

STAFF PAPER

November 2013

IASB Meeting

Project	Rate-regulated Activities: Research project		
Paper topic	Preliminary analysis of asset and liability definitions		
CONTACT(S)	Jane Pike	jpike@ifrs.org	+44 (0)20 7246 6925

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Background***Previous IASB project***

1. The IASB's previous Rate-regulated Activities project resulted in the issue of the Exposure Draft *Rate-regulated Activities* (the 2009 ED). The 2009 ED proposed that regulatory balances derived from a specific type of rate regulation (cost-of-service regulation) should result in the recognition of assets and liabilities.
2. Virtually all respondents from the utilities industry supported the general proposal to recognise regulatory balances as assets and liabilities. However, many disagreed that such recognition should be restricted to regulatory balances that arise only in cost-of-service regulation and suggested instead that it should apply to a much wider range of rate regulation. The responses from non-utilities industry respondents were split almost evenly between those that agreed and those that disagreed with the general proposal for recognising regulatory balances as assets and liabilities.¹
3. Some who agreed with the recognition of regulatory balances as assets and liabilities noted that the proposals were similar to the requirements for such balances in US GAAP. Some commentators argued that the conclusions reached by the IASB should be consistent with those of the US Financial Accounting

¹ See paragraphs 12-15 and Appendix E of IASB Agenda Paper 7 *Summary comment letter analysis*, February 2010.

Standards Board (FASB) because the definitions of assets and liabilities in the respective conceptual frameworks of both US GAAP and IFRS are similar, albeit not identical.

4. However, the mixed views expressed in the responses to the 2009 ED and the subsequent deliberations of those responses resulted in the IASB suspending the project in September 2010. The IASB decided that it was unable to form a timely conclusion as to whether, and if so what types of, rate regulation should lead to the recognition of regulatory balances as assets and liabilities. Subsequently, there has been a lot of confusion as to why ‘regulatory assets’ and ‘regulatory liabilities’ are recognised in accordance with US GAAP but not in accordance with IFRS.

Current IASB project

5. In September 2012, the IASB decided to restart the project with the development of a Discussion Paper. Developing a Discussion Paper will provide the opportunity for a broader debate on the circumstances in which rate-regulated activities may give rise to assets or liabilities.
6. As part of the research work for this project, the IASB published, in March 2013, a Request for Information *Rate Regulation*. The responses received highlighted that there is a wide variety of types of rate regulation. To help filter this information the IASB, with input from its Rate-regulated Activities Consultative Group, has decided to focus on a number of common features of rate regulation.² These features have been identified as being most likely to:
 - (a) distinguish rate-regulated activities from general commercial activities;
and
 - (b) have the biggest impact on the amount, timing and certainty of cash flows and ‘regulated earnings’.³

² The features are discussed later in this paper and are also described in more detail in IASB Agenda Paper 9A *Research Project: Features of rate regulation*, October 2013.

³ We have heard from users that they value information about the amount, timing and certainty of cash flows and ‘regulated earnings’ (see IASB Agenda Paper 9A *Rate regulation: User needs*, September 2013 and paragraph 18 of Agenda Paper 9B *Research Project: Unit of Account*, October 2013).

7. In October 2013, the IASB considered the rights and obligations expected to arise from the common features of rate regulation.⁴ As a result, the IASB tentatively decided that the next stage of the staff's analysis as to whether rate regulation might result in assets and liabilities being recognised in IFRS financial statements should focus on one particular feature. This feature is a regulatory 'true-up' adjustment, which arises in a 'dual-element adjustment' type of rate-setting mechanism that is described in the following paragraphs.⁵

The 'dual-element adjustment' rate-setting mechanism

8. In a competitive market, the 'value' of the goods or services provided is most easily identified as the market price, which reflects the interaction between supply and demand and the market participants' willingness to buy or sell at that price. However, within the context of this analysis, rate regulation applies in circumstances in which there is no competitive market.⁶ Consequently, the rate regulation is designed to try to establish a 'fair and reasonable' price to reflect the value of the goods or services supplied.
9. The form of rate regulation being addressed in this analysis incorporates a rate-setting mechanism that sets the price to be charged to customers based on two distinguishable components:
- (a) the estimated price for the period, reflecting the estimated costs and volumes for the period; and
 - (b) an identifiable 'true-up' adjustment that is based on past performance and events (see paragraph 12 below).
10. We do not consider the first component (the estimated price for the period) to be a distinguishing feature of rate regulation. Entities commonly set selling prices that use estimates of costs and volumes as a starting point, which may then be adjusted to reflect market conditions. In our view, the component of the price that reflects

⁴ See Agenda Papers 9-9B *Rate-regulated Activities: Research project*, October 2013.

