IFRS

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STAFF PAPER

ASAF Meeting

Project	**Rate-regulated Activities**
Paper topic	Implications of the Exposure Draft *Conceptual Framework for Financial Reporting* for the Rate-regulated Activities project

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Introduction

1. In July 2015, ASAF members were asked to provide views about possible accounting approaches that could be developed to reflect the financial effects of a type of rate regulation described as 'defined rate regulation' in the Discussion Paper *Reporting the Financial Effects of Rate Regulation*, published in September 2014 (the Rate Regulation DP). ASAF members expressed mixed views.[1]

2. Some ASAF members considered that there should be no adjustment to reflect the financial effects of defined rate regulation because the regulatory relationship between the entity and the rate regulator was not sufficiently strong to support changing the existing IFRS accounting practice.

3. Others suggested that the regulatory relationship maybe strong enough to create financial effects that could lead to the recognition of 'regulatory assets' and 'regulatory liabilities'. However, they questioned whether the occurrence of sufficiently strong defined rate regulation is significant enough that the benefits of developing an accounting model to change the existing predominant IFRS practice would outweigh the costs.

4. Some ASAF members who supported making adjustments to the existing predominant IFRS practice were comfortable with recognising a regulatory liability in cases in which the consideration was included in amounts billed to

[1] The summary note of the discussion is reproduced in Appendix 1.

customers in advance of the entity carrying out the specified activity. In contrast, they were not comfortable with recognising a regulatory asset when the activity was carried out in advance of billing to customers. This suggested a preference for recognising the related consideration at the later of:

(a) billing customers; and

(b) carrying out the specified activity.

Purpose of the discussion

5. At this time, we are exploring whether we can develop proposals for an accounting model to more faithfully reflect the financial effects of defined rate regulation in IFRS financial statements. In order to progress this work, it is important for us to be able to communicate to stakeholders how any model that may be developed fits with the proposals in the Exposure Draft *Conceptual Framework for Financial Reporting*, published in May 2015 (the *Conceptual Framework* ED).

6. The purpose of the discussion in this meeting is:

   (a) to clarify:

      (i) the way that defined rate regulation works; and

      (ii) the proposed concepts in the *Conceptual Framework* ED.

   (b) to help staff to understand more clearly the basis of the ASAF members' views about reporting the financial effects of rate regulation that were expressed in the July 2015 meeting. In particular, we would like to hear how members relate their views to the concepts proposed in the