*) permits users to better understand the effects of defined rate regulation on financial position, performance and cash flows. Depending on how the IASB further develops the project and which accounting model will be proposed in a future ED and/or final standard, the IASB should consider whether the requirement to present regulatory balances separately in the primary financial statements is required when applying IAS1 *Presentation of Financial Statements*.

24. Notwithstanding the accounting model proposed, in order to enhance the relevance and understandability of the information provided in the IFRS financial statements, ESMA is of the view that, if the IASB develops specific accounting requirements for defined rate regulation, separate presentation in primary financial statements or separate disclosure in a single comprehensive note should equally be required.

25. Separate presentation of regulatory deferral account balances or separate disclosure in a single note would enhance comparability of financial statements across different industries and jurisdictions. Moreover, enabling users to better understand the underlying drivers of performance and cash flows would further enhance the quality and comparability of financial information. Given that different industries can be subject to defined rate regulation in different jurisdictions and that those impacted may change over time, the preservation of the comparability of financial information becomes even more important.

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?

26. ESMA agrees that the existence of a formal rate regulation framework and of a rate regulator whose role and authority is established by law or other enforceable legal act or document is an indispensable feature of defined rate regulation. In order to achieve consistency in application of the requirements and their enforceability, self-imposed rate regulation should not be in the scope of defined rate regulation as does not create enforceable rights and obligations and thus does not allow for its objective verifiability. Accordingly, no deferral accounting balances assets or liabilities should result from self-imposed rate regulation regime.

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?

27. As already stated in our answer to question 7, we believe that the IASB should carefully consider any interactions with the current IFRS and with the [revised] Conceptual Framework. We believe that the interactions identified in the DP represent a good starting point when developing further any accounting model to reflect the financial effects of rate regulation.