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Discussion Paper DP/2013/1
A Review of the Conceptual Framework for Financial Reporting

The Edison Electric Institute (EEI), American Gas Association (AGA), and National Association of Water Companies appreciate the opportunity to comment on the International Accounting Standards Board's (the Board's) Discussion Paper DP/2013/1, *A Review of the Conceptual Framework for Financial Reporting* (the Discussion Paper).

EEI is the association that represents all U.S. investor-owned electric companies. Our members provide electricity for 220 million Americans, operate in all 50 states, and directly employ more than a half-million workers. With more than $85 billion in annual capital expenditures, the electric power industry is responsible for millions of additional jobs. EEI has 70 international electric companies as Affiliate Members, and 250 industry suppliers and related organizations as Associate Members. Organized in 1933, EEI provides public policy leadership, strategic business intelligence, and essential conferences and forums.

The AGA is an American trade organization representing natural gas supply companies and others with an interest in the production of natural gas. AGA represents more than 200 local energy companies that deliver clean natural gas throughout the U.S. There are more than 71 million residential, commercial and industrial natural gas customers in the U.S., of which 92 percent — more than 65 million customers — receive their gas from AGA members. Today, natural gas meets almost one-fourth of the United States' energy needs. Founded in 1918, AGA advocates the interests of its members and their customers, and provides information and services promoting efficient demand and supply growth, and operational excellence, in the safe, reliable and efficient delivery of natural gas.

The National Association of Water Companies is the voice of the private water industry, representing quality service providers, innovation drivers and responsible partners. Each day, private water service companies help provide essential water and wastewater services to nearly 73 million people in the United State, more than a quarter of the population.

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Together, EEI, AGA, and the National Association of Water Companies are commenting on the Discussion Paper on behalf of their U.S. members who are predominantly financial statement preparers.

As background, EEI, AGA, the National Association of Water Companies, and their members have been actively involved in the Board's ongoing rate-regulated activities (RRA) project, the purpose of which is to perform a comprehensive review of rate regulation and to develop a Discussion Paper. The Board has previously mentioned that it plans to use examples from the RRA project to test the definitions of assets and liabilities being developed in the Conceptual Framework project. Given the interrelationship between the RRA and Conceptual Framework projects, our response primarily focuses on questions from the Discussion Paper that could have a bearing on, or factor into, issues under consideration in the RRA project.

We have provided responses to the specific questions from the Discussion Paper below.

Question 2

The IASB proposes the following definitions:

a) **An asset is a present economic resource controlled by the entity as a result of past events**
b) **A liability is a present obligation of the entity to transfer an economic resource as a result of past events**
c) **An economic resource is a right, or other source of value, that is capable of producing economic benefits.**

Do you agree with these definitions? Why or why not? If you do not agree, what changes do you suggest, and why?

We agree with the proposed definitions. As stated in the Discussion Paper, financial statements should provide information regarding an entity's prospects for future cash flows. We agree that a resource or obligation *capable* of producing an inflow or outflow of economic benefits is a more useful and relevant determination of an asset or liability than the current definition and that the degree of certainty of the inflows or outflows of economic benefits is better addressed in the recognition or measurement criteria. (as further expanded upon in our response to Question 3 below). We believe that the proposed definitions, in at least some circumstances, would recognize that rights and obligations created by rate-regulation constitute assets and liabilities under International Financial Reporting Standards (IFRS). We discuss certain pertinent aspects of the definitions in support of our conclusion below.

Present Resource and Obligation

As described in our response to the Board's RRA request for information (RFI) dated May 30, 2013, U.S. regulated entities operate under a well-developed and long-standing regulatory compact. Under the regulatory compact, a utility is effectively granted a monopoly via a franchise for the provision of service within a defined geographic territory, with an obligation to serve all customers within that territory. In exchange for such franchise, the utility is allowed to charge rates which are designed to recover its costs, and provide it with an opportunity to recover a reasonable profit or return on its investment. We believe that the existence of the regulatory compact and the actions of regulators in accordance with their authority create present resources and obligations that are incremental to the cost or market value of providing utility service in the current period.

