

## STAFF PAPER

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Project	Rate-regulated Activities		
Paper topic	Interaction with IFRS 3 <i>Business Combinations</i>		
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### Purpose of this paper

1. The purpose of this paper is to explore the interaction between the accounting model for regulatory assets and regulatory liabilities (the model) and the requirements of IFRS 3 *Business Combinations*, and to consider whether an exception to the recognition and measurement principles of IFRS 3 should be provided for regulatory assets and regulatory liabilities acquired in a business combination.

### Summary of recommendations

2. Staff recommend that, as an exception to the recognition and measurement principles of IFRS 3, an entity should recognise and measure a regulatory asset acquired or regulatory liability assumed in a business combination in accordance with the measurement principles in the accounting model for regulatory assets and regulatory liabilities.

### Structure of this paper

3. This paper is structured as follows:

- (a) Background (paragraphs 4-7);
- (b) Differences between the model and fair value (paragraphs 8-27);
- (c) Subsequent measurement (paragraphs 28-32); and
- (d) Possible exceptions (paragraphs 33-43).

## Background

4. At the Board's November 2018 meeting, staff presented a paper<sup>1</sup> recommending that the accounting model for regulatory assets and regulatory liabilities *should not retain* the exceptions to the requirements of IFRS 3 provided by paragraph B18 of IFRS 14 *Regulatory Deferral Accounts*.<sup>2</sup>
5. However, at that meeting the Board chose not to take a decision on the staff recommendation. The Board asked staff to conduct further analysis for discussion at a future meeting, in order to better understand the potential interaction between the principles of the model and the application of IFRS 3 before taking a decision.
6. The Board also raised two questions for staff to consider:
  - (a) would the fair value of regulatory assets or regulatory liabilities generally approximate their pre-acquisition carrying values? If so, would the costs of applying IFRS 3 outweigh the benefits?
  - (b) if initially measured at fair value under IFRS 3, would subsequent adjustments result when the entity reverts to applying the recognition and measurement principles prescribed by the model?
7. This paper will seek to:
  - (a) further explore the interaction with IFRS 3 now that the model's measurement principles have been substantially finalised; and
  - (b) address the questions raised by the Board.

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<sup>1</sup> [November 2018 Agenda Paper Reference 9B](#)

<sup>2</sup> IFRS 14 was designed to permit entities to grandfather their previous GAAP accounting policies for regulatory deferral account balances. IFRS 14 therefore contains an exception to the general recognition and measurement principles of IFRS 3 for acquired regulatory deferral account balances, specifying that an acquirer shall instead apply its previous GAAP accounting policies for this purpose.

## Differences between the model and fair value

8. This section responds to the first question asked by Board members in November 2018 (paragraph 6(a)). It reviews the model's measurement principles, summarises pertinent aspects of the measurement of fair value in accordance with IFRS 13 *Fair Value Measurement* and then compares the outcomes of those two measurement bases.

### ***The model's measurement principles***

9. The model requires an entity to measure a regulatory asset or regulatory liability at a modified historical cost by applying a cash-flow-based measurement technique. An entity would estimate the future cash flows arising from the regulatory asset or regulatory liability and discount these using the rate of interest or return provided by the regulatory agreement, except in the limited circumstances where the entity determines that rate is inadequate or where the rate provides excess compensation or excess charge as a result of an identifiable transaction or event.<sup>3</sup>
10. In order to minimise the model's complexity, these measurement principles have been developed around the concept of a rate of interest or return provided by the regulatory agreement that (except in the limited circumstances mentioned in the preceding paragraph) is 'adequate' and therefore acceptable to apply, rather than requiring the independent determination of an 'exact' discount rate that precisely compensates the entity for the time value of money and uncertainty inherent in the estimated future cash flows. This concept was developed to reflect the economics of rate-regulation and to meet the needs of users in a manner which can be easily and consistently applied.
11. One exception is provided to these measurement principles—for regulatory assets or regulatory liabilities that relate to expenses or income that will be included in/deducted from the future rates when cash is paid/received, an entity would:

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<sup>3</sup> Refer to a detailed discussion of the model's measurement principles in [Agenda Paper 9C Measurement principles](#) and [Agenda Paper 9D Measurement: discounting estimated cash flows](#) which were presented to the Board in June 2019.

