

**Comments on the Commerce  
Commission's Review of Electricity  
Information Disclosure Requirements**

**Prepared for the Electricity Networks  
Association**

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## Executive Summary

This report comments on the approach taken by the Commerce Commission, and the valuation methods proposed, in its two discussion papers that review the information disclosure requirements applying to electricity lines businesses.

### *Use of a conceptual framework and GAAP*

The review faces many of the issues faced by accounting standards setters when developing accounting standards, as both processes are concerned with defining reporting requirements. To assist in the development of consistent and coherent accounting standards many standards setters have developed conceptual frameworks that provide high-level guidance to the design of standards.

We suggest the Commission should use the applicable conceptual framework for New Zealand (the NZ Framework) in the review to frame and assess the various reporting options it is considering. This would greatly enhance the clarity of debate throughout the review as the NZ Framework provides a structured way of considering such issues. Its use should also improve the durability of the results of the review as the NZ Framework reflects the experience of many years of international accounting standard setting and research.

Similarly, we consider the disclosure requirements should be framed in a way that is consistent with GAAP, unless there are compelling reasons to the contrary.

Consistency with GAAP is likely to lead to more durable requirements, and would enable a wide range of practices developed under GAAP to be used in the preparation and interpretation of the disclosed information. These practices include the collection, storage and reporting of financial information, audit tests and procedures, and the interpretation of the disclosed information by the Commission, analysts and other stakeholders. Conversely, requirements inconsistent with GAAP would raise the costs of compliance considerably and result in information that would require its own interpretation.

It is noteworthy that the then Ministry of Commerce in 1998 considered amending the disclosure regulations and its enabling legislation at the time to an approach that would not have been consistent with GAAP, but decided against this approach.

### *Clarify dimensions of performance that require monitoring*

The discussion papers do not set out clearly the dimensions of performance of lines businesses that the Commission considers require monitoring (either by itself or other stakeholders). We suggest the Commission should clarify these dimensions of performance early in the review process. If it were clear as to the performance that is to be monitored, it would be much more straightforward to determine what information should be disclosed.

In particular, we suggest the Commission should clarify the dimensions of performance it intends to consider when resetting thresholds, and how the reset in 2009 is to be undertaken. Without clarity on this important point it is difficult to see how lines businesses can usefully comment on the proposed set of information disclosure requirements.

### *Valuation methodologies*

The Commission's Valuation Choice paper proposes two possible valuation methods; indexed ODV and an indexed form of historic cost (IHC). This is in contrast to a draft decision paper issued in 2002 in which the Commission committed to providing lines businesses a choice between ODV (possibly indexed) and an un-indexed form of historic cost (DHC).

The key difference between the DHC method put forward in 2002 and the IHC method now proposed is the manner in which it exposes a lines business to regulatory risk (due to the difference in the relative timing of cash flows they would give rise to). The IHC method is similar to the indexed ODV method in this regard but the DHC method is not. Now that the two proposals appear similar in terms of regulatory risk, this key issue has not received the attention it deserves in the Valuation Choice paper.

Recent practice to date in New Zealand with respect to regulatory valuation methodologies and their application to regulatory decision-making has been inconsistent, as illustrated by the regulatory valuations and their applications in the electricity sector since 1994, and the Commission's practice in electricity and other sectors over the last five years (the change in proposed valuation methods from DHC to IHC is one example). Inconsistency of this kind undermines the ability of investors to be able to predict with confidence the regulatory rules that will be applied in the future, and reduces confidence in the durability of the rules.

We consider a prerequisite to introducing an indexed valuation method (either ODV or IHC) should be that the Commission puts in place regulatory commitments that address current regulatory uncertainties (to the extent they are under its control), in order to address the greater exposure to regulatory risk that such methods would place on lines businesses.

It may be useful when considering how to address these regulatory uncertainties to make a distinction between regulatory governance and regulatory rules. In the context of the targeted control regime this distinction could be made along the following lines:

- The regulatory rules would include specifying all the items covered in the Commission's information disclosure review (including the valuation method to be used and the detailed rules related to that), and setting out how that information would be used in the setting of thresholds, in post-breach inquiries (e.g. as per the Assessment and Inquiry Guidelines), and in setting prices under control.
- The regulatory governance arrangements would contain commitments as to the principles and processes the Commission would use when considering a change to the regulatory rules, for example when updating the ODV Handbook asset values, or when reviewing the methods used to reset the thresholds.

In our view such an approach would reduce considerably the current regulatory uncertainties faced by lines businesses under the targeted control regime and has the potential to set the necessary regulatory context for the possible use of regulatory rules that are robust over the longer term, but also expose a lines business to increased regulatory risks (e.g. the use of an indexed valuation method).

An additional feature of the Part 4A regime is the possibility of responsibility for the regime shifting to the Electricity Commission. In our view this issue as to which institution will in the future be responsible for the regime would need to be addressed in order for the approach described above to be credible.

In the absence of addressing these regulatory uncertainties we suggest the Commission revert to the valuation option of un-indexed DHC as presented in the December 2002 paper, as it provides lines businesses greater scope to manage their exposure to regulatory risk.

This ability to manage regulatory risk is a key component of promoting “the efficient operation of markets directly related to electricity distribution and transmission services...” as set out in the purpose statements (section 52E and 52T) of Part 4A, as it is fundamental to achieving efficient levels of investment in the sector.

However, we consider the preferred approach would be to address the regulatory uncertainty issues and implement an ODV valuation method properly.

## Introduction

1. We have been requested by the Electricity Networks Association (ENA) to comment on the approach taken by the Commerce Commission, and the valuation methods proposed, in its two discussion papers<sup>1</sup> that commence a review of the information disclosure requirements applying to electricity lines businesses. This report sets out our comments on these papers and suggestions on how best to take the review forward.

## Context of review

2. The review of the information disclosure requirements encompasses all of the existing information disclosure requirements, and thus includes:
  - Financial aspects of the requirements, such as the statements of financial performance, of financial position, the components that make up those statements (e.g. the valuation of system fixed assets), and performance measures derived from them (e.g. return on investment).
  - Non-financial aspects of the requirements, such as reporting on service performance and asset management plans.
3. Given the wide scope of the review, and the importance of the outcomes from it for the electricity lines sector, it is important that the review is well structured and guided by a clear set of principles and processes. To that end we discuss the following issues in this report and suggest the Commission:
  - Make use of the conceptual framework developed by the accounting profession which is used to guide the development of accounting standards. The review faces many of the issues faced by accounting standards setters when developing accounting standards, as both processes are concerned with defining reporting requirements. The conceptual framework reflects years of international experience and research in setting reporting requirements. Similarly, we suggest the disclosure requirements be developed in a manner that is consistent with generally accepted accounting practice (GAAP), to enable the widely used reporting practices, auditing tests and interpretation of reports developed under GAAP to be used in relation to the disclosed information.
  - Clarify the dimensions of performance of lines businesses that it intends to monitor, or that it considers other stakeholders wish to monitor. In particular, we suggest the Commission should clarify the dimensions of performance it intends to consider when resetting thresholds, and how the reset in 2009 is to be undertaken. Determining what information should be disclosed would be much more straightforward if the performance that is to be monitored were clear.

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<sup>1</sup> "Regulation of Electricity Lines Businesses, Review of the Information Disclosure Regime – Discussion Paper", and "Regulation of Electricity Lines Businesses, Implementing Valuation Choice for System Fixed Assets – Draft Decisions and Discussion Paper", Commerce Commission, 24 December 2004.