Control

The regulatory compact creates exclusive, legally enforceable present rights to collect from, and present obligations to refund economic resources to, a group of customers within a defined service territory. Rate-regulated entities control these economic resources because of their exclusive rights and obligations under the regulatory compact to provide service and to bill and collect such amounts from a customer base within a designated service area. The Discussion Paper highlights that in order to demonstrate control, an entity must have the ability to direct the use of the economic resource and that

> "sometimes an entity establishes its ability to direct the use of an economic resource by having access that is not available to others, for example, by having possession of the economic resource and being able to prevent access to it by others."

The monopoly or near-monopoly created by the regulatory compact establishes the rate-regulated entity's right to recover its costs from (or refund over collections to) customers and prevents others from obtaining that right.[1]

Past Events

These rights and obligations created by the existence of the regulatory compact arise from activities and events (e.g., costs incurred or milestones achieved) in the current or one or more prior periods. We believe that the costs incurred or performance targets achieved (as

[1] An additional specific example of a rate-regulated entity's ability to control is a securitization transaction where a regulatory asset and the "right to bill" has been considered the rate-regulated entity's property and considered collateral in securitization related financings.

part of the utility fulfilling its obligation to serve) constitute past event(s). Absent such past events, the only amounts billable by the utility would represent the current period cost of service. To the extent that the bill is increased or decreased to reflect the recovery or refund of additional amounts beyond the current period cost of service, those amounts represent the transfer of economic resources associated with past events.

We acknowledge that collection or refund of incremental amounts in connection with future billings may give the appearance of being associated with future period sales. However, upon evaluation of the substance of this practice, such future billings are merely a settlement mechanism implemented as a practical, efficient, low-cost way to settle rights and obligations associated with past events. In the U.S., the body of customers in any one utility's franchise territory is relatively stable, and thus recovery or refund of prior amounts is included in future bills for the sake of convenience.

Capable of Economic Benefit

These rights and obligations represent the present economic resources underlying the entity's prospects for future cash flows. As discussed in our response to the Board's RRA RFI dated May 30, 2013, there are various rate-setting mechanisms that facilitate the regulatory compact's objective of allowing the rate-regulated entity to recover its costs (plus a reasonable rate of return) from its customers. The two most common rate-setting mechanisms in the U.S. are base rates and actual cost recovery mechanisms, commonly referred to as trackers.

Both traditional rate-setting mechanisms, such as base rates, as well as mechanisms with an automatic or formal true-up feature, such as trackers, create legally enforceable rights and obligations that we believe meet the Board's proposed asset and liability definitions. While trackers provide a relatively precise true-up of costs, base rates create an equally enforceable right for a rate-regulated entity to recover its costs from customers. The regulatory compact itself, rather than the specific form of the rate-setting mechanism used to effectuate that compact, creates rights and obligations and differentiates rate-regulated entities from companies operating in competitive markets, whose prices are set by the market.

While competitive market participants seek to set their prices at a level to maximize their profit, rate-regulated entities have a legally enforceable right and obligation to charge amounts that recover their costs. The fact that the regulatory compact permits/requires utilities to charge more or less than the market price to recover or refund regulator-created assets or liabilities demonstrates that the regulatory compact creates economic resources for either the utility or its customers that are otherwise unavailable to non-regulated entities and their customers.

Question 3

Whether uncertainty should play any role in the definitions of an asset and a liability, and in the recognition criteria for assets and liabilities, is discussed in paragraphs 2.17–2.36. The IASB's preliminary views are that:

a) the definitions of assets and liabilities should not retain the notion that an inflow or outflow is 'expected'. An asset must be capable of producing economic benefits. A liability must be capable of resulting in a transfer of economic resources.

b) the Conceptual Framework should not set a probability threshold for the rare cases in which it is uncertain whether an asset or a liability exists. If there could be significant uncertainty about whether a particular type of asset or liability exists, the IASB would decide how to deal with that uncertainty when it develops or revises a Standard on that type of asset or liability.

c) the recognition criteria should not retain the existing reference to probability.