⁵ This is the second component of the adjustment arising from what is described as a 'dual-element' rate-setting mechanism in paragraphs 30-34 of IASB Agenda Paper 9A *Research project: Features of rate regulation*, October 2013.

⁶ See IASB Agenda Paper 9A *Features of rate regulation*, October 2013.

estimated costs and volumes represents the best estimate of the 'fair and reasonable' price for the goods that are sold during the period.

11. Without rate regulation, most entities can make 'real-time' adjustments to the selling price in reaction to changes in their estimates for costs or volumes. Such real-time price adjustments are rarely available to rate-regulated entities. Consequently, in the type of rate-setting mechanism under review, the selling price is fixed until the end of the regulatory period. The permitted true-up adjustment that is related to past performance and events is then accumulated until the selling price can be adjusted at the start of the next regulatory period.
12. The purpose of the true-up adjustment is to ensure that the entity is able to earn the amount of revenue permitted by the rate regulation during the regulatory period; that is the period for which the rate calculation established by the rate regulation applies. The items that are captured by the true-up adjustment will be specified in the rate regulation. The amount of this true-up adjustment is calculated based on past performance and/or events that have arisen during the regulatory period and before the financial reporting date. The common types of items captured include:
 - (a) volume and price variances from expected costs;
 - (b) volume variances from permitted revenues;
 - (c) costs (or revenues) triggered by specified events (for example, costs incurred to repair storm damage or a gain/loss incurred on disposal of property, plant and equipment);
 - (d) financial bonuses awarded or penalties imposed for meeting or failing to meet a performance target; and
 - (e) timing differences between amounts recognised for financial reporting purposes and those recognised for regulatory purposes. For example, a timing difference can arise when pension costs are recognised for regulatory purposes only when paid, but for financial reporting purposes the entity's defined benefit pension costs are attributed to periods of service in accordance with the plan's benefit formula, or in some cases on a straight-line basis.

Purpose of this paper

13. The purpose of this Agenda Paper 9 is to consider whether a rate-setting mechanism that incorporates a true-up adjustment could result in the existence of assets and liabilities, as defined in the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*).
14. However, because the contents of the existing *Conceptual Framework* may be subject to revision, as proposed in the Discussion Paper: *A Review of the Conceptual Framework for Financial Reporting*, published in July 2013 (the *Conceptual Framework DP*), any conclusions that are reached in this analysis of rate regulation may also be subject to revision.
15. Consequently, this analysis is intended merely to provide a starting point for the discussion to be included in the Discussion Paper that is being developed as part of the IASB's Rate-regulated Activities research project.

Summary

16. The staff's preliminary view is that the true-up adjustments that are required by the rate-setting mechanism and that result from past performance, do represent a right or an obligation of the entity that is capable of resulting in the transfer of economic benefits to or from the entity.
17. Consequently, we think that:
 - (a) when the regulatory adjustment is positive, an asset exists; and
 - (b) when the regulatory adjustment is negative, a liability exists.
18. This preliminary view is based on our understanding of the existing definitions of assets and liabilities, on conclusions reached in existing IFRSs and in other ongoing projects, as well as on the proposed definitions of assets and liabilities and other supporting material in the *Conceptual Framework DP*. For convenience, the existing and proposed definitions⁷ are reproduced below:

⁷ The table of definitions is contained in paragraph 2.11 of the *Conceptual Framework DP* (except for 'control', which is defined in DP paragraph 3.23)

	Existing definitions	Proposed definition
Asset (of an entity)	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 present economic resource controlled by the entity as a result of past events.
Liability (of an entity)	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.	a present obligation of the entity to transfer an economic resource as a result of past events.
Economic resource	[no existing definition]	a right, or other source of value, that is capable of producing economic benefits.
Control	[no existing definition]	An entity controls an economic resource if it has the present ability to direct the use of the economic resource so as to obtain the economic benefits that flow from it.

19. At this stage, we are asking the IASB to comment on whether this initial analysis is a reasonable basis on which to progress the work on this project. We have not reached a conclusion as to what type of asset or liability exists, and nor have we discussed recognition criteria or the measurement basis that might be appropriate to use. This analysis will be influenced by the IASB’s tentative conclusions at this meeting.