4. The Commission's Valuation Choice paper discusses possible valuation methods. The Commission has issued a number of papers on this topic in recent years and in December 2002 it issued draft decisions in relation to valuation methods for lines businesses. The review timetable indicates the Commission intends to take decisions on this topic earlier than in relation to most other aspects of the review. Given this context we comment in more detail on the proposed valuation methods.

## Use of conceptual framework and GAAP

5. Accounting standard setters address similar issues to those faced by the Commission in its review of the information disclosure requirements as in both cases the objective is to produce a set of reporting requirements. To assist in the development of consistent and coherent accounting standards many standards setters have developed conceptual frameworks that provide high level guidance to the design of standards.
6. In the New Zealand context, the Institute of Chartered Accountants of New Zealand (ICANZ) has developed such a conceptual framework which is about to be overtaken, as part of New Zealand's move to adopt international accounting standards, by a New Zealand version of the International Accounting Standards Board's (IASB) conceptual framework (referred to as the NZ Framework).<sup>2</sup> We use the NZ Framework as our reference to conceptual frameworks in this report.
7. The NZ Framework covers the following issues that are likely to be relevant and useful to the information disclosure review (the relevant sections from it are appended):
  - Qualitative characteristics of financial statements. These cover understandability, relevance, reliability and comparability.
  - Elements of financial statements. This includes defining the elements used to measure the financial position in the balance sheet, namely assets, liabilities and equity. The elements related to measurement of performance in the income statement are income and expenses.
  - Recognition of elements in financial statements. This sets out the criteria as to when an element should be recognised, which in general terms is when it is probable that any future economic benefit associated with the element will flow to or from the reporting entity, and the element has a cost or value that can be measured reliably.
  - Measurement of the elements of financial statements. This concerns the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the financial statements.

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<sup>2</sup> A final and approved version of the New Zealand Framework has yet to be issued so in this report all references are to the exposure draft version of it, which is available at [www.icanz.co.nz/StaticContent/ags/iased.cfm](http://www.icanz.co.nz/StaticContent/ags/iased.cfm). However most aspects of the exposure draft we refer to are from the IASB Framework (and not from the NZ additions to it) and therefore can be expected to be unchanged in the final version.

- Elements of non-financial statements. This is a NZ addition to the IASB Framework and defines the elements of non-financial statements as inputs, outputs, and outcomes.
8. In the day to day reporting of financial statements many of the above issues do not arise explicitly as they have been articulated in accounting standards and are part of GAAP. However, the Commission's review involves either writing regulatory accounting standards specific to the information disclosure requirements, or in some way adopting or modifying the accounting standards used for general purpose financial reporting, and therefore the qualitative characteristics set out in the NZ Framework will need to be addressed in the review in some way.
  9. We suggest that using the NZ Framework explicitly in the review to frame and assess reporting options would greatly enhance the clarity of debate throughout the review as it provides a structured way of considering such issues. It should also improve the durability of the results of the review as the NZ Framework reflects the work and experience of many years of international accounting standard setting and research.
  10. Similarly, we consider the disclosure requirements should be framed in a way that is consistent with GAAP, unless there are compelling reasons to the contrary.
  11. Consistency with GAAP is likely to lead to more durable requirements, and would enable the use of a wide range of practices developed under GAAP in the preparation and interpretation of the disclosed information. These practices include the collection, storage and reporting of financial data, auditing tests and procedures, and the interpretation of the disclosed information by the Commission, analysts and other stakeholders. Conversely, requirements inconsistent with GAAP would raise the costs of compliance considerably and result in information that would require its own interpretation.
  12. It is noteworthy that the then Ministry of Commerce in 1998 considered amending the disclosure regulations at the time (and proposing changes to enabling legislation) to an approach that would not have been consistent with GAAP, but decided against this approach, as follows:<sup>3</sup>

*"The Ministry has reviewed its approach to the applicability of GAAP to the financial statements disclosed under the Regulations, and has concluded that these statements should be GAAP compliant. GAAP is the authoritative set of rules for accounting purposes in New Zealand, and it seems sensible to base the regulatory accounts on this firm foundation.*

*The earlier proposal that conflicts between GAAP and the Regulations with respect to the financial statements should be resolved in favour of the Regulations (i.e. the Regulations would take precedence), has accordingly been dropped. The Electricity Act 1992 requires that the disclosed financial statements comply with GAAP, and the Ministry does not propose to amend this requirement."*

13. The Commission notes in the Review paper that the information disclosure regime under Part 4A is not required by law to be compliant with GAAP, as was the previous

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<sup>3</sup> Paragraphs 34 and 35 of "Discussion Paper – Proposals for Amending the Electricity (Information Disclosure) Regulations", Energy Markets Policy Group, Resources & Networks Branch, Ministry of Commerce, September 1998.

disclosure regime administered by the Ministry of Economic Development under the Electricity Act 1992.<sup>4</sup>

14. In our view the binding constraints on the Commission as to whether it frames the information disclosure requirements to be consistent with GAAP are the practical difficulties of not doing so, and problems with durability of using untested alternatives (which would add another element of regulatory risk), rather than the legal constraint referred to.

## Need for clarity as to the performance that is to be monitored

15. The Commission discusses the intended use of information disclosed under the disclosure regime and considers disclosed information could be used for:<sup>5</sup>

- Setting thresholds.
- Assessing compliance against thresholds.
- The initial stage of a post-breach inquiry. The Commission has other powers under section 98 of the Commerce Act to acquire information in relation to an inquiry or the possible subsequent stage of setting prices under control.
- Fulfilling the wider purpose of the specific information disclosure provisions, section 57T, which is:

*“The purpose of this subpart is to promote the efficient operation of markets directly related to electricity distribution and transmission services by ensuring that large line owners and large electricity distributors make publicly available reliable and timely information about the operation and behaviour of those businesses, so that a wide range of people are informed about such factors as profits, costs, asset values, price (including terms and conditions of supply), quality, security, and reliability of supply of those businesses.”*

16. Given this wide range of potential uses for the disclosed information, it would be useful for the Commission to define the dimensions of performance that it considers are important to monitor. The Commission states:<sup>6</sup>

*“The primary objective of information disclosure is to support market efficiency objectives, through providing a dataset that enables assessment of the various dimensions of the efficiency of lines business, subject to consumer demands for service quality.”*

17. The Commission expands on its view as to the information likely to be of interest to various potential users in chapter 3 of the Review paper, and concludes with the table

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<sup>4</sup> See paragraphs 148 and 149 of the Review paper.

<sup>5</sup> See paragraphs 49 – 54 of the Review paper.

<sup>6</sup> Paragraph 11 of the Review paper.

below which aims to match various components of information disclosure to dimensions of economic efficiency.<sup>7</sup>

**Table 1 – Relationship between Objectives and Information Required**

Aspect of “Market Efficiency” Objective	Related Component of Information Disclosure
<b>Allocative efficiency and assessment of excess returns</b>	<ul style="list-style-type: none"> <li>▪ Line charges and pricing methodology</li> <li>▪ Excess returns (and supporting financial information)</li> <li>▪ Quality information</li> </ul>
<b>Productive efficiency</b>	<ul style="list-style-type: none"> <li>▪ Cost information</li> <li>▪ Quality information</li> <li>▪ Input and output statistics</li> </ul>
<b>Dynamic efficiency</b>	<ul style="list-style-type: none"> <li>▪ Capital expenditure information</li> <li>▪ Asset value</li> <li>▪ Asset management plans</li> <li>▪ Input and output statistics</li> <li>▪ Quality information</li> </ul>

18. The Caygill Inquiry suggested that, following the approach of information disclosure regimes in Australia and the United Kingdom, greater emphasis should be placed on measures of outcomes, rather than inputs.<sup>8</sup> KPMG, who were commissioned to report on distribution business performance indicators for the purposes of the Inquiry, concluded that principal performance indicators should focus on those matters most important to customers. These indicators were considered to be

- *“availability of supply;*
- *fitness for purpose of supply; and*
- *price.”<sup>9</sup>*

19. Taking the above views into account, we consider it would be useful in the review to present together the following items:

- The dimensions of performance that the Commission considers need to be monitored.