Do you agree? Why or why not? If you do not agree, what do you suggest, and why?

We support the Board's preliminary view to remove the notion of *expected* inflows or outflows from the asset and liability definitions. We agree that, in their purest form, assets and liabilities are resources or obligations that are *capable* of producing or resulting in the transfer of economic benefits. However, we believe that the assets and liabilities ultimately reflected in an entity's financial statements should take into account the cash inflows or outflows that the resource or obligation is expected to produce or transfer. The Board has stated that for financial information to be useful, it must be relevant and representationally faithful. To be relevant, financial statement information must be timely and have predictive or feedback value. To include an economic resource (or the obligation to transfer an economic resource) in the financial statements without reflecting the related expected cash inflows or outflows would not be predictive and, thus, not provide relevant information to users of the financial statements.

Given that recognition and measurement issues are typically closely related, we believe that the effects of uncertainty can be addressed in either criterion, each having their advantages and disadvantages. Under the existing IASB Conceptual Framework (and consistent with the Financial Accounting Standard Board's Conceptual Framework), an entity records the entire economic resource or obligation based on whether future cash inflows or outflows are probable, which may overstate or understate the cash inflows or outflows the entity ultimately realizes. For example, an entity may control an economic resource that has a 50% likelihood of producing economic benefits and, therefore, not recognize the asset (assuming the entity interprets 'probable' as greater than 50% likelihood of occurring). Under this approach, the entity may not be providing financial statement users the most relevant information given that the 50% likely outcome is not reflected in its financial statements.

By addressing uncertainty in the measurement criteria, entities would record the portion of the resource or obligation that is expected to result in inflows or outflows, which may provide users of financial statements more relevant information. On the other hand, this approach may imply a level of precision of estimating future outcomes that does not exist and potentially result in financial statement preparers using their discretion in estimating future outcomes to manage earnings. Additionally, as the Board highlighted in the Discussion Paper, the cost of measuring the uncertainty of certain rights or obligations may outweigh the benefits and certain measures of uncertainty may not be verifiable.

As highlighted above, there are arguments for addressing uncertainty in either recognition or measurement; however, in weighing the pros and cons, we believe that uncertainty is more appropriately addressed in the recognition criteria and the existing reference to probability, therefore, should be retained.

Question 5

Constructive obligations are discussed in paragraphs 3.39–3.62. The discussion considers the possibility of narrowing the definition of a liability to include only obligations that are enforceable by legal or equivalent means. However, the IASB tentatively favours retaining the existing definition, which encompasses both legal and constructive obligations—and adding more guidance to help distinguish constructive obligations from economic compulsion. The guidance would clarify the matters listed in paragraph 3.50.

Do you agree with this preliminary view? Why or why not?

We agree with retaining the notion of constructive obligations in the final Conceptual Framework and providing additional guidance to clarify the difference between constructive obligations and economic compulsion.

Question 6

The meaning of 'present' in the definition of a liability is discussed in paragraphs 3.63–3.97. A present obligation arises from past events. An obligation can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. However, it is unclear whether such past events are sufficient to

create a present obligation if any requirement to transfer an economic resource remains conditional on the entity's future actions. Three different views on which the IASB could develop guidance for the Conceptual Framework are put forward:

a) **View 1: a present obligation must have arisen from past events and be strictly unconditional. An entity does not have a present obligation if it could, at least in theory, avoid the transfer through its future actions.**

b) **View 2: a present obligation must have arisen from past events and be practically unconditional. An obligation is practically unconditional if the entity does not have the practical ability to avoid the transfer through its future actions.**

c) **View 3: a present obligation must have arisen from past events, but may be conditional on the entity's future actions. The IASB has tentatively rejected View 1. However, it has not reached a preliminary view in favour of View 2 or View 3.**

Which of these views (or any other view on when a present obligation comes into existence) do you support? Please give reasons.