Definitions of asset and liability

20. Previously, many opponents of recognising ‘regulatory assets’ and ‘regulatory liabilities’ have argued that the right to increase or the obligation to reduce the rate chargeable for future sales does not create a present resource/right or a present obligation. They argue that, in the vast majority of rate-regulatory frameworks, the recovery or reversal of the amounts recorded in regulatory deferral accounts⁸ is conditional on future sales being made.
21. In addition, they argue that the ability to increase rates in the future is not a resource ‘controlled’ by the entity, because the related inflow of economic

⁸ The term “regulatory deferral account balances” is defined in the Exposure Draft *Regulatory Deferral Accounts* as: “The “balance of any expense (income) deferral or variance account this is included in the setting of future rate(s) by the rate regulator and that would not otherwise be recognised as an asset or liability in accordance with other Standards.”. For the purpose of the analysis in this paper, the term ‘true-up adjustment’ is used to more precisely depict the adjustment arising from the rate-setting mechanism described in paragraphs 8-12 of this paper.

benefits is conditional on making future sales to customers whom the entity cannot compel to make future purchases from the entity.

22. Alternatively, those that support the recognition of regulatory deferral account balances as ‘regulatory assets’ and ‘regulatory liabilities’ argue that certain types of rate-regulatory frameworks grant the entity a right to earn a specified amount of revenue. Such frameworks also oblige the entity to restrict the amount of revenue earned to the specified or ‘allowed’ amount. Consequently, they argue that any regulatory deferral account balance has arisen because of past sales to customers, with the balance on the account reflecting the change to the estimated amount already billed.
23. In addition, they argue that the rate regulation uses the adjustment to future rates as a practical mechanism to recover or refund the regulatory deferral account balances, but that the mechanism does not change the substance of the right or obligation.

The focus of the analysis

24. For the purpose of the analysis in this paper, we focus on the regulatory true-up adjustment described earlier in this paper as the critical feature of rate regulation. We think that this provides a more specific focus for the analysis than has been used previously. In the past, analyses of the issue have usually been based on a more general view of regulatory deferral account balances, which have not made a distinction between the specific true-up adjustment feature and other common features that are related to the rate-setting mechanism.⁹ In our view, there are a number of important features related to the rate-setting mechanism, but those features do not change the rights or obligations associated with the true-up adjustment. Instead they support the use of the future sales price as a practical and reliable mechanism to collect/deliver the cash flows associated with the true-up adjustment. We will refer to them later in this analysis wherever they are relevant. The supporting features are:

- (a) the obligation to maintain the supply of rate-regulated goods or services to customers on a non-discriminatory basis;

⁹ An analysis of the supporting features is contained in IASB Agenda Paper 9A *Features of rate regulation*, October 2013.

- (b) the exclusive or near-exclusive right to supply the rate-regulated goods or services;
- (c) the existence of an authorised rate regulator; and
- (d) the essential or near-essential nature of the goods or services that are subject to rate regulation.

25. The analysis presented in this paper uses various paragraphs in the *Conceptual Framework DP*, for which we provide cross-references and limited extracts. Consequently, those paragraphs may need to be referred to for a greater understanding of our analysis, which we break down into the following issues:

- (a) enforceability and control of the economic resource;
- (b) present right/obligation and past event; and
- (c) reduced inflow versus outflow.

Existing Conceptual Framework

26. The existing definition of an asset includes a requirement for the resource to be controlled by the entity. Although the IASB has defined ‘control’ in some individual projects,¹⁰ the existing *Conceptual Framework* does not define the terms ‘resource’ or ‘control’. Consequently, we think that the meaning of these terms is unclear and has led to different interpretations.
27. The existing definition of a liability contains the terms “present” and “as a result of past events”. The existing definition of an asset also contains the term “as a result of past events”. However, the existing *Conceptual Framework* contains little guidance on whether an entity can have a present obligation while any requirement to transfer an economic resource remains conditional on the entity’s future actions, such as making future sales. Consequently, this aspect of the definition is unclear and the principles underlying its application in different Standards can appear inconsistent.¹¹

¹⁰ For example, in the IASB’s Exposure Draft *Revenue from Contracts with Customers*, published in November 2011, and in IFRS 10 *Consolidated Financial Statement*.

¹¹ This conclusion is based on paragraph 3.2 of the *Conceptual Framework DP*.

28. In our view, the lack of clarity in the definitions of asset and liability has contributed to the confusion as to whether the existing *Conceptual Framework* supports the recognition of ‘regulatory assets’ and ‘regulatory liabilities’. Consequently, the analysis in this paper draws on the additional guidance and explanatory material proposed in the *Conceptual Framework DP*.

