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November 17, 2009

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

RE: ED 2009/8 -- *Rate-regulated Activities*

Our firm, Financial Reporting Advisors, LLC, provides accounting and SEC reporting advisory services, litigation support services, and dispute resolution services. We specialize in applying generally accepted accounting principles to complex business transactions.

On balance, we support the International Accounting Standards Board (IASB) addressing the issue of accounting for the effects of cost-of-service rate regulation. As Canada, and possibly the United States, transition to International Financial Reporting Standards in the next few years, the issue of accounting for the effects of cost-of-service rate regulation will become quite important.

Our primary concern with the ED relates to its recognition criteria, specifically the construct of the scope of the ED. Just as good disclosure cannot compensate for bad accounting, good measurement cannot compensate for bad recognition criteria. As currently drafted, we believe the scope criteria would allow for the recognition of regulatory assets in situations in which there is an insufficient connection between the past event (incurring costs) and future revenues to justify the recognition of an asset. We believe that changes are needed to ensure that regulatory assets are recognized only when the regulation results in the regulated entity having the economic equivalent of a receivable that is akin to the right to charge higher prices for later deliveries under a single contract.

Rationale for recognition of regulatory assets

We agree with the statement in paragraph BC36 that the effect of cost-of-service regulation is similar to a "cost plus" contract as defined in IAS 11, *Construction Contracts*. On that basis, we agree that actions of a regulator may create assets and liabilities ("regulatory" assets and liabilities) that meet the definition of assets and liabilities in the IASB's *Framework for the Preparation and Presentation of Financial Statements*. We recommend that the IASB use the analogy to a cost plus contract as its primary argument for the recognition of regulatory assets and eliminate the arguments in paragraphs BC21-BC22. We do not find the arguments in paragraphs BC21-BC22 to be helpful when considering

the possible recognition of regulatory assets. First, the examples used in those paragraphs are acquisitions of intangible rights from third parties whereas a regulatory asset is a cost that, except for the actions of a regulator, is a period expense of the reporting entity. Second, the arguments in paragraphs BC21-BC22 do nothing to explain why the actions of a regulator using cost-of-service regulation may create a recognizable asset, but the actions of a regulator using price-cap regulation do not create a recognizable asset. Finally, equating the acquisition of an intangible asset from a third party with an incurred cost seems to create a dangerous precedent. For example, using the logic in paragraphs BC21-BC22, it could be argued that costs incurred for advertising campaigns or maintenance of equipment should be recognized as an asset.

Scope

As stated above, we believe the analogy to the accounting for cost plus contracts should be the primary basis for recognition of regulatory assets and liabilities. Consequently, we evaluate the appropriateness of the scope criteria in the ED by comparing the economic effect of the actions of a regulator for an entity that meets the scope criteria in paragraph 3 of the ED to the economic effect of a hypothetical cost plus contract between the regulated entity and its aggregate customer base. We have two recommendations related to the scope criteria as a result of analyzing the scope criteria in this manner.

- We recommend that a third criterion be added that limits the applicability of this standard to situations in which the aggregate customer base has no realistic alternative to purchasing the regulated good or service from the regulated entity.

In all cases, the customer base has no legal obligation to purchase services from the regulated entity. However, with the addition of a criterion such as the one we recommend, the aggregate customer base could be seen to have a constructive obligation to purchase from the regulated entity. Absent such a criterion, the regulated entity has an obligation to make the regulated good or service available at a price based on its costs, but its aggregate customer base has no legal or constructive obligation to purchase any portion of its requirements for the regulated good or service from the regulated entity. Such a situation appears to us to be equivalent to an entity making an offer to a customer rather than equivalent to an entity entering into a cost plus contract with a customer. If the aggregate customer base has a realistic alternative to the good or service provided by the regulated entity, the regulator is not truly committing the aggregate customer base to purchase its requirements of the regulated good or service from the regulated entity (that is, in the event the price of the regulated entity's goods or services exceeds the price from alternative suppliers, the aggregate customer base may no longer purchase the regulated entity's goods or services). As a result, the actions of a regulator in this situation do not put the regulated entity in a position similar to an entity that has a cost plus contract with the aggregate customer base and therefore do not support the recognition of a regulatory asset. If the aggregate customer base has a realistic alternative to purchasing the regulated good or service from the regulated entity, it is hard to distinguish such a fact pattern from price cap regulation. Said another way, in this situation, we do not believe there is a sufficient "cause-and-effect" relationship between the regulated entity's incurred costs and its future revenues to justify recognition of a regulatory asset.