<sup>7</sup> This is Table 2, page 35, of the Review report.

<sup>8</sup> “Inquiry into the Electricity Industry”, *Report to the Minister of Energy*, June 2000, p 41.

<sup>9</sup> As described in the “Inquiry into the Electricity Industry”, *Report to the Minister of Energy*, June 2000, p 41.

- Information that is available, or could be disclosed at reasonable cost, relevant to each dimension of performance.
- Performance measures relevant to each performance dimension that could be reported on or derived from the disclosed information.

20. We provide an initial but incomplete example below to illustrate how this approach could be presented.

**Table 2 - Dimensions of performance, information and performance measures**

<b>Dimensions of performance to be monitored</b>	<b>Possible disclosed information on performance dimension</b>	<b>Possible performance measures</b>
Service performance – this relates to reporting on the nature and quality of the service provided	Service quality (e.g. voltage) Service reliability (e.g. frequency and duration of outages)	Voltage levels Service reliability (e.g. SAIDI, SAIFI, CAIDI, CAIFI)
Financial performance – this relates to reporting on prices and the revenues derived from the services provided, the costs to provide them, and earnings from the business.	Statements of financial performance and of position, cashflow statements. Costs relative to outputs Pricing methodology	Return on Investment Cost efficiency measures
Procedural issues – this relates to particular processes or actions the supplier takes that are expected to be leading indicators of service or financial performance in the future	Asset management plans Nature and extent of engagement with consumers	Probably not applicable

21. There would be a number of advantages from structuring this aspect of the review along these lines:

- It would enable proposed information disclosure requirements to be assessed relative to the performance dimension for which they are intended to provide monitoring information. Such an assessment needs to include whether the proposed information disclosures would provide a reliable measure of the relevant performance dimension. To do so will require typically input from engineering, economic and accounting perspectives.
- It would foster debate as to the most efficient ways to monitor various performance dimensions.

- It would highlight where there is missing information. For example, if it is intended that the information is to be used for the resetting of thresholds in 2009, it would be useful to know the performance dimensions and performance measures that the Commission intends to use in that reset. If they were known, it would be much more straightforward to determine what information is required to be disclosed for them. Conversely, until the Commission discloses its intention in this regard, it appears to us lines businesses are not in a position to respond usefully as regards how well any proposed information disclosure requirements would meet the information needs of the threshold reset.

## Discussion of proposed valuation methods

22. The Commission's paper on Valuation Choice proposes the use, for valuing system fixed assets, of:
  - ODV for starting values as at 1 April 2004.
  - A choice between ODV and Indexed Historic Cost (IHC) going forward, with the constraint that once a choice is made by a lines business, it is not able to switch to the other.
23. The Commission states that the reason it is developing the IHC method is that it committed in its draft decisions of December 2002 that it would provide lines businesses the option between ODV and depreciated historic cost (DHC) going forward. However, the DHC method contemplated in 2002 did not involve indexing and thus is a different method to that now being proposed.<sup>10</sup>
24. The key difference between the DHC method put forward in 2002 and the IHC method now proposed is the manner in which it exposes a lines business to regulatory risk. The IHC method is similar to the indexed ODV method in this regard but the DHC method was not. Now that the two proposals are similar on this dimension, this key issue of regulatory risk does not receive the attention it deserves in the Valuation Choice paper. We expand on this below.
25. An indexed method (ODV or IHC) relative to a non-indexed DHC method differs in the following ways:
  - The cash profiles for the lines business are, in the case of the indexed method, deferred in time relative to those of the non-indexed method. This is illustrated in Figure 1 below.
  - For the two methods to be equivalent in NPV terms to the lines business, each method needs to be implemented properly and maintained over the life of the assets.<sup>11</sup>

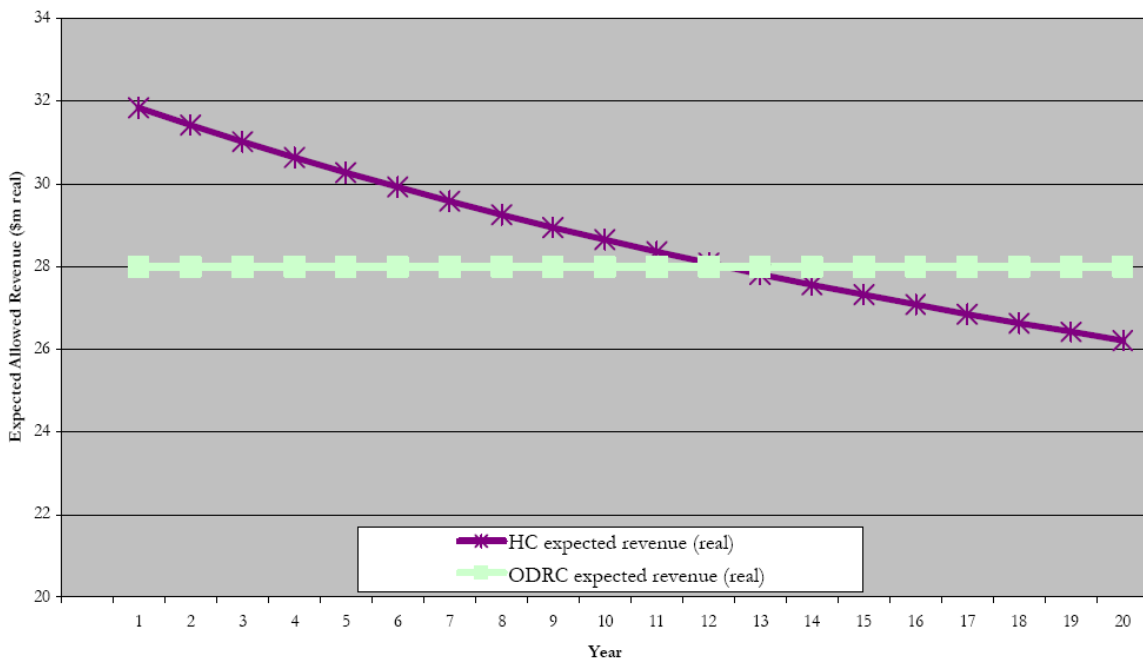
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<sup>10</sup> "Regulation of Electricity Lines Businesses: Targeted Control Regime – Draft Decisions", Commerce Commission, 23 December 2002, pp 26-27. The Commission states that if lines businesses using ODV values are not exposed to revaluation risk, they "should have the same WACC as businesses using DHC" (paragraph 119). This implies that the DHC method under consideration would not be indexed (since indexing implies revaluation and accompanying risks).

<sup>11</sup> "Historic Cost and Replacement Cost: Efficiency Implications of their Use in Price Setting", Tony van Zijl and Timothy Irwin of LECG, 14 August 2001.

- In the case of the indexed method, the lines business is exposed to the regulator changing the regulatory rules through the life of the assets toward the non-indexed method, such that the NPV equivalence is not met, and the foregone cash revenues in the early years relative to the non-indexed method are not matched with higher revenues in the later years.
- With the non-indexed method we consider this regulatory risk is much less as the likelihood of a regulator changing the regulatory rules toward the indexed method *and* requiring the historical difference to be paid back to consumers in some way is much less.