Conceptual Framework DP

29. Although the existing *Conceptual Framework* defines an asset as a resource and a liability as an obligation, the *Conceptual Framework DP* notes that “some readers have sometimes confused the resource (asset) or the obligation (liability) with the resulting inflow or outflow of economic benefits”.¹² Consequently, the *Conceptual Framework DP* provides additional guidance to refocus the definitions of asset and liability onto the resource or obligation and away from the resulting inflow or outflow of economic benefits.¹³
30. The proposed definitions of assets and liabilities in the *Conceptual Framework DP* both contain the terms “present” and “as a result of past events”. The addition of the term “present” to the definition of an asset makes explicit a notion that was already implicit in the existing definition. In addition, it emphasises the accounting for the past transaction or other event that brought the resource under the entity’s control or imposed the obligation on the entity, and emphasises the parallel between the definitions of asset and liability.¹⁴
31. The *Conceptual Framework DP* provides additional guidance on the definitions of asset and liability, including guidance on “control”,¹⁵ “present obligation”,¹⁶ and the role of future actions or events that are outside the entity’s control and those that depend on the entity’s future actions.¹⁷ The following paragraphs use the additional guidance in the *Conceptual Framework DP* to analyse whether the

¹² See paragraph 2.13 of the *Conceptual Framework DP*.

¹³ For example, see paragraph 2.14 and paragraph 3.4-3.15 of the *Conceptual Framework DP*.

¹⁴ See paragraphs 2.13 and 2.16 of the *Conceptual Framework DP*.

¹⁵ See paragraphs 3.16-3.32 of the *Conceptual Framework DP*.

¹⁶ See paragraphs 3.63-3.69 of the *Conceptual Framework DP*.

¹⁷ See paragraphs 3.70-3.97 of the *Conceptual Framework DP*.

‘true-up’ adjustment that is required by some rate-regulatory mechanisms could represent the existence of a ‘regulatory asset’ or ‘regulatory liability’.

Enforceability and control of the economic resource

32. An economic resource is not defined in the existing *Conceptual Framework* but is defined in paragraph 2.11 of the *Conceptual Framework DP* as “a right, or other source of value, that is capable of producing economic benefits”.
33. The following paragraphs try to distinguish between the right (or obligation) related to the true-up adjustment and the mechanism used to collect or deliver the economic benefits associated with the true-up adjustment.

A right or other source of value

34. The rate-setting mechanism is formally established by the rate regulation, which is binding on the authorised rate regulator as well as on the rate-regulated entity. In the type of rate-setting mechanism being analysed, the amount of the true-up adjustment relates directly to past transactions and events.¹⁸ The rate regulation will also establish the method to be used to recover from or ‘refund’ to customers the amount of the true-up adjustment.¹⁹
35. In some, albeit rare, cases, the adjustment will be settled with the rate regulator. This means that the entity will pay cash to, or receive cash from, the rate regulator or other designated body, depending on whether the true-up adjustment is positive or negative. In other, again rare, cases, the entity will raise additional bills or credit notes to specific customers or groups of customers that had purchased the rate-regulated goods or services from the entity in the past. The amounts billed or credited will equal the value of the true-up adjustment and will be allocated to the customers in proportion to their past purchases during the regulatory period. In this context, the regulatory period is the period over which the ‘true-up’ adjustment is accumulated.

¹⁸ See paragraph 12 of this paper.

¹⁹ The mechanisms described in paragraphs 35-36 of this paper were identified in IASB Agenda Paper 9 *Request for Information response summary*, July 2013.

36. However, the methods of recovering or refunding the amount of the adjustment described in the paragraph above are, as noted, rarely used in practice. The most common method used is to adjust the price for future sales in order to recover or refund the amount of the true-up adjustment over a suitable period of time. The length of time usually depends on a number of factors, including the size of the adjustment and the ability of customers to absorb a price increase.
37. The rate regulator is usually able to use future sales as a practical, low-cost and reliable mechanism for ensuring that the entity can recover the amount of any positive true-up adjustment or refund the amount of any negative true-up adjustment. This is because other distinguishing features of rate regulation support this mechanism; in particular, the exclusive or near-exclusive right to supply the rate-regulated goods or services and the essential or near-essential nature of those goods or services. These two features contribute to relatively inelastic demand and a high level of predictability of the timing and probability of reversal through future sales.
38. We do not think that the mechanism used to reverse the true-up adjustment changes the entity's right or obligation to recover or refund the true-up adjustment. Instead, we think that the mechanism affects the timing of the resulting cash flows. Consequently, if future sales are used as the collection or delivery mechanism, and if demand for the goods or services were to change, increases would usually accelerate the cash flows, and decreases would delay them. The amount of the cash flows would, however, remain unchanged because the amount is fixed by the regulatory true-up adjustment calculation.²⁰

Control

39. As noted in paragraph 26 above, the existing *Conceptual Framework* does not define "control" but the IASB has defined it in some individual projects. In the *Conceptual Framework* DP, the IASB proposes to build on these definitions to define the meaning of control within the context of the definition of an asset.²¹

²⁰ The mechanism used will also affect the probability of recovering or delivering the cash flows related to the true-up adjustment. We plan to address this issue in the later analysis of recognition criteria and measurement/impairment.