- (a) use the same measurement basis that it uses when measuring the related liability or asset; and
- (b) adjust the measurement of the regulatory asset or regulatory liability to reflect any uncertainty not present in the related liability or asset.

### ***Fair value***

12. Paragraph 18 of IFRS 3 sets out the standard’s basic measurement principle, which requires an acquirer to measure the identifiable assets it has acquired and liabilities it has assumed in a business combination at their acquisition-date fair values.
13. Paragraph 24 of IFRS 13 defines fair value as ‘the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.’
14. Paragraphs 61-66 of IFRS 13 discuss the use of valuation techniques to measure fair value. In this discussion, three widely-used valuation techniques are identified: the market approach, the cost approach and the income approach.
15. Regulatory assets and regulatory liabilities do not trade in active markets and there are generally few observable inputs that could be incorporated into an estimate of their fair value. Furthermore, an acquirer would typically not consider or pay for regulatory assets or regulatory liabilities in isolation, but instead would generally consider how these items contribute to the cash flows of the business as a whole. Accordingly, the market approach would generally not be applicable in determining the fair value of regulatory assets or regulatory liabilities.
16. The cost approach, which reflects the amount that would be required currently to replace the service capacity of an asset (often referred to as current replacement cost)<sup>4</sup>, will also generally not be applicable, as a market participant would not be able to acquire or ‘construct’ an asset similar to a regulatory asset.
17. As a result, we would expect the *income approach* to be employed in most situations to measure the fair value of a regulatory asset or regulatory liability.

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<sup>4</sup> Paragraph B8 of IFRS 13 *Fair Value Measurement*

18. Paragraphs B10-B30 of IFRS 13 provide guidance on the application of the income approach, the basic elements of which involve forming assessments of market participant views for: the amount of future cash flows, variations in amount or timing of these cash flows, the time value of money, the price for bearing the uncertainty inherent in the cash flows and other factors if market participants take them into account in the circumstances.

***Comparison between measurement under the model and fair value***

19. There are many similarities between the model’s measurement principles and the income approach described by IFRS 13.
20. Under both approaches, an entity would begin by estimating a stream of future cash flows and considering the potential for variations in the amount or timing of these cash flows; therefore, the estimated future cash flows should be similar under both approaches (except in the unlikely event that an entity concludes that market participants would reach different conclusions about the amount, timing and uncertainty of those cash flows) .
21. If an entity applied IFRS 3 without exception, it would determine the discount rate that a market participant would demand to compensate it for the time value of money, the uncertainty inherent in the cash flows and any other factors that market participants may take into account.
22. However, in applying the model an entity would, in the majority of situations, discount the estimated future cash flows using the rate provided by the regulatory agreement.<sup>5</sup>
23. The resulting measurement outcome might be different from fair value if the rate provided by the regulatory agreement does not closely align with the rate which a market participant would demand for the specific regulatory asset or regulatory liability at the measurement date. This could occur for various reasons, including the fact that regulatory rates are typically only reset at intervals, which may be infrequent

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<sup>5</sup> Except in the limited circumstances where that rate is determined to be inadequate or where, as a result of an identifiable transaction or event, it provides excess compensation or excess charge. If, for a regulatory asset, the rate is determined to be inadequate, then the entity would determine the minimum adequate rate using the process set out in [Agenda Paper 9D presented in June 2019](#) to initially and subsequently measure the regulatory asset.

and therefore result in a time lag in reflecting market developments. There may also be other specific factors at play, such as an abnormally high return being provided on capital items to encourage investment in aging infrastructure.

24. The following example illustrates the impact that such a difference would have on an entity's financial reporting:

**Example 1**

Entity S is subject to defined rate regulation and applies the accounting model for regulatory assets and regulatory liabilities. It has one regulatory asset with a carrying amount of CU100 at the end of X0. The amount of CU100 is due to be included in the rates charged to customers in Year X5. The regulatory agreement provides a rate of return of 5% on this item and permits the return to be included in the rates charged to customers each year as it accrues. The next rate review under the regulatory agreement is scheduled for Year X2. There are no indications that the 5% rate is inadequate (or provides excess compensation or excess charge for an identifiable transaction or event), and as a result, the entity uses this rate as the discount rate in its measurement of the regulatory asset:

Regulatory asset	X0	X1	X2	X3	X4	X5	Total
Opening balance		100.0	100.0	100.0	100.0	100.0	-
Return at: <input type="text" value="5%"/>	-	5.0	5.0	5.0	5.0	5.0	25.0
Recovery through the rate(s)	-	(5.0)	(5.0)	(5.0)	(5.0)	(105.0)	(125.0)
Closing balance	100.0	100.0	100.0	100.0	100.0	-	-

Entity S is acquired by Entity P at the end of X0. Entity P applies the fair value measurement principle of IFRS 3 in accounting for the acquisition of Entity S's regulatory asset. Assume that Entity P arrives at the same estimate of the future cash flows to be received from the regulatory asset as Entity S did prior to the acquisition. However, Entity P determines that a market participant would demand a discount rate of only 3% to compensate it for the time value of money, uncertainties inherent in the cash flows and other market factors at the measurement (acquisition) date, and thus utilises this rate to determine the initial measurement of the regulatory asset, resulting in a fair value of CU109.2 as illustrated as below:

Regulatory asset	X0	X1	X2	X3	X4	X5	Total
Opening balance		109.2	107.4	105.7	103.8	101.9	-
Return at: <input type="text" value="3%"/>	-	3.3	3.2	3.2	3.1	3.1	15.8
Recovery through the rate(s)	-	(5.0)	(5.0)	(5.0)	(5.0)	(105.0)	(125.0)
Closing balance	109.2	107.4	105.7	103.8	101.9	(0.0)	-

A comparison of the impact on the statement of profit and loss pre- and post-acquisition is as follows:

	X0	X1	X2	X3	X4	X5	Total
<b>Pre-acquisition</b>							
Forecast regulatory income/(expense)		-	-	-	-	(100.0)	(100.0)
<b>Post-acquisition</b>							
Forecast regulatory income/(expense)		(1.7)	(1.8)	(1.8)	(1.9)	(101.9)	(109.2)
<b>Difference</b>	-	(1.7)	(1.8)	(1.8)	(1.9)	(1.9)	(9.2)

The higher regulatory expense recognised by Entity P in the post-acquisition accounting effectively represents the reduced return that Entity P earns as a result of paying a higher amount (CU109) to acquire the regulatory asset. As a result, Entity P effectively does not report a return of its investment as though it were income (ie as it would have had it not recognised the increase to the value of the regulatory asset).

25. However, the financial reporting benefit (illustrated above) as a result of estimating the fair value of regulatory assets or regulatory liabilities acquired would not be without costs. These costs include:
- (a) challenges inherent in determining an appropriate market discount rate;
  - (b) the need to separately track regulatory assets and regulatory liabilities measured initially at these market discount rates, which are not specified by the regulatory agreement; and
  - (c) the potential issues caused for subsequent measurement of these items (as discussed in paragraphs 28-32).
26. Therefore, in response to the Board’s question in paragraph 6(a), we would expect the fair value of regulatory assets or regulatory liabilities to be determined in a manner which is generally similar to that required by the measurement principles of the model—that is, via an income approach beginning with an estimate of the stream of future cash flows. Differences in resulting measurement outcomes may result however, if the rate provided by the regulatory agreement does not approximate the rate which a market participant would demand for the specific regulatory asset or regulatory liability at the measurement date.

27. Whilst requiring the recognition and measurement principles of IFRS 3 to be applied without exception may result in a benefit to the financial reporting for the acquisition, the associated costs set out above could outweigh these benefits.

### Subsequent measurement

28. This section addresses the second question asked by Board members in November 2018 (paragraph 6(b)).
29. There is a general principle in paragraph 54 of IFRS 3 that an acquirer shall subsequently measure and account for assets and liabilities in accordance with the applicable IFRSs for those items. As Board members discussed at their November 2018 meeting, if an acquirer was required to recognise regulatory assets and regulatory liabilities initially at fair value in accordance with IFRS 3, but thereafter is required to revert to applying the model's measurement principles, this could result in the recognition of subsequent gains or losses that do not depict any economic phenomena in the real world but simply reflect a movement from one measurement basis to another.
30. Paragraph 6.48 of the *Conceptual Framework for Financial Reporting* states that:  
 '[...]If the initial measurement basis is inconsistent with the subsequent measurement basis, income and expenses might be recognised at the time of the first subsequent measurement solely because of the change in measurement basis. Recognising such income and expenses might appear to depict a transaction or other event when, in fact, no such transaction or event has occurred. Hence, the choice of measurement basis for an asset or liability, and for the related income and expenses, is determined by considering both initial measurement and subsequent measurement.'
31. Staff have identified two ways in which such inconsistencies could arise if regulatory assets and regulatory liabilities are measured initially at fair value in accordance with IFRS 3:
- (a) if a regulatory asset (or regulatory liability) exists at the acquisition date but the probability of an inflow (or outflow) of economic benefits is less probable than no inflow (or outflow), the entity would nevertheless