We support View 2, which states that a present obligation must have arisen from past events and be practically unconditional (i.e., the entity does not have the practical ability to avoid the transfer through its future actions). We agree that it need not be certain that a present obligation will result in the transfer of an economic resource, but the present obligation must be <u>capable</u> of resulting in a transfer of the economic resources (i.e. the obligation exists even though the amount is uncertain). Therefore, if an entity has the unilateral ability and discretion to take action to avoid future transfers or use of assets, an obligating event has <u>not</u> incurred. On the other hand, if the entity has no practical ability to avoid the obligation, whether due to legal constraint or other operational or regulatory factors, a liability has been incurred.

Rate-Regulated Activities
As mentioned previously, our industries are actively involved in the RRA project and we are aware that the definitions in the revised Conceptual Framework will be tested in the RRA project. We believe that the typical liabilities created by rate regulation are best defined by View 2. We believe that a regulatory obligation is imposed due to a past transaction or event (e.g., collection from customers for future costs, over-recovery or refund of a gain from the sale of assets used for utility service). Furthermore, the regulated entity has a present unconditional (no practical, unilateral discretion to avoid) obligation pursuant to the regulatory process (established by legislation or regulation).

Given that certain rate tariffs require specific approval by a rate regulator and refunds are typically settled through reductions of future billings, one could argue that the rate-regulated entity has the ability, in theory, to avoid the obligation and, therefore, would not record a liability under View 1. However, this would not convey economic reality or provide financial statement users with relevant information. Therefore, we do not support View 1. We also do not support View 3 given that it may result in the recording of liabilities related to obligations that may never be settled.

Emission Trading Schemes
Due to the relevance of emission trading schemes in our industry, we also considered paragraphs 3.90 to 3.95 of the Discussion Paper, where the Board specifically addressed the implications of the three views for emission trading schemes. EEI believes that the "past event" only occurs when pollutants are emitted and not when the allowances are allocated. Therefore, under any of the three views, a liability would only be recorded when pollutants are emitted.

Question 8

Paragraphs 4.1–4.27 discuss recognition criteria. In the IASB's preliminary view, an entity should recognise all its assets and liabilities, unless the IASB decides when developing or revising a particular Standard that an entity need not, or should not, recognise an asset or a liability because:

a) **recognising the asset (or the liability) would provide users of financial statements with information that is not relevant, or is not sufficiently relevant to justify the cost; or**

b) **no measure of the asset (or the liability) would result in a faithful representation of both the asset (or the liability) and the changes in the asset (or the liability), even if all necessary descriptions and explanations are disclosed.**

Do you agree? Why or why not? If you do not agree, what changes do you suggest, and why?

We agree with the criteria in (a) and (b) above. The criteria are converged with the recognition criteria in FASB Statement of Financial Accounting Concepts No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises." Concepts Statement No. 5 defines the fundamental recognition criteria as those items meeting the definition of an element of financial statements which possess measurability, relevance and reliability. The reliability criteria further emphasizes that the information is representationally faithful, verifiable and neutral. These are essentially the same criteria in the revised IASB Conceptual framework (par.4.7).

As is noted in paragraph 4.7 of the discussion paper, the existing Conceptual Framework includes recognition criteria, and existing standards are based on the Conceptual Framework. We agree that financial statement users should look first to individual IASB standards for guidance on recognition of assets and liabilities. However, as is currently the case for users of U.S. GAAP who look to the FASB Conceptual framework when specific guidance is not provided in specific standards, users of IFRS would similarly look to the IASB Conceptual Framework to aid them in making an accounting determination if no specific IASB guidance exists related to an individual situation. This inherently will allow professional judgment to be exercised when applying the Conceptual Framework.