**Figure 1 - Timing of cash revenues under an indexed (ODRC) and non-indexed historic cost methods<sup>12</sup>**



26. Thus in our view one of the key choices between the two valuation methods put forward in the December 2002 draft decisions was that lines businesses could make a choice as to their exposure to regulatory risk. The two methods now proposed do not offer that choice and we consider that is a backward step in the New Zealand context, for the following reasons.

27. It is well known that lines businesses invest in assets with lives somewhere between 40 to 60 years, which are for the most part “sunk” (i.e. have little value in alternative use). The value of such assets is dependent critically on any regulatory rules that constrain the prices that may be charged for the services delivered by them. Consistent and durable rules that provide investors the confidence that they will be able to obtain an

<sup>12</sup> Ibid, p 11.

adequate return on their investments over their life are a central feature of a robust regulatory regime. Economic research highlights the importance of such regulatory rules in attracting capital to these sectors.<sup>13</sup>

28. Recent practice to date in New Zealand with respect to regulatory valuation methodologies and their application to regulatory decision-making has been inconsistent. This is illustrated below in relation to regulatory valuations and their applications in the electricity sector since 1994, and the Commission's practice in electricity and other sectors over the last five years.

- An ODV Handbook was issued in 1994 by the then Ministry of Commerce and information disclosure regulations promulgated that included a key financial performance measure termed accounting rate of profit (AROP).
- The electricity information disclosure regulations were modified in significant ways in 1999 by the Ministry, including to align the disclosure requirements with generally accepted accounting practice (GAAP), and a change in AROP to a return on investment (ROI) measure which was derived using a different set of calculations (particularly as regards tax).
- The Commission completed its final report in the Airports Pricing Inquiry in 2002, and that report used the historic cost valuation method (un-indexed) in the cost building block approach to assess the reasonableness of prices.<sup>14</sup>
- In December 2002 the Commission released a draft decision paper that would require lines businesses to report their asset valuations using a starting position of ODV, and for subsequent years would provide lines businesses the choice between DHC or ODV.<sup>15</sup> It was clear in that paper that the version of DHC contemplated in the draft decision would not be indexed.
- The Commission issued its threshold decisions for the period 2004-2009 in December 2003.<sup>16</sup> All lines businesses' thresholds were set in relation to an

<sup>13</sup> Examples include: For a discussion of the importance of limiting arbitrary administrative action see "The Institutional Foundations of Regulatory Commitment: A Comparative Analysis of Telecommunications Regulation", Brian Levy and Pablo T. Spiller, *Journal of Law, Economics, and Organization*, Vol. 10, No. 2 (Oct., 1994), pp 201-246. For analysis of the efficiency effects of regulation depicted as a repeated game between the utility and the regulator see "The Dynamic Efficiency of Regulatory Constitutions", Richard J Gilbert and David M Newberry, *RAND Journal of Economics*, Vol. 25, No. 4, Winter 1994, pp 538-554. For analysis of the trade-offs between innovation, investment and the form of mandatory unbundling of the telecommunications local loop used in the US see "Innovation, Investment and Unbundling", Thomas M Jorde, J Gregory Sidak and David J Teece, *Yale Journal of Regulation*, Vol. 17:1. 2000, pp 1-37.

<sup>14</sup> "Final Report Part IV Inquiry into Airfield Activities at Auckland, Wellington and Christchurch International Airports", Commerce Commission, 1 August 2002

<sup>15</sup> "Targeted Control Regime – Draft Decisions", Commerce Commission, 23 December 2002. The Commission states (p 3) that it "intends to require each lines business to adopt and commit to either Depreciated Historic Cost (DHC) or Optimised Deprival Value (ODV), for the purposes of valuing system fixed assets in its regulatory accounts."

<sup>16</sup> "Regulation of Electricity Lines Businesses Targeted Control Regime: Threshold Decisions (Regulatory Period Beginning 2004)", Commerce Commission, 23 December 2003

expected industry-wide improvement in efficiency determined through total factor productivity analysis (the B factor), and were allocated differing thresholds depending on their performance relative to a “C” factor. The C factor depended on relative performance in multilateral total factor productivity analysis, and a relative comparison of profitability conducted using a measure of “residual rates of return”. None of these measures had been reported previously by lines businesses or the Commission. The ROI financial performance measure, introduced in 1999 and reported in line business disclosures annually since then, was not used to determine either factor.

- The Commission released its first determination on the Telecommunications Service Obligation (TSO) cost calculation on 17 December 2003. This determination used replacement cost asset values and included the use of a tilted annuity approach to calculating depreciation which adjusts capital costs over time in line with the expected rate of increase or decrease of the optimised replacement cost of the capital equipment.<sup>17</sup>
  - The asset values in the Electricity ODV Handbook were updated in 2004, for the first time since 1994.<sup>18</sup>
  - The Commission completed its final report in the Gas Inquiry.<sup>19</sup> In this Inquiry the Commission used ODV asset values based on a 1999 Draft Gas ODV Handbook, did not update those values to current market values, but indexed asset values using the forecast CPI for the 2004 -2008 period in its modelling.
  - In December 2004 the Commission released two discussion papers on the review of the electricity information disclosure regime and the valuation methods lines business could use as part of the information disclosure regime. The discussion papers proposed an indexed historic valuation method (IHC), and an indexed ODV method. The IHC method differs from the DHC method in the draft decision of December 2002 in that the IHC would be indexed but the DHC method would not have been.
29. The above list demonstrates that the Commission has yet to establish a consistent approach to defining asset valuation methods and applying the resulting valuations to regulatory decisions. Inconsistency of this kind undermines the ability of investors to be able to predict with confidence the regulatory rules that will be applied in the future, and reduces confidence in the durability of the rules.
30. We consider a prerequisite to introducing an indexed valuation method (either ODV or IHC) should be that the Commission puts in place regulatory commitments that address current regulatory uncertainties (to the extent they are under its control), in

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<sup>17</sup> “Determination for TSO Instrument for Local Residential Service for period between 20 December 2001 and 30 June 2002”, Commerce Commission, 17 December 2003, p 37.

<sup>18</sup> “Handbook for Optimised Deprival Valuation of System Fixed Assets of Electricity Lines Businesses”, Commerce Commission, 30 August 2004.

<sup>19</sup> “Section 56 Gas Control Inquiry: Final Report”, Commerce Commission, 29 November 2004.

order to address the greater exposure to regulatory risk that such methods would place on lines businesses.

31. In designing such regulatory commitments, it may be useful to make a distinction between regulatory governance and regulatory incentives (or rules), as set out by Levy and Spiller:<sup>20</sup>

*“In trying to understand different countries’ ability to commit to particular regulatory processes and institutions, we find it useful to look at regulation as a design problem. Regulatory design has two components: regulatory governance and regulatory incentives. We define the governance structure of a regulatory system as the mechanisms that societies use to constrain regulatory discretion and to resolve conflicts that arise in relation to these constraints. The regulatory incentive structure comprises the rules governing utility pricing, cross or direct subsidies, entry, interconnection, etc. In contrast to regulatory governance, the structure of regulatory incentives has been the central preoccupation of virtually all theoretical work on regulation. A main result of this study, though, is that such emphasis is inadequate. Although we find that regulatory incentives indeed affect performance, their impact (positive or negative) comes to the forefront only if regulatory governance has successfully been put into place.*

*Both regulatory governance and incentives are choice variables in the hands of policy-makers.”*

32. In the context of the targeted control regime this distinction between regulatory rules and their governance could be used along the following lines:

- The regulatory rules would include specifying all the items covered in the Commission’s information disclosure review (including the valuation method to be used and the detailed rules related to that), and setting out how that information would be used in the setting of thresholds, and in post-breach inquiries (e.g. as per the Assessment and Inquiry Guidelines) and in setting prices under control.
- The regulatory governance arrangements would contain commitments as to the principles and processes the Commission would use when considering a change to the regulatory rules, for example when updating the ODV Handbook asset values, or when reviewing the methods used to reset the thresholds.