recognise that item in accordance with the recognition and measurement principles of IFRS 3; however, if in its subsequent measurement the entity employs the ‘most likely amount’ method<sup>6</sup> of estimating future cash flows in accordance with the principles of the model, it would recognise a *Day 2* loss (or gain) on the first subsequent remeasurement of the regulatory asset (or regulatory liability) to nil applying the model.<sup>7</sup>

- (b) if an entity subsequently updates its estimate of future cash flows and at the same time updates the discount rate because of a change in the rate of interest or return provided by the regulatory agreement (in accordance with the measurement principles of the model) to a rate that is different from the discount rate determined in the fair value measurement of the regulatory asset or regulatory liability upon acquisition, this would result in a subsequent gain or loss.

32. A simple example can help to illustrate the point made by paragraph 31(b):

**Example 2**

Assume the same fact pattern as Example 1.

Subsequent to initial recognition Entity P applies the requirements of the accounting model for regulatory assets and regulatory liabilities. At the time of the rate review at the end of Year X2, the regulatory agreement changes the applicable rate of return (for the category of item to which the regulatory asset belongs) to 4%. Because the regulatory agreement has changed the future cash flows by changing the interest rate or return rate, Entity P updates those cash flows and also updates the applicable discount rate in its measurement of the regulatory asset in accordance with the requirements of the model. This results in the following outcome:

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<sup>6</sup> In accordance with the measurement principles of the model, an entity estimates the future cash flows arising from a regulatory asset or regulatory liability using the ‘most likely amount’ method or the ‘expected value’ method, depending on which method the entity concludes would better predict the amount of the cash flows. This concept is discussed further in [Agenda Paper 9C presented to the Board in June 2019](#).

<sup>7</sup> The practical outcome of that remeasurement to nil would be the same as derecognition.

Regulatory asset	X0	X1	X2	X3	X4	X5	Total
Opening balance		-	-	105.7	-	-	-
Loss	-	-	-	(5.7)	-	-	-
Revised opening balance	-	-	-	100.0	100.0	100.0	-
Return at: <span style="border: 1px solid black; padding: 2px;">4%</span>	-	-	-	4.0	4.0	4.0	12.0
Recovery through the rate(s)	-	-	-	(4.0)	(4.0)	(104.0)	(112.0)
Closing balance	-	-	-	100.0	100.0	-	-

In contrast, no loss would have been recognised had there been no business combination (ie the closing balance and revised carrying amount upon the rate review at the end of Year 2 in Entity S would have both been CU100).

Staff believe that this example illustrates how an exception to the measurement principle of IFRS 3 avoids the reporting of a loss that arises solely from a change in measurement basis.

### Possible exceptions

33. Providing an exception to the recognition and measurement principles of IFRS 3 would avoid the issues identified in the previous section, by enabling consistent initial and subsequent recognition and measurement.
34. This section reviews existing exceptions in IFRS 3. It then considers the treatment of one particular category of regulatory assets and regulatory liabilities: those that will lead to the inclusion or deduction of amounts in determining future rates when cash is ultimately paid or received.

