STAFF PAPER

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Project	Rate-regulated Activities		
Paper topic	Recognition		
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Purpose of this paper

1. The objective of this paper is to recommend criteria for the recognition of regulatory assets and regulatory liabilities arising from timing differences created by the operation of the rate-adjustment mechanism established in the regulatory agreement.

Summary of the staff's recommendation

2. We recommend the model:

   (a) requires the recognition of regulatory assets or regulatory liabilities if it is more likely than not that they exist (ie the model sets a symmetrical recognition threshold of 'more likely than not' in cases of existence uncertainty); and

   (b) should not include specific requirements for entities to assess whether to recognise regulatory assets or regulatory liabilities in either of the following situations:

      (i) if the probability of an inflow or outflow of economic benefits is low.

      (ii) in conditions of high measurement uncertainty.

3. We think that using this recognition criterion to determine whether to recognise regulatory assets and regulatory liabilities will result in information that is useful to users of financial statements.

Structure of the paper

4. The structure of the paper is as follows:

   (a) Background information (paragraphs 5–8);

   (c) Staff analysis (paragraphs 9–23);

   (d) Conclusions (paragraphs 24–30);

   (e) Other matters (paragraphs 31–34); and

   (f) Recommendations (paragraph 35).

Background information

Recognition criteria in the revised Conceptual Framework

5. According to the revised *Conceptual Framework for Financial Reporting* (revised *Conceptual Framework*) an asset or liability is recognised only if recognition of that asset or liability and of any resulting income, expenses or changes in equity provides users of financial statements with information that is useful, ie with:

   (a) *relevant information* about the asset or liability and about any resulting income, expenses or changes in equity (see paragraph 7); and

   (b) a *faithful representation* of the asset or liability and of any resulting income, expenses or changes in equity (see paragraph 8).

6. In addition, the revised *Conceptual Framework* states that an asset or liability is recognised if the benefits of the information provided to users of financial statements by recognition are likely to justify the costs of providing and using that information (see paragraph 30). In some cases, the costs of recognition may outweigh its benefits.

Relevance

7. The revised *Conceptual Framework* states that recognition of an asset, liability and any resulting income, expenses or changes in equity may not result in relevant information if:

(a) it is uncertain whether an asset or liability exists; or

(b) an asset or liability exists, but the probability of an inflow or outflow of economic benefits is low.

Faithful representation

8. The revised *Conceptual Framework*:

(a) states that the level of measurement uncertainty affects whether recognition of an asset or a liability provides a faithful representation of that asset or liability and of any resulting income, expenses or changes in equity; and

(b) discusses situations when all available measurements of an asset or liability may be subject to such a high level of measurement uncertainty that recognising the asset or liability would not provide useful information.

Staff analysis

Design of the regulatory agreement

9. We have learnt that the terms of the regulatory agreements are typically clear enough to identify most timing differences that qualify to be included in the rate-adjustment mechanism. The terms of the agreements typically are also clear about the time period over which specified types of timing differences are scheduled to reverse and the rate of any compensation or charge for the time lag between origination and reversal. The time period set for reversal takes into account the anticipated effect of the approved change in the rate on the expected level of demand for the regulated goods or services (goods or services).

10. In addition, regulatory agreements contain detailed record-keeping requirements that entities have to fulfil to enable identification and tracking of individual timing differences from origination to the unwinding through amounts billed to customers. These detailed record-keeping requirements enable oversight by the regulator through monitoring, supervision and audit procedures.

11. The regulator's oversight procedures include the intermittent review and formal approval of the rate calculation, including the application of the rate-adjustment mechanism. This approval process confirms the existence of regulatory assets and regulatory liabilities at the time of the approval. The process also provides evidence to support the measurement of the amount of the timing difference, the time period over which it is scheduled to reverse, and the rate of any compensation or charge for the time lag between origination and reversal.

12. The approval process also helps clarify the intent, meaning and interpretation of the regulatory agreement and its effect on the rate calculation.

Effect of the design of the regulatory agreement on uncertainty

13. As a result of the design of the rate formula and the oversight procedures, once a timing difference has been identified as creating a regulatory asset or a regulatory liability (ie an asset or liability exists):

    (a) there is typically a high probability that an inflow or outflow of economic benefits will flow from the regulatory asset or regulatory liability. Although those flows are sometimes subject to the risk of unexpected falls in demand, it is rare for that demand risk to be so severe that there is only a low probability that no flows at all will occur.