²¹ See paragraphs 3.16-3.25 of the *Conceptual Framework* DP.

40. In addition, the *Conceptual Framework* DP contains some additional guidance to support the proposed definition. In particular, paragraph 3.27 notes that: “For an entity to control an economic resource, the economic benefits arising from the resource must flow to the entity (either directly or indirectly) rather than to another party”.
41. Paragraph 3.27 goes on to confirm that: “This requirement does not imply that the entity can ensure that the resource will generate economic benefits in all circumstances. Instead it means that, if the resource generates economic benefits, the entity is the party that will receive them”.
42. This concept that the entity does not need to control whether the resource will generate economic benefits is not new. The *Conceptual Framework* DP provides some explanatory material that clarifies what is already generally accepted in long-established practice and in existing IFRSs.²² For example, IAS 2 *Inventories* has established that inventories are assets. This is so even when the entity holds inventories speculatively, hoping that there will be sufficient demand for those inventories that will result in future sales to customers, even if those customers have not been identified yet.
43. Similarly, other types of assets are commonly recognised that are capable of generating an inflow of economic benefits but that do not guarantee that the inflow will occur. This approach is supported in paragraph AG10 of the application guidance in IAS 32 *Financial Instruments: Presentation*, which states:

AG10 Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. **Control of such physical and intangible assets creates an opportunity to generate an inflow** of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset. [Emphasis added.]

²² The IASB distinguish, in Chapter 2 of the *Conceptual Framework* DP, between existence uncertainty (that is, does a right/resource or an obligation exist?) and outcome uncertainty. Paragraph 2.32 explains that outcome uncertainty refers to cases where the asset or liability exists, but the outcome (that is, the realisation of the resulting inflows or outflow) is uncertain. The same paragraph provides some examples, including inventory.

44. When considering whether the true-up adjustment will reverse fully, we accept that this will usually rely on sufficient sales being made in the future. However, we think that this is an issue related to the recognition and measurement of the adjustment instead of the existence of a right/resource or obligation.²³

Staff's tentative conclusion on enforceability and control

45. We think that the true-up adjustments that are required by the rate-setting mechanism, and that result from past performance, represent rights or obligations of the entity that are capable of resulting in the transfer of economic benefits to or from the entity.
46. We think that it is important to distinguish the right/resource (asset) or the obligation (liability) from the resulting inflow or outflow of economic benefits. Consequently, although the mechanism usually used for collecting or delivering the related cash flows is dependent upon future sales, we do not think that this changes the entity's right or obligation related to the regulatory true-up adjustment. Whether that right or obligation exists as a 'present' right or obligation at the reporting date is discussed in the paragraphs below.

Present right/obligation and past event

47. The proposed definitions of assets and liabilities in the *Conceptual Framework* DP both contain the terms 'present' and 'as a result of past events'. As noted in paragraphs 27 and 30 above, this is consistent with the definitions in the existing *Conceptual Framework*.
48. Paragraphs 3.63-3.66 of the *Conceptual Framework* DP discuss the term "present" and "as a result of past events" within the context of obligations. In particular, paragraph 3.66 notes that:

A liability can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. Activities conducted

²³ We will consider recognition and measurement issues in the next stage of the analysis of the true-up adjustment.

by the entity could include, for example, making sales, earning profits or even operating on a particular date—the important fact is that the amount of the liability is determined by reference to that activity.

49. We think that those comments are equally applicable to determining whether an asset exists at the reporting date. This is because the proposed changes are intended to emphasise that there is a parallel or symmetry between the definition of assets and the definition of liabilities.²⁴
50. As noted in paragraph 24 above, we are analysing the regulatory true-up adjustment that is determined by reference to the past activities that have occurred before the end of the reporting period. When this adjustment is negative, we think that it represents an obligation to ‘refund’ an amount of revenue that has been billed to customers for past sales. This view is perhaps clearer in the rare cases when the entity is required to make a direct payment to the rate regulator or other authorised body, or is required to provide credit notes or cash refunds to specific customers that have been ‘over-billed’ in the period during which the regulatory adjustment has arisen.²⁵
51. However, in the vast majority of cases, the rate regulator uses future sales as a reliable mechanism for the entity to refund the amount of any negative true-up adjustment (or to recover the amount of any positive true-up adjustment).²⁶
52. Consequently, having identified that the true-up adjustment is calculated on the basis of past transactions and events, we think that it would be helpful to consider whether this is sufficient to create a present obligation at the reporting date, when the mechanism to settle the obligation relies on future sales. This is because the IASB has acknowledged that, when trying to determine whether a liability exists, it has encountered difficulties in practice because