33. In our view such an approach would reduce considerably the current regulatory uncertainties faced by lines businesses under the targeted control regime and would have the potential to set the necessary regulatory context for the possible use of regulatory rules that are robust over the longer term, but also expose a lines business to increased regulatory risks (e.g., the use of an indexed valuation method).

34. An additional feature of the targeted control regime is the possibility of responsibility for it shifting to the Electricity Commission.<sup>21</sup> In our view this issue as to which

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<sup>20</sup> “The Institutional Foundations of Regulatory Commitment: A Comparative Analysis of Telecommunications Regulation”, Brian Levy and Pablo T. Spiller, *Journal of Law, Economics, and Organization*, Vol. 10, No. 2 (Oct., 1994), p 205.

<sup>21</sup> Section 57DC of the Commerce Act 1986 provides for this.

institution will in the future be responsible for the regime would need to be addressed in order for the approach described above to be credible.

35. In the absence of addressing these regulatory uncertainties we suggest the Commission revert to the valuation option of un-indexed DHC as presented in the December 2002 paper, as it provided lines businesses greater scope to manage their exposure to regulatory risk. This ability to manage regulatory risk is a key component of promoting *“the efficient operation of markets directly related to electricity distribution and transmission services...”* as set out in the purpose statements (section 52E and 52T) of Part 4A, as it is fundamental to achieving efficient levels of investment in the sector.
36. However, we consider the preferred approach would be to address the regulatory uncertainty issues and implement an ODV valuation method properly, for the reasons set out below.

### **Advantages of valuation choice not clear**

37. The Commission develops the IHC method in the Valuation Choice paper:<sup>22</sup>

*“because the Commission has proposed that lines businesses be permitted to choose between using either the Optimised Deprival value (ODV) method or the (depreciated) Historic Cost method for valuing their system fixed assets under Part 4A...”*

38. The Commission does not consider in the Valuation Choice paper whether providing a choice of valuation method is a sound approach.
39. In the December 2002 paper the reason for proposing a choice of valuation method appears to have been:<sup>23</sup>

*“Investors in system fixed assets should expect to recover their reasonable costs. In theory, there are an infinite number of revenue profiles that can deliver this outcome. In particular, it does not matter whether revenues are driven by high or low rates of depreciation, or if returns are based on historic or replacement costs.”*

40. It appears DHC was proposed as a possible valuation method as it is capable (as is ODV also) of ensuring investors recover their reasonable costs.
41. However, in the Valuation Choice paper the IHC method is assessed not in terms of whether it ensures that investors are able to recover their reasonable costs, but rather in relation to whether the results of this method would enable comparison with lines businesses that are using ODV. It appears the criterion for acceptable valuation methods has changed between the two papers.
42. It is not clear to us what advantages there are in having two permissible valuation methods where the criterion for one method (IHC) is whether it would provide results similar to the other method (indexed ODV). This approach implicitly suggests that the indexed ODV method conforms best to the Commission’s requirements.

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<sup>22</sup> Paragraph 6 of “Regulation of Electricity Lines Businesses, Implementing Valuation Choice for System Fixed Assets, Draft Decisions and Discussion Paper”, Commerce Commission, 24 December 2004.

<sup>23</sup> Paragraph 111 of “Regulation of Lines Businesses, Targeted Control Regime, Draft Decisions”, Commerce Commission, 23 December 2002.

43. We consider the IHC method would have some particular weaknesses relative to the indexed ODV method:
- It does not incorporate any procedures to reconcile the results of the indexing over a number of years with market values for the assets. Over extended periods of time and in the context of technological change the gap between the result of indexing and market values for assets could be large. For example, an error of 1% per annum compounding in the indexing relative to shifts in market values would amount to a 10.5% error over 10 years, and 22% over 20 years.
  - It would involve some form of capital efficiency review which would presumably be different to the process of optimisation under ODV. The Commission is yet to define what such a review would comprise.
  - We understand IHC would not be permissible under FRS-3 or the equivalent IFRS standard, whereas an indexed version of ODV (provided it reflected market values and the entity used efficient production methods and thereby did not have significant surplus assets) is likely to be compliant.
44. Unless compelling reasons can be found for adopting the IHC method (other than the commitment by the Commission in its draft decision in 2002 to a different form of historic cost valuation), we suggest it be discarded.
45. However, as mentioned above, we consider the un-indexed DHC method committed to by the Commission in its draft decisions of December 2002 should be reconsidered unless the Commission is able to address the regulatory risk issues inherent in an indexed valuation method.

## **Appendix – Extract from New Zealand Framework**

This following are pages 20 to 40 of the exposure draft of the New Zealand Framework, as issued by the Institute of Chartered Accountants of New Zealand in 2004.

## Qualitative Characteristics of Financial Statements

24. Qualitative characteristics are the attributes that make the information provided in financial statements useful to users. The four principal qualitative characteristics are understandability, relevance, reliability and comparability.

### Understandability

25. An essential quality of the information provided in financial statements is that it is readily understandable by users. For this purpose, users are assumed to have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information with reasonable diligence. However, information about complex matters that should be included in the financial statements because of its relevance to the economic decision-making needs of users should not be excluded merely on the grounds that it may be too difficult for certain users to understand.

### Relevance

26. To be useful, information must be relevant to the decision-making needs of users. Information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present or future events or confirming, or correcting, their past evaluations.
27. The predictive and confirmatory roles of information are interrelated. For example, information about the current level and structure of asset holdings has value to users when they endeavour to predict the ability of the entity to take advantage of opportunities and its ability to react to adverse situations. The same information plays a confirmatory role in respect of past predictions about, for example, the way in which the entity would be structured or the outcome of planned operations.
28. Information about financial position and past performance is frequently used as the basis for predicting future financial position and performance and other matters in which users are directly interested, such as dividend and wage payments, security price movements and the ability of the entity to meet its commitments as they fall due. To have predictive value, information need not be in the form of an explicit

forecast. The ability to make predictions from financial statements is enhanced, however, by the manner in which information on past transactions and events is displayed. For example, the predictive value of the income statement is enhanced if unusual, abnormal and infrequent items of income or expense are separately disclosed.

### Materiality

29. The relevance of information is affected by its nature and materiality. In some cases, the nature of information alone is sufficient to determine its relevance. For example, the reporting of a new segment may affect the assessment of the risks and opportunities facing the entity irrespective of the materiality of the results achieved by the new segment in the reporting period. In other cases, both the nature and materiality are important, for example, the amounts of inventories held in each of the main categories that are appropriate to the business.
30. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.

### Reliability

31. To be useful, information must also be reliable. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.
32. Information may be relevant but so unreliable in nature or representation that its recognition may be potentially misleading. For example, if the validity and amount of a claim for damages under a legal action are disputed, it may be inappropriate for the entity to recognise the full amount of the claim in the balance sheet, although it may be appropriate to disclose the amount and circumstances of the claim.

**Faithful Representation**

33. To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the entity at the reporting date which meet the recognition criteria.
34. Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognise them in the financial statements; for example, although most entities generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

**Substance Over Form**

35. If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).

**Neutrality**

36. To be reliable, the information contained in financial statements must be neutral, that is, free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the

making of a decision or judgement in order to achieve a predetermined result or outcome.