    (b) there is typically little measurement uncertainty. The explicit terms detailed in the regulatory agreement, together with the detailed record-keeping requirements needed to provide supporting evidence would enable a reasonable estimate to be made of the effect on the regulated rate.

14. Consequently, the remainder of our analysis focuses on existence uncertainty.

Existence uncertainty

15. As highlighted in paragraph 9, the terms of the regulatory agreements are typically clear enough to result in little uncertainty about the existence of most timing differences that result in regulatory assets and regulatory liabilities. This is especially so for those items that the regulator has already formally approved before the entity has finalised its financial statements. For such approved items, there is no existence uncertainty—the formal approval notice confirms existence.

16. However, the entity will need to apply judgement to assess whether items that the regulator has not formally approved before the entity finalises its financial statements should be recognised as regulatory assets or regulatory liabilities. We have grouped these unapproved items into two categories for our analysis:

    (a) timing differences that relate to ‘automatic’ rate adjustments that are mentioned explicitly in the regulatory agreement (paragraphs 17–18); and

    (b) timing differences that are not mentioned explicitly in the regulatory agreement (paragraphs 19–23).

Timing differences for ‘automatic’ rate adjustments mentioned explicitly in the regulatory agreement

17. We have learnt that regulatory agreements commonly contain sufficiently explicit terms to identify specified items that will be reflected in future rate adjustments, subject only to verification of the evidence supporting the amount of the timing difference. An example of such timing differences are input costs that the regulatory agreement specifies will flow through to customers so that any positive or negative price variances from the amounts estimated in the previous rate determination will be included or deducted in the future rate through the rate-adjustment mechanism. Another example is a determinable bonus or penalty amount arising when an entity exceeds or fails a specified performance target.

18. There is little or no existence uncertainty for these items because the terms of the regulatory agreement are sufficiently explicit and are enforceable. If the entity has maintained the appropriate records to provide sufficient evidence to support its calculation for an allowable or chargeable estimation variance, or its

performance against a target, then that evidence supports the existence of the entity's right to charge the increased rate or an entity's obligation to provide goods or services at a reduced rate. The right or the obligation exists even if the entity has not yet submitted its regulatory returns to the regulator for formal 'approval'.

Timing differences not mentioned explicitly in the regulatory agreement

19. A regulatory agreement will not typically specify every transaction or event that it is intended to cover. Judgement may be needed to interpret the terms and conditions of the regulatory agreement to assess whether some items are within its scope. However, for many such items, the entity will have sufficient experience in interpreting the regulation to enable it to make a reasonable assessment of the outcome of the approval process.

20. An example of such timing differences is when an unanticipated event, such as a major storm, results in a significant variation in repair and maintenance costs from the amount included in the budgets/ forecasts used to support the previous rate determination. In such cases, a timing difference arises between when the entity carries out the repairs and when the entity reflects any resulting additional amount in rates.

21. In these cases, entities typically consider a hierarchy of different factors when assessing the probability that a timing difference will be approved by a regulator, including, in descending order:

    (a) existence of explicit requirements or guidance in legislation or regulation;

    (b) direct precedents—ie the entity's past experience with the regulator in similar circumstances;

    (c) indirect precedents—such as the experience of other entities regulated by the same regulator or the decisions of other regulators in similar circumstances; and

    (d) advice from legal or experienced advisors.

22. We have also learnt that there is typically frequent communication between the entities and the regulators. As a result, entities can usually obtain preliminary

(non-binding) views from the regulator to help them assess the probability of approval of timing differences that create regulatory assets or regulatory liabilities.

23. In the majority of cases, sufficient evidence is available for entities to make a reasonable assessment of whether a regulatory asset or regulatory liability exists and will be accepted by the regulator—ie existence uncertainty is typically low.

Conclusions

Existence uncertainty (paragraph 7)

24. We have heard concerns about the perceived risk that recognising a regulatory asset or regulatory liability when one does not exist could mislead users of financial statements. Consequently, we suggest that the model requires entities to assess existence uncertainty and sets a threshold for recognition.

25. Our research has not provided us with strong evidence to support setting a threshold higher than more likely than not. Nor has our research provided evidence to support setting a threshold that is higher for the recognition of regulatory assets than for regulatory liabilities—that is, setting an asymmetrical threshold.