Consider a regulated entity that provides residential landline telephone services to customers in its service territory under an exclusive cost-of-service regulatory scheme. Prior to the widespread availability of mobile phones, its aggregate customer base had no realistic alternative to the regulated entity's landline phone service. However, once mobile phone service became widely available, the

regulator's ability to commit the aggregate customer base to purchase residential landline service was compromised and, in our view, the regulated entity should no longer be eligible to recognize regulatory assets. Another example would be a toll road operator that is regulated on a cost-of-service basis. As long as drivers have a realistic alternative to using the toll road, the actions of the regulator cannot create the economic equivalent of a receivable from the aggregate customer base for costs that the toll road operation has incurred and hopes to pass on to its customers in future periods.

- We recommend the definition of a regulator be narrowed to require the regulator to be independent of the regulated entity.

Under the ED as currently drafted, the regulator could be, for example, the governing board of a cooperative. In that situation, the same group of individuals represents the members of the cooperative, functions as the governing board of the cooperative, and is the "regulator" of the cooperative. Such a situation seems inconsistent with the premise that the regulator is negotiating with the regulated entity on behalf of the aggregate customer base. It appears to us that the most meaningful financial reporting for such an entity may be financial reporting absent the recognition of regulatory assets and liabilities. We suggest the IASB specifically ask users of such entities' financial statements whether the application of this proposed standard would be an improvement in financial reporting for such entities.

A designated cost of equity funds

Paragraph BC49 refers to "a designated cost of equity funds" being included as part of the cost of property in situations in which the regulator establishes the regulated entity's rates on such a basis. However, paragraph 16 of the ED limits the amounts to be included in property to "amounts that would otherwise be recognized as regulatory assets." Regulatory assets are defined as "an entity's right to recover specific previously incurred costs …." In other words, there must be a cost incurred that otherwise would be recognized as an expense in order for a regulated entity to recognize a regulatory asset. A designated cost of equity funds is not an incurred cost. Consequently, as written, the ED appears to preclude the capitalization of a designated cost of equity funds. That result is contrary to the discussion in paragraphs BC49-BC52 and therefore we believe it is contrary to the IASB's intent. We recommend that the ED be revised to explicitly address the recognition of a designated cost of equity funds as part of the carrying amount of constructed assets. It should be noted that FASB Codification Topic 980, *Regulated Operations*, defines two terms – incurred costs (similar definition as in the ED) and allowable costs (which includes a designated cost of equity funds) – in order to address this specific issue.

Assuming that the IASB does intend for regulated entities to capitalize a designated cost of equity funds as part of property, is the ability to capitalize a designated cost of equity funds limited to property or could a regulated entity capitalize a designated cost of equity funds in other circumstances? For example, could a designated cost of equity funds be capitalized related to an incurred cost such as storm damage that is expected to be allowed to be recovered in rates in a future period?

Other issues

Paragraph 12 states that regulatory assets should be measured at the end of each reporting period at their expected present value. We believe that the expected present value of a regulatory asset should never exceed the amount of the incurred cost referenced in paragraph 8(a). We recommend that

paragraph 12 explicitly state that the recognized regulatory assets cannot exceed the amount of incurred costs.

We recommend that the final standard itself explicitly address the presentation of the effect of recognizing regulatory assets and liabilities in the statement of operations (that is, that the recognition of a regulatory asset reduces the amount of expense recognized rather than being reflected as an increase in revenue). As drafted, this issue is not addressed in the ED until paragraph IE21.

Contrary to the assertion in BC32, some regulated entities in the United States can and do offer discounts from their cost-of-service based rates established by regulators. For example, a rate-regulated natural gas pipeline may, with the approval of its regulator, enter into a contract to transport natural gas for a rate less that its total cost-of-service tariff rate. For some entities, this may be a temporary situation and for others it may be expected to continue for the foreseeable future. Does the ability to offer discounts disqualify an entity's operations from applying this standard? Does the temporary offering of such discounts disqualify an entity's operations from applying this standard?

Finally, we recommend that the final standard include a summary of the differences between the final standard and FASB Codification Topic 980. It is our understanding that, in the absence of specific guidance in this area, entities in various jurisdictions have followed the guidance in the FASB literature. Consequently, such a summary would be useful to entities in a number of jurisdictions as they convert to IFRS.

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We appreciate the opportunity to comment on the referenced document. We would be pleased to discuss our comments with the IASB or the IASB staff at your convenience. Please contact Richard Petersen at 312-345-9102 or Petersen@Finra.com if there are any questions about our comments.

Very truly yours,

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