**Prudence**

37. The preparers of financial statements do, however, have to contend with the uncertainties that inevitably surround many events and circumstances, such as the collectability of doubtful receivables, the probable useful life of plant and equipment and the number of warranty claims that may occur. Such uncertainties are recognised by the disclosure of their nature and extent and by the exercise of prudence in the preparation of the financial statements. Prudence is the inclusion of a degree of caution in the exercise of the judgements needed in making the estimates required under conditions of uncertainty, such that assets or income are not overstated and liabilities or expenses are not understated. However, the exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income, or the deliberate overstatement of liabilities or expenses, because the financial statements would not be neutral and, therefore, not have the quality of reliability.

**Completeness**

38. To be reliable, the information in financial statements must be complete within the bounds of materiality and cost. An omission can cause information to be false or misleading and thus unreliable and deficient in terms of its relevance.

**Comparability**

39. Users must be able to compare the financial statements of an entity through time in order to identify trends in its financial position and performance. Users must also be able to compare the financial statements of different entities in order to evaluate their relative financial position, performance and changes in financial position. Hence, the measurement and display of the financial effect of like transactions and other events must be carried out in a consistent way throughout an entity and over time for that entity and in a consistent way for different entities.
40. An important implication of the qualitative characteristic of comparability is that users be informed of the accounting policies employed in the preparation of the financial statements, any changes in

those policies and the effects of such changes. Users need to be able to identify differences between the accounting policies for like transactions and other events used by the same entity from period to period and by different entities. Compliance with [New Zealand GAAP], including the disclosure of the accounting policies used by the entity, helps to achieve comparability. [Amended by FRSB – final sentence, reference to NZ GAAP inserted.]

41. The need for comparability should not be confused with mere uniformity and should not be allowed to become an impediment to the introduction of improved accounting standards. It is not appropriate for an entity to continue accounting in the same manner for a transaction or other event if the policy adopted is not in keeping with the qualitative characteristics of relevance and reliability. It is also inappropriate for an entity to leave its accounting policies unchanged when more relevant and reliable alternatives exist.
42. Because users wish to compare the financial position, performance and changes in financial position of an entity over time, it is important that the financial statements show corresponding information for the preceding periods.

## Constraints on Relevant and Reliable Information

### Timeliness

43. If there is undue delay in the reporting of information it may lose its relevance. Management may need to balance the relative merits of timely reporting and the provision of reliable information. To provide information on a timely basis it may often be necessary to report before all aspects of a transaction or other event are known, thus impairing reliability. Conversely, if reporting is delayed until all aspects are known, the information may be highly reliable but of little use to users who have had to make decisions in the interim. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users.

### Balance between Benefit and Cost

44. The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic. The benefits derived from information should exceed the cost of providing it. The evaluation of benefits and costs is, however, substantially a judgmental process. Furthermore, the

costs do not necessarily fall on those users who enjoy the benefits. Benefits may also be enjoyed by users other than those for whom the information is prepared; for example, the provision of further information to lenders may reduce the borrowing costs of an entity. For these reasons, it is difficult to apply a cost-benefit test in any particular case. Nevertheless, standard-setters in particular, as well as the preparers and users of financial statements, should be aware of this constraint.

### Balance between Qualitative Characteristics

45. In practice a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter of professional judgment.

### True and Fair View/Fair Presentation

46. Financial statements are frequently described as showing a true and fair view of, or as presenting fairly, the financial position, performance and changes in financial position of an entity.<sup>5</sup> Although this Framework does not deal directly with such concepts, the application of the principal qualitative characteristics and of appropriate accounting standards normally results in financial statements that convey what is generally understood as a true and fair view of, or as presenting fairly such information.

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<sup>5</sup> For details of regulatory requirements in New Zealand, refer to the Financial Reporting Act 1993, the Public Finance Act 1989 and the Local Government Act 2002.

## The Elements of Financial Statements

47. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The elements directly related to the measurement of financial position in the balance sheet are assets, liabilities and equity. The elements directly related to the measurement of performance in the income statement are income and expenses. The statement of changes in financial position usually reflects income statement elements and changes in balance sheet elements; accordingly, this Framework identifies no elements that are unique to this statement.
48. The presentation of these elements in the balance sheet and the income statement involves a process of sub-classification. For example, assets and liabilities may be classified by their nature or function in the business of the entity in order to display information in the manner most useful to users for purposes of making economic decisions.

### Financial Position

49. The elements directly related to the measurement of financial position are assets, liabilities and equity. These are defined as follows:
- An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
  - A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
  - Equity is the residual interest in the assets of the entity after deducting all its liabilities.
50. The definitions of an asset and a liability identify their essential features but do not attempt to specify the criteria that need to be met before they are recognised in the balance sheet. Thus, the definitions embrace items that are not recognised as assets or liabilities in the balance sheet because they do not satisfy the criteria for recognition discussed in paragraphs 82 to 98. In particular, the expectation that future economic benefits will flow to or from an entity must be sufficiently certain to

meet the probability criterion in paragraph 83 before an asset or liability is recognised.

51. In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form. Thus, for example, in the case of finance leases, the substance and economic reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its useful life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge. Hence, the finance lease gives rise to items that satisfy the definition of an asset and a liability and are recognised as such in the lessee's balance sheet.
52. Balance sheets drawn up in accordance with current Standards may include items that do not satisfy the definitions of an asset or liability and are not shown as part of equity. The definitions set out in paragraph 49 will, however, underlie future reviews of existing Standards and the formulation of further Standards.

### Assets

53. The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity. The potential may be a productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash or cash equivalents or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the costs of production.

#### Public Benefit Entities

NZ 53.1 This Framework uses the term “future economic benefits”. This term is to be read as having the same meaning as the term “service potential”. Assets provide a means for entities to achieve their objectives. Assets that are used to deliver goods and services in accordance with an entity’s objectives but which do not directly generate net cash inflows are often described as embodying “service potential.” Assets that are used to generate net cash inflows are often described as embodying “future economic benefits.” [Based on IPSAS 1 *Presentation of Financial Statements*, paragraph 10]

54. An entity usually employs its assets to produce goods or services capable of satisfying the wants or needs of customers; because these goods or services can satisfy these wants or needs, customers are prepared to pay for them and hence contribute to the cash flow of the entity. Cash itself renders a service to the entity because of its command over other resources.
55. The future economic benefits embodied in an asset may flow to the entity in a number of ways. For example, an asset may be:
- used singly or in combination with other assets in the production of goods or services to be sold by the entity;
  - exchanged for other assets;
  - used to settle a liability; or
  - distributed to the owners of the entity.
56. Many assets, for example, property, plant and equipment, have a physical form. However, physical form is not essential to the existence of an asset; hence patents and copyrights, for example, are assets if future economic benefits are expected to flow from them to the entity and if they are controlled by the entity.
57. Many assets, for example, receivables and property, are associated with legal rights, including the right of ownership. In determining the existence of an asset, the right of ownership is not essential; thus, for example, property held on a lease is an asset if the entity controls the benefits which are expected to flow from the property. Although the capacity of an entity to control benefits is usually the result of legal rights, an item may nonetheless satisfy the definition of an asset even when there is no legal control. For example, know-how obtained from a development activity may meet the definition of an asset when, by keeping that know-how secret, an entity controls the benefits that are expected to flow from it.
58. The assets of an entity result from past transactions or other past events. Entities normally obtain assets by purchasing or producing them, but other transactions or events may generate assets; examples include property received by an entity from government as part of a programme to encourage economic growth in an area and the discovery of mineral deposits. Transactions or events expected to occur in the future do not in themselves give rise to assets; hence, for example, an intention to purchase inventory does not, of itself, meet the definition of an asset.