26. We have learnt that, when recognising regulatory assets or regulatory liabilities in financial statements using IFRS 14 *Regulatory Deferral Accounts* or reporting requirements established by other standard-setters, entities tend to use a threshold that approval is ‘more likely than not’ or ‘probable’. We understand that there may be some diversity in the percentage used to apply these terms, with some preparers using a threshold as high as a 70-75 per cent likelihood of approval. We do not think, however, this supports embedding any natural bias into the requirements of the model.[1]

[1] Agenda Paper 9A discussed at the December 2017 Board meeting includes a summary of the information received from the Consultative Group for Rate Regulation. That paper can be found at: http://www.ifrs.org/-/media/feature/meetings/2017/december/international-accounting-standards-board/ap09a-rra.pdf.

27. Consequently, we think that the recognition threshold should be set at 'more likely than not' and be the same for both regulatory assets and regulatory liabilities—in other words, it should be symmetrical.[2]

Low probability of inflow or outflow (paragraph 7)

28. Once an entity has concluded a regulatory asset or regulatory liability exists, there is a high probability that an inflow or outflow of economic benefits will follow. Consequently, we do not think that the model should include specific requirements for entities to assess whether to recognise regulatory assets or regulatory liabilities if the probability of an inflow or outflow of economic benefits is low.

Measurement uncertainty (paragraph 8)

29. We think it will be unusual to observe regulatory assets or regulatory liabilities with a level of measurement uncertainty that is so high that their recognition might not provide useful information. The nature of the regulation, and the evidence needed to support the existence of a regulatory asset or regulatory liability, means that an entity should be able to make a reasonable estimate of its measurement. Consequently, we do not think that it is necessary for the model to include specific requirements for entities to assess whether to recognise regulatory assets or regulatory liabilities in conditions of high measurement uncertainty.

Cost of providing the information (paragraph 6)

30. We think that the benefits of the information provided to users of financial statements by recognising regulatory assets and regulatory liabilities when their existence is more likely than not should justify the costs of providing and using

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[2] This conclusion differs from the staff recommendation to use a 'highly probable' threshold for regulatory assets discussed by the Board in its February 2017 meeting (Agenda Paper 9C). That paper can be found at: http://www.ifrs.org/-/media/feature/meetings/2017/february/iasb/rate-regulated-activities/ap9c-rate-regulated-activities.pdf. The Board asked staff to reconsider that recommendation in the wider context of uncertainty in the revised *Conceptual Framework*. We have revised our recommendation because the previous recommendation did not reflect existence uncertainty. Instead, it reflected measurement uncertainty of the inflows of economic benefits arising from the regulatory asset.

that information. This is mainly because, for regulatory purposes, entities already need to fulfil detailed record-keeping requirements (ie the recommended recognition criteria are aligned to the operational processes that entities are required to follow for regulatory purposes).

Other matters

31. Other matters dealing with initial recognition of the regulatory assets or regulatory liabilities are:
    (a) changes in facts and circumstances (see paragraphs 32–33); and
    (b) disclosure (see paragraph 34).

Changes in facts and circumstances

32. An entity will need to reassess its judgement about whether a regulatory asset or regulatory liability exists if there is a change in the facts and circumstances on which the judgement or estimate was based. Such changes include the arrival of new information that affects that judgement or estimate.

33. Those changes in facts and circumstances may result in an entity changing its conclusion about whether regulatory assets or regulatory liabilities exist. In such cases, an entity should account for these changes when they occur, using the guidance and requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

Disclosure

34. The revised *Conceptual Framework* states that entities may need to disclose information about recognised and unrecognised assets and liabilities, including information about their nature and about the risks that arise from them. At a future meeting, we will present a paper for the Board to consider what disclosure requirements to include in the model.

Recommendations

35. On the basis of our analysis, we recommend the model:

    (a) requires the recognition of regulatory assets or regulatory liabilities if it is more likely than not that they exist (ie the model sets a symmetrical recognition threshold of ‘more likely than not’ in cases of existence uncertainty); and

    (b) should not include specific requirements for entities to assess whether to recognise regulatory assets or regulatory liabilities in either of the following situations:

        (i) if the probability of an inflow or outflow of economic benefits is low.

        (ii) in conditions of high measurement uncertainty.

Questions for the Board

Recognition criteria
Do Board members agree with the recognition criteria proposed by the staff in paragraph 35?