“it is unclear whether those past events are **sufficient** to create a present obligation to transfer an economic resource if such a transfer remains conditional on future

²⁴ See paragraphs 2.13(b) and 2.16(b) of the *Conceptual Framework DP*.

²⁵ See paragraph 35 of this paper.

²⁶ See paragraph 36 of this paper.

events that have not occurred, or on further actions that the entity has not taken, by the reporting date.”²⁷

53. Paragraphs 3.67-3.97 of the *Conceptual Framework* DP address this question. We use the discussion in those paragraphs in our analysis below (paragraphs 54-63).

Transfer is conditional on future events or actions

54. The type of true-up adjustment being considered in this paper relates to past transactions or events that have arisen by the reporting date. When the amount of the adjustment is negative, the rate regulation obliges the entity to reduce the price it charges to customers for future sales of the regulated goods or services. Previously, some have argued that the reversal of a negative ‘regulatory deferral account balance’ is conditional on making sales in the future and so is not a ‘present’ obligation.
55. The following paragraphs consider this view within the context of the more specific regulatory true-up adjustment.

Future events outside the control of the entity

56. The nature of the rate regulation requires the entity to continue to provide the essential goods or services on demand at the reduced price. Some would argue that the obligation is conditional only on future events that are outside the entity’s control and, consequently, that a liability should be recognised. This is because it is only conditional on customers demanding the goods or services. In other words, the entity has an unconditional ‘stand-ready obligation’.²⁸ Consequently, although the entity does not know at the reporting date whether it will be required to transfer resources, it has an unconditional obligation to stand ready to transfer the resources if the specified future event occurs. Other examples²⁹ of such stand-ready obligations that are recognised as liabilities in IFRS financial statements include an insurer’s obligation to compensate a policyholder on the occurrence of an insured event, a manufacturer’s warranty obligation to make

²⁷ See paragraph 3.66 of the *Conceptual Framework* DP.

²⁸ A ‘stand-ready obligation’ is described in paragraphs 3.70-3.71 of the *Conceptual Framework* DP.

²⁹ See paragraph 3.70 of the *Conceptual Framework* DP.

good manufacturing defects, and a guarantor's obligation to compensate a lender if a borrower defaults.

57. The IASB has concluded that these unconditional obligations are present obligations that meet the definition of a liability.³⁰

Future events that depend on the entity's future actions

58. An alternative argument against the recognition of a liability is that the entity does not have an unconditional obligation to refund a negative true-up adjustment. Instead, the entity has a conditional obligation that depends on its own future actions, that is, it depends on the entity making sales in the future.

59. The IASB has tentatively rejected the view (described as View 1 in the *Conceptual Framework DP*) that an obligation must be strictly unconditional. It does not think that an entity should omit from its financial statements liabilities that have arisen from past events and that the entity has no practical ability to avoid. Doing so would exclude relevant information about the inevitable future costs of the entity's past actions.³¹

60. The *Conceptual Framework DP* presents two further views (View 2 and View 3) as alternatives to View 1.³² However, the IASB has not reached a preliminary view on whether the definition of a liability:

- (a) should include only those liabilities that the entity has no practical ability to avoid (View 2); or
- (b) should also include conditional obligations that the entity might be able to avoid through its future actions but that have nevertheless arisen as a result of past events (View 3).

61. As already noted, the rate regulation requires the entity to continue to provide the essential goods or services on demand at the reduced price. In addition, there is usually no competition and the goods or services are considered to be essential or

³⁰ See paragraph 3.71 of the *Conceptual Framework DP*, which also notes that the requirements of several recent and proposed Standards—such as the draft Revenue Standard and the Exposure Draft *Insurance Contracts* that was published in June 2013—reflect this conclusion.

³¹ See paragraph 3.96 of the *Conceptual Framework DP*.

³² These alternative views are discussed in paragraphs 3.77-3.89 in the *Conceptual Framework DP*.

near-essential. Consequently, customers have little choice except to purchase the rate-regulated goods or services from the entity. As a result, we think that it can be argued that the entity has no practical ability to avoid refunding the negative true-up adjustment balance (View 2).

62. In addition, the amount of the true-up adjustment required is based on past performance (including variances from expected costs and permitted revenues and/or bonuses/penalties for meeting or failing to meet incentive targets) and other designated events (such as incurring costs for storm damage repairs). Consequently, even if the entity could avoid making future sales, the balance has nevertheless arisen as a result of past transactions and events (View 3).
63. Consequently, we think that the obligation to refund the negative true-up adjustment would be classified as a liability under both the alternative Views 2 and 3.

Identify of the party to whom the obligation is owed

64. Previously, some have argued that the identity of the future customers that will benefit from the reduced sales price might be different from the past customers that have, in effect, overpaid. However, we do not think that the fact that the individual customers buying the goods, and thereby claiming the refund, can change, precludes recognition of a liability. Indeed, paragraph 20 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* confirms that, although an obligation always involves another party to whom the obligation is owed, it is not necessary to know the identity of that party.
65. In the case of rate regulation, the adjustment to the price usually affects all customers or all customers within a certain group or groups. Each customer has a right to buy the regulated goods or services at the reduced price and, in that way, benefit from the refund. That right usually exists independently of whether the customer has bought goods or services from the entity in the past. Similarly, the entity's obligation to sell the regulated goods or services to each customer at the reduced price exists independently from the identity of the individual customers.
66. Consequently, we think that the fact that the refund may be given to different customers than those that have previously purchased the goods or services, and so were previously 'over-billed', does not affect the existence of the obligation.

Reduced inflow versus outflow

67. One of the arguments against the recognition of a liability for a negative regulatory adjustment balance is that a rate-regulated entity's obligation to reduce prices in the future does not meet the existing definition of a liability, because the obligation is settled by transferring future goods at a lower price. Proponents of this view argue that this results in a reduced inflow of economic benefits but does not result in an actual outflow.
68. The aggregate amount of the true-up adjustment is determined independently of the period price component of the rate (that is, the estimated price for the period, reflecting the estimated costs and volumes for the period).³³ Although rate regulators can use different mechanisms to settle the true-up adjustment, the most common method uses an adjustment to the price charged for future sales.
69. In some cases, the amount of the overall price that relates to the period price component, and the amount related to the true-up adjustment (or adjustments), are reported separately to customers. In other cases, the customer is not made aware of the two distinct components and may only see a combined price in bills from the entity. In either case, the customer is required to pay the net amount to the entity for the volume of goods or services delivered to them in the period.
70. We accept that when the true-up adjustment is settled through a price adjustment to future sales, the amount of the true-up adjustment is realised in conjunction with the period price component as part of a net receipt from the customer. However, as already stated,³⁴ we do not think that the mechanism used to settle the true-up adjustment changes the nature of the obligation (or right). Consequently, we think that the view that there is no liability because there is only a reduced inflow of economic benefits but no outflow confuses the distinction between the obligation (liability) and the method that is used to realise the resulting outflows.
71. We also think that further arguments can be made to support this conclusion:

³³ The two components of the price charged to customers are described in paragraph 9 of this paper.

³⁴ See paragraph 38 of this paper.

- (a) the resulting cash flows from future sales can be allocated to the period price component and to the true-up adjustment component (see paragraphs 72-75 below); and
- (b) the future goods/services will be transferred in exchange for economic resources of lower value (see paragraphs 76-82 below).

Allocation of cash flows

72. The rate regulation considered in this analysis distinguishes between the price charged to customers for ‘current’ goods and services (the period price component), and the amount that relates to goods and services delivered in previous periods (the true-up adjustment component). The components of the price are usually separately identifiable by the entity.
73. In order to apply the rate-setting mechanism, each price adjustment that relates to past activities can usually be identified and ‘tracked’ through the record-keeping system. In some cases, the bills provided to customers show the different components of the pricing structure, distinguishing between the ‘current’ price and the adjustments related to the past. Consequently, when the entity bills the customer for sales in the current period, it can allocate, based on sales made, the net receivables due from customers into distinct components, each reflecting different components of the net price:
- (a) receivable related to goods and services delivered in the current period;
 - (b) receivable related to goods and services delivered in past period(s) (positive regulatory adjustments); and
 - (c) payable related to goods and services delivered in past period(s) (negative regulatory adjustments).