Question 11

How the objective of financial reporting and the qualitative characteristics of useful financial information affect measurement is discussed in paragraphs 6.6–6.35. The IASB's preliminary views are that:

a) **the objective of measurement is to contribute to the faithful representation of relevant information about:**

   i. **the resources of the entity, claims against the entity and changes in resources and claims; and**

   ii. **how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources.**

b) **a single measurement basis for all assets and liabilities may not provide the most relevant information for users of financial statements;**

c) **when selecting the measurement to use for a particular item, the IASB should consider what information that measurement will produce in both the statement of financial position and the statement(s) of profit or loss and OCI;**

d) **the relevance of a particular measurement will depend on how investors, creditors and other lenders are likely to assess how an asset or a liability of that type will contribute to future cash flows. Consequently, the selection of a measurement:**

   i. **for a particular asset should depend on how that asset contributes to future cash flows; and**

ii. for a particular liability should depend on how the entity will settle or fulfill that liability.

e) the number of different measurements used should be the smallest number necessary to provide relevant information. Unnecessary measurement changes should be avoided and necessary measurement changes should be explained; and

f) the benefits of a particular measurement to users of financial statements need to be sufficient to justify the cost.

Do you agree with these preliminary views? Why or why not? If you disagree, what alternative approach to deciding how to measure an asset or a liability would you support?

We agree with the Board that measurement of assets and liabilities should not be limited to one basis in order to provide the most relevant and useful information to investors, creditors and other users of financial statements. We further agree with the Board's views of the factors noted in Section 6 of the Discussion Paper that should be considered when evaluating the measurement basis for a given asset or liability. In considering these factors, we believe management's intent to use an asset or settle a liability significantly affects the relevance of any measurement basis.

Question 12

The IASB's preliminary views set out in Question 11 have implications for the subsequent measurement of assets, as discussed in paragraphs 6.73–6.96. The IASB's preliminary views are that:

a) if assets contribute indirectly to future cash flows through use or are used in combination with other assets to generate cash flows, cost-based measurements normally provide information that is more relevant and understandable than current market prices.

b) if assets contribute directly to future cash flows by being sold, a current exit price is likely to be relevant.

c) if financial assets have insignificant variability in contractual cash flows, and are held for collection, a cost-based measurement is likely to provide relevant information.

d) if an entity charges for the use of assets, the relevance of a particular measure of those assets will depend on the significance of the individual asset to the entity.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

Generally we agree with the Board's preliminary views of the factors to be considered when determining the measurement basis for a particular asset. However, we disagree that the significance of an individual asset to an entity should impact its measurement basis. An asset's measurement basis should be evaluated without regard to materiality or significance. An entity should separately evaluate the materiality of a particular asset as part of the recognition process. As information, we believe that regulatory assets would generally be measured using a cost-based measurement approach given that they do not have significant variability and are held for collection from customers through future billings.

Question 13

The implications of the IASB's preliminary views for the subsequent measurement of liabilities are discussed in paragraphs 6.97–6.109. The IASB's preliminary views are that:

a) cash-flow-based measurements are likely to be the only viable measurement for liabilities without stated terms.

b) a cost-based measurement will normally provide the most relevant information about:

i. liabilities that will be settled according to their terms; and

ii. contractual obligations for services (performance obligations).

c) current market prices are likely to provide the most relevant information about liabilities that will be transferred.

Do you agree with these preliminary views and the proposed guidance in these paragraphs? Why or why not? If you disagree, please describe what alternative approach you would support.

We agree with the Boards preliminary views for subsequent measurement of liabilities as discussed in paragraphs 6.97–6.109. Specifically, we agree that a cash flow based measurement is often the most relevant measurement for liabilities without stated terms. We also agree that the Conceptual Framework should not define a list of acceptable cash flow based measurements. Rather, individual standards should address the appropriate cash flow based measurement applicable to the liability addressed by that standard. In this manner, each standard would be able to customize the measurement basis of the liability to ensure the most relevant basis is presented to users of the financial statements based on the particular nature of the liability. As information, we believe that regulatory liabilities would generally be measured using a cost-based measurement approach given that they are typically settled according to terms set forth by the rate regulator.

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Conclusion

We support the Board's initiative to reassess certain aspects of its Conceptual Framework and appreciate your consideration of our comments. We would be pleased to further discuss the impact on our industry with you or provide any additional information you may find helpful in addressing the questions in the Discussion Paper.

Very truly yours,

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