59. There is a close association between incurring expenditure and generating assets but the two do not necessarily coincide. Hence, when an entity incurs expenditure, this may provide evidence that future economic benefits were sought but is not conclusive proof that an item satisfying the definition of an asset has been obtained. Similarly the absence of a related expenditure does not preclude an item from satisfying the definition of an asset and thus becoming a candidate for recognition in the balance sheet; for example, items that have been donated to the entity may satisfy the definition of an asset.

## Liabilities

60. An essential characteristic of a liability is that the entity has a present obligation. An obligation is a duty or responsibility to act or perform in a certain way. Obligations may be legally enforceable as a consequence of a binding contract or statutory requirement. This is normally the case, for example, with amounts payable for goods and services received. Obligations also arise, however, from normal business practice, custom and a desire to maintain good business relations or act in an equitable manner. If, for example, an entity decides as a matter of policy to rectify faults in its products even when these become apparent after the warranty period has expired, the amounts that are expected to be expended in respect of goods already sold are liabilities.
61. A distinction needs to be drawn between a present obligation and a future commitment. A decision by the management of an entity to acquire assets in the future does not, of itself, give rise to a present obligation. An obligation normally arises only when the asset is delivered or the entity enters into an irrevocable agreement to acquire the asset. In the latter case, the irrevocable nature of the agreement means that the economic consequences of failing to honour the obligation, for example, because of the existence of a substantial penalty, leave the entity with little, if any, discretion to avoid the outflow of resources to another party.
62. The settlement of a present obligation usually involves the entity giving up resources embodying economic benefits in order to satisfy the claim of the other party. Settlement of a present obligation may occur in a number of ways, for example, by:
- payment of cash;
  - transfer of other assets;

- (c) provision of services;
- (d) replacement of that obligation with another obligation; or
- (e) conversion of the obligation to equity.

An obligation may also be extinguished by other means, such as a creditor waiving or forfeiting its rights.

63. Liabilities result from past transactions or other past events. Thus, for example, the acquisition of goods and the use of services give rise to trade payables (unless paid for in advance or on delivery) and the receipt of a bank loan results in an obligation to repay the loan. An entity may also recognise future rebates based on annual purchases by customers as liabilities; in this case, the sale of the goods in the past is the transaction that gives rise to the liability.
64. Some liabilities can be measured only by using a substantial degree of estimation. Some entities describe these liabilities as provisions. In some countries, such provisions are not regarded as liabilities because the concept of a liability is defined narrowly so as to include only amounts that can be established without the need to make estimates. The definition of a liability in paragraph 49 follows a broader approach. Thus, when a provision involves a present obligation and satisfies the rest of the definition, it is a liability even if the amount has to be estimated. Examples include provisions for payments to be made under existing warranties and provisions to cover pension obligations.

## Equity

65. Although equity is defined in paragraph 49 as a residual, it may be sub-classified in the balance sheet. For example, in a corporate entity, funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments may be shown separately. Such classifications can be relevant to the decision-making needs of the users of financial statements when they indicate legal or other restrictions on the ability of the entity to distribute or otherwise apply its equity. They may also reflect the fact that parties with ownership interests in an entity have differing rights in relation to the receipt of dividends or the repayment of capital.
66. The creation of reserves is sometimes required by statute or other law in order to give the entity and its creditors an added measure of protection

from the effects of losses. Other reserves may be established if national tax law grants exemptions from, or reductions in, taxation liabilities when transfers to such reserves are made. The existence and size of these legal, statutory and tax reserves is information that can be relevant to the decision-making needs of users. Transfers to such reserves are appropriations of retained earnings rather than expenses.

67. The amount at which equity is shown in the balance sheet is dependent on the measurement of assets and liabilities. Normally, the aggregate amount of equity only by coincidence corresponds with the aggregate market value of the shares of the entity or the sum that could be raised by disposing of either the net assets on a piecemeal basis or the entity as a whole on a going concern basis.
68. Reporting entities may include sole proprietorships, partnerships and trusts and various types of government business undertakings. The legal and regulatory framework for such entities is often different from that applying to corporate entities. For example, there may be few, if any, restrictions on the distribution to owners or other beneficiaries of amounts included in equity. Nevertheless, the definition of equity and the other aspects of this Framework that deal with equity are appropriate for such entities. [Amended in NZ Framework – Scope of first sentence broadened to incorporate a wider range of entities.]

## Performance

69. Profit is frequently used as a measure of performance or as the basis for other measures, such as return on investment or earnings per share. The elements directly related to the measurement of profit are income and expenses. The recognition and measurement of income and expenses, and hence profit, depends in part on the concepts of capital and capital maintenance used by the entity in preparing its financial statements. These concepts are discussed in paragraphs 102 to 110.
70. The elements of income and expenses are defined as follows:
- (a) Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.
  - (b) Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences

of liabilities that result in decreases in equity, other than those relating to distributions to equity participants.

#### Public Benefit Entities

NZ 70.1. In the context of public benefit entities, references to contributions from, or distributions to, equity participants should be read as contributions from, or distributions to, equity holders acting in their capacity as equity holders. [New]

71. The definitions of income and expenses identify their essential features but do not attempt to specify the criteria that would need to be met before they are recognised in the income statement. Criteria for the recognition of income and expenses are discussed in paragraphs 82 to 98.
72. Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items of income and expenses that arise in the course of the ordinary activities of the entity and those that do not. This distinction is made on the basis that the source of an item is relevant in evaluating the ability of the entity to generate cash and cash equivalents in the future; for example, incidental activities such as the disposal of a long-term investment are unlikely to recur on a regular basis. When distinguishing between items in this way consideration needs to be given to the nature of the entity and its operations. Items that arise from the ordinary activities of one entity may be unusual in respect of another.
73. Distinguishing between items of income and expense and combining them in different ways also permits several measures of entity performance to be displayed. These have differing degrees of inclusiveness. For example, the income statement could display gross margin, profit from ordinary activities before taxation, profit from ordinary activities after taxation, and net profit.

#### Income

74. The definition of income encompasses both revenue and gains. Revenue arises in the course of the ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent.

75. Gains represent other items that meet the definition of income and may, or may not, arise in the course of the ordinary activities of an entity. Gains represent increases in economic benefits and as such are no different in nature from revenue. Hence, they are not regarded as constituting a separate element in this Framework.
76. Gains include, for example, those arising on the disposal of non-current assets. The definition of income also includes unrealised gains; for example, those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long term assets. When gains are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Gains are often reported net of related expenses.
77. Various kinds of assets may be received or enhanced by income; examples include cash, receivables and goods and services received in exchange for goods and services supplied. Income may also result from the settlement of liabilities. For example, an entity may provide goods and services to a lender in settlement of an obligation to repay an outstanding loan.

#### Expenses

78. The definition of expenses encompasses losses as well as those expenses that arise in the course of the ordinary activities of the entity. Expenses that arise in the course of the ordinary activities of the entity include, for example, cost of sales, cost of services provided, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment. [2<sup>nd</sup> sentence amended in NZ Framework – the words “cost of services provided” were inserted.]
79. Losses represent other items that meet the definition of expenses and may, or may not, arise in the course of the ordinary activities of the entity. Losses represent decreases in economic benefits and as such they are no different in nature from other expenses. Hence, they are not regarded as a separate element in this Framework.
80. Losses include, for example, those resulting from disasters such as fire and flood, as well as those arising on the disposal of non-current assets. The definition of expenses also includes unrealised losses, for example, those arising from the effects of increases in the rate of exchange for a

foreign currency in respect of the borrowings of an entity in that currency. When losses are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Losses are often reported net of related income.