74. When the sales are made to customers, the amount of the price adjustment that relates to past periods becomes a financial asset³⁵ or financial liability³⁶, in the same way as normal trade receivables/payables. However, we do not think that the fact that the settlement mechanism results in a net inflow of cash precludes recognition of separate assets and liabilities for the components that are netted at settlement.
75. Nor do we suggest that, prior to the relevant sales being made to customers, the amounts of the price adjustments that are not yet reflected in sales are financial assets or financial liabilities. The ‘unbilled’ balance of the true-up adjustment relates to the rate regulation, not the individual contracts with customers. However, we do not think that this precludes these regulatory amounts from being depicted as assets and liabilities in the financial statements.³⁷

Exchange for resources of lower value

76. The existing *Conceptual Framework* definition of a liability uses the term “the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits”. In our view, this does not require that the settlement must result in an outflow of cash, but could result in the outflow of a variety of resources, including the outflow of the goods or services being sold. We think that this interpretation is supported in the *Conceptual Framework DP*,

³⁵ Paragraph 11 of IAS 32 *Financial Instruments: Presentation* defines a *financial asset* as “any asset that is:

- (a) cash;
- (b) an equity instrument of another entity;
- (c) a contractual right:
 - (i) to receive cash or another financial asset from another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or :: [. . .]”.
- (d) a contract that will or may be settled in the entity’s own equity instruments and is: [. . .]”.

³⁶ Paragraph 11 of IAS 32 *Financial Instruments: Presentation* defines a *financial liability* as “any liability that is:

- (a) a contractual obligation :
 - (i) to deliver cash or another financial asset to another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- (b) a contract that will or may be settled in the entity’s own equity instruments and is: [. . .]”.

³⁷ At this stage, we have not reached a conclusion as to what type of asset or liability exists. This analysis will be influenced by the IASB’s tentative conclusions at this meeting.

which suggests that the entity could settle an obligation in a variety of ways, including transferring assets other than cash and rendering services.³⁸

77. This approach is also reflected in existing IFRSs, and is highlighted in paragraph AG11 of the application guidance in IAS 32 *Financial Instruments: Presentation*, which states:

AG11 Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities **because the outflow of economic benefits associated with them is the delivery of goods and services** rather than a contractual obligation to pay cash or another financial asset. [Emphasis added.]

78. We are not suggesting that all obligations to deliver goods or services should be recognised as liabilities. In some cases, the obligation may be part of an executory contract³⁹ in which the entity is obliged to deliver, but has not yet delivered, goods or services in exchange for consideration of equal value. We do not suggest that the entity should recognise a liability for this obligation, unless the contract is onerous.⁴⁰ This is because the obligation is matched with a right or resource of equal value within an executory arrangement.
79. We think that this view is consistent with paragraph 3.38 of the *Conceptual Framework DP*. This paragraph notes that a requirement to provide economic resources only if, at the same time or earlier, the entity expects to receive economic resources of equal or greater value does not give rise to a present obligation. We interpret this to mean that a requirement to provide economic resources in exchange for resources of lesser value can (or does) give rise to a present obligation.

³⁸ See paragraph 3.36 of the *Conceptual Framework DP*.

³⁹ Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent (paragraph 3 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

⁴⁰ See paragraph 66 of IAS 37.

80. As stated in paragraph 9 of this paper, there are two distinct components to the price charged to customers:
- (a) the estimated price for the period, reflecting the estimated costs and volumes for the period; and
 - (b) an identifiable ‘true-up’ adjustment that is based on past performance and events.
81. The first component is, we think, designed to provide consideration that is of equal value to the goods or services being supplied in the period. However, when circumstances change from the estimates used and the rate regulation prevents the entity from reflecting that change in the selling price in the current regulatory period, the price set may cease to reflect consideration of equal value.
82. Consequently, when the true-up adjustment is negative, we think that it can be argued that this results in the entity having to transfer the rate-regulated goods or render the rate-regulated services in exchange for consideration of a lesser value. As a result, we think that it can be argued that this gives rise to a present obligation.

Staff’s tentative conclusion on the existence of a present right or obligation

83. Our analysis focuses on the regulatory true-up adjustment that is based on past performance and events (including variances from expected costs and permitted revenues, bonuses/penalties for meeting or failing to meet incentive targets and other designated events, such as incurring costs for storm damage repairs). In our view, although the mechanism used to collect or deliver the resulting cash flows is usually linked to future sales, the entity’s right or obligation to settle the true-up adjustment exists independently of that mechanism.
84. Consequently, when the regulatory adjustment is positive, we think this represents a right to bill customers for an amount of revenue that relates to past transactions and events. Similarly, when this adjustment is negative, we think that it represents an obligation to ‘refund’ an amount of revenue that has previously been billed to customers but that exceeds the amount of revenue that the entity is entitled to retain.