### Existing exceptions in IFRS 3

35. An exception to the recognition and measurement principles of IFRS 3 would not be unprecedented. Paragraphs 22-31A of IFRS 3 list a number of exceptions for items which are the subject of standards with recognition or measurement requirements that differ from the general recognition and measurement principles of IFRS 3.
36. These paragraphs provide exceptions in respect of:
  - (a) the recognition principle of IFRS 3 for contingent liabilities;
  - (b) the measurement principle of IFRS 3 for reacquired rights, share-based payment transactions, assets held for sale and insurance contracts; and

- (c) both the recognition and measurement principles for income taxes, employee benefits, indemnification assets and some leases.
37. Two of these exceptions are particularly relevant to the analysis in this paper:
- (a) income taxes – an acquirer is required to recognise and measure a deferred tax asset or liability arising from the assets acquired and liabilities assumed in a business combination in accordance with IAS 12 *Income Taxes*; and
  - (b) employee benefits – an acquirer is required to recognise and measure a liability (or asset, if any) related to the acquiree’s employee benefit arrangements in accordance with IAS 19 *Employee Benefits*.
38. Given the particular measurement requirements of IAS 12 and IAS 19, which differ from the general measurement principles of IFRS 3, these exceptions avoid the reporting of post-combination gains or losses arising solely from subsequent measurement using a different measurement basis under the applicable standard when underlying economic circumstances have not changed. This is based on the notion that a business combination that is a fair value exchange should not give rise to the recognition of immediate post-combination gains or losses.<sup>8</sup>
39. Exceptions are also provided in respect of the *recognition* requirements of IAS 12 and IAS 19. The Basis for Conclusions on IFRS 3 indicates that the recognition exceptions, while potentially unnecessary, were provided alongside the measurement exceptions to indicate more clearly that an acquirer should apply the recognition and measurement requirements of those standards in accounting for a business acquisition (ie for the avoidance of doubt).

***Exception for items included in/deducted from the future rates when cash is paid/received***

40. As set out in paragraph 11, the Board has tentatively concluded on the need for an exception to the model’s general measurement principles: for expenses or income that will be included in/deducted from the future rates when cash is paid/received.
41. These items have characteristics similar to those of the indemnification assets referred to by paragraphs 28-29 of IFRS 3, whereby a seller in a business combination

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<sup>8</sup> Paragraphs BC281(a) and BC297 of Basis for Conclusions on IFRS 3

contractually indemnifies the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability. IFRS 3 provides a recognition and measurement exception for such indemnification assets, requiring their recognition at the same time as, and measured on the same basis and using the same assumptions as, the underlying asset or liability.

42. To achieve consistency with the subsequent accounting for such items given their particular measurement requirements, at a minimum, an exception to the recognition and measurement principles of IFRS 3 would be required for these items, allowing for their initial recognition and measurement in accordance with the exception contained in the model—that is applying the same measurement basis as used when measuring the related liability or asset (and adjusting the measurement of the regulatory asset or regulatory liability to reflect any uncertainties that are not present in the related liability or asset).
43. However, if a broader exception to the recognition and measurement principles of IFRS 3 was provided for **all regulatory assets and liabilities**, this would encompass this category of items as well, and a separate exception would not be required solely for these items.

## Recommendation

44. In conclusion, whilst we acknowledge that it is generally undesirable to introduce further exceptions to IFRS 3, we think that any benefits of requiring recognition and initial measurement of acquired regulatory assets and regulatory liabilities at fair value would not outweigh the potential costs—these costs include determining an appropriate market discount rate, tracking regulatory assets and liabilities measured at such market discount rates which are not present in the regulatory agreement, and the possibility of subsequent remeasurements caused solely by a change in measurement basis.
45. Furthermore, for the reasons set out in paragraphs 40-42, an exception would be required in any event for items included in/deducted from the future rates when cash is paid/received. Providing an exception to the recognition and measurement principles of IFRS 3 for *all* regulatory assets or regulatory liabilities would avoid the

need for a ‘two-tier’ approach that provides an exception for some regulatory assets or regulatory liabilities but not for others.

46. As a result of our analysis, staff recommend that, as an exception to the recognition and measurement principles of IFRS 3, an entity should recognise and measure a regulatory asset acquired or regulatory liability assumed in a business combination in accordance with the measurement principles in the accounting model for regulatory assets and regulatory liabilities.

### Question for the Board

#### Exception to IFRS 3 requirements

1. Does the Board agree with the staff’s recommendation in paragraph 46?
2. If not, does the Board agree that, for the reasons set out in paragraphs 40-42, an exception to the recognition and measurement principles of IFRS 3 should be provided for those regulatory assets and regulatory liabilities that arise when item of expense or income will be included in / deducted from future rates when cash is paid/received?