## Capital Maintenance Adjustments

81. The revaluation or restatement of assets and liabilities gives rise to increases or decreases in equity. While these increases or decreases meet the definition of income and expenses, they are not included in the income statement under certain concepts of capital maintenance. Instead these items are included in equity as capital maintenance adjustments or revaluation reserves. These concepts of capital maintenance are discussed in paragraphs 102 to 110 of this Framework.

## Recognition of the Elements of Financial Statements

82. Recognition is the process of incorporating in the balance sheet or income statement an item that meets the definition of an element and satisfies the criteria for recognition set out in paragraph 83. It involves the depiction of the item in words and by a monetary amount and the inclusion of that amount in the balance sheet or income statement totals. Items that satisfy the recognition criteria should be recognised in the balance sheet or income statement. The failure to recognise such items is not rectified by disclosure of the accounting policies used nor by notes or explanatory material.
83. An item that meets the definition of an element should be recognised if:
- it is probable that any future economic benefit associated with the item will flow to or from the entity; and
  - the item has a cost or value that can be measured with reliability.
84. In assessing whether an item meets these criteria and therefore qualifies for recognition in the financial statements, regard needs to be given to the materiality considerations discussed in paragraphs 29 and 30. The interrelationship between the elements means that an item that meets the definition and recognition criteria for a particular element, for example,

an asset, automatically requires the recognition of another element, for example, income or a liability.

## The Probability of Future Economic Benefit

85. The concept of probability is used in the recognition criteria to refer to the degree of uncertainty that the future economic benefits associated with the item will flow to or from the entity. The concept is in keeping with the uncertainty that characterises the environment in which an entity operates. Assessments of the degree of uncertainty attaching to the flow of future economic benefits are made on the basis of the evidence available when the financial statements are prepared. For example, when it is probable that a receivable owed by an entity will be paid, it is then justifiable, in the absence of any evidence to the contrary, to recognise the receivable as an asset. For a large population of receivables, however, some degree of non-payment is normally considered probable; hence an expense representing the expected reduction in economic benefits is recognised.

## Reliability of Measurement

86. The second criterion for the recognition of an item is that it possesses a cost or value that can be measured with reliability as discussed in paragraphs 31 to 38 of this Framework. In many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. When, however, a reasonable estimate cannot be made the item is not recognised in the balance sheet or income statement. For example, the expected proceeds from a lawsuit may meet the definitions of both an asset and income as well as the probability criterion for recognition; however, if it is not possible for the claim to be measured reliably, it should not be recognised as an asset or as income; the existence of the claim, however, would be disclosed in the notes, explanatory material or supplementary schedules.
87. An item that, at a particular point in time, fails to meet the recognition criteria in paragraph 83 may qualify for recognition at a later date as a result of subsequent circumstances or events.
88. An item that possesses the essential characteristics of an element but fails to meet the criteria for recognition may nonetheless warrant disclosure in the notes, explanatory material or in supplementary

schedules. This is appropriate when knowledge of the item is considered to be relevant to the evaluation of the financial position, performance and changes in financial position of an entity by the users of financial statements.

### Recognition of Assets

89. An asset is recognised in the balance sheet when it is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.
90. An asset is not recognised in the balance sheet when expenditure has been incurred for which it is considered improbable that economic benefits will flow to the entity beyond the current accounting period. Instead such a transaction results in the recognition of an expense in the income statement. This treatment does not imply either that the intention of management in incurring expenditure was other than to generate future economic benefits for the entity or that management was misguided. The only implication is that the degree of certainty that economic benefits will flow to the entity beyond the current accounting period is insufficient to warrant the recognition of an asset.

### Recognition of Liabilities

91. A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventory ordered but not yet received) are generally not recognised as liabilities in the financial statements. However, such obligations may meet the definition of liabilities and, provided the recognition criteria are met in the particular circumstances, may qualify for recognition. In such circumstances, recognition of liabilities entails recognition of related assets or expenses.

### Recognition of Income

92. Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease

of a liability has arisen that can be measured reliably. This means, in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities (for example, the net increase in assets arising on a sale of goods or services or the decrease in liabilities arising from the waiver of a debt payable).

93. The procedures normally adopted in practice for recognising income, for example, the requirement that revenue should be earned, are applications of the recognition criteria in this Framework. Such procedures are generally directed at restricting the recognition as income to those items that can be measured reliably and have a sufficient degree of certainty.

### Recognition of Expenses

94. Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. This means, in effect, that recognition of expenses occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets (for example, the accrual of employee entitlements or the depreciation of equipment).
95. Expenses are recognised in the income statement on the basis of a direct association between the costs incurred and the earning of specific items of income. This process, commonly referred to as the matching of costs with revenues, involves the simultaneous or combined recognition of revenues and expenses that result directly and jointly from the same transactions or other events; for example, the various components of expense making up the cost of goods sold are recognised at the same time as the income derived from the sale of the goods. However, the application of the matching concept under this Framework does not allow the recognition of items in the balance sheet which do not meet the definition of assets or liabilities.
96. When economic benefits are expected to arise over several accounting periods and the association with income can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets such as property, plant, equipment, goodwill, patents and trademarks; in such cases the expense is referred to as depreciation or amortisation. These allocation procedures are intended to recognise

expenses in the accounting periods in which the economic benefits associated with these items are consumed or expire.

97. An expense is recognised immediately in the income statement when an expenditure produces no future economic benefits or when, and to the extent that, future economic benefits do not qualify, or cease to qualify, for recognition in the balance sheet as an asset.
98. An expense is also recognised in the income statement in those cases when a liability is incurred without the recognition of an asset, as when a liability under a product warranty arises.

## Measurement of the Elements of Financial Statements

99. Measurement is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet and income statement. This involves the selection of the particular basis of measurement.
100. A number of different measurement bases are employed to different degrees and in varying combinations in financial statements. They include the following:
  - (a) *Historical cost.* Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition. Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.
  - (b) *Current cost.* Assets are carried at the amount of cash or cash equivalents that would have to be paid if the same or an equivalent asset was acquired currently. Liabilities are carried at the undiscounted amount of cash or cash equivalents that would be required to settle the obligation currently.
  - (c) *Realisable (settlement) value.* Assets are carried at the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal. Liabilities are carried at their settlement values; that is, the undiscounted amounts of cash or cash equivalents expected to be paid to satisfy the liabilities in the normal course of business.
  - (d) *Present value.* Assets are carried at the present discounted value of the future net cash inflows that the item is expected to generate in the normal course of business. Liabilities are carried at the present discounted value of the future net cash outflows that are expected to be required to settle the liabilities in the normal course of business.
101. The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. This is usually combined with other measurement bases. For example, inventories are usually carried at the lower of cost and net realisable value, marketable

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securities may be carried at market value and pension liabilities are carried at their present value. Furthermore, some entities use the current cost basis as a response to the inability of the historical cost accounting model to deal with the effects of changing prices of non-monetary assets.

### **The Elements of Non-financial Statements**

#### **All Entities**

NZ 101.1. The elements of service performance are inputs, outputs and outcomes.

- (a) Inputs are the resources used to produce the goods and services which are the outputs of the reporting entity.
- (b) Outputs are the goods and services produced by the reporting entity.
- (c) Outcomes are the impacts on, or consequences for, the community resulting from the existence and operations of the reporting entity.  
[Based on FRS-2, paragraph 10.3]

NZ 101.2. Service performance is primarily reported in non-financial terms. Additional financial information related to service performance may also be reported. Which elements are to be reported will depend on the entity's specific activities and its accountability obligations. [Based on FRS-2, paragraph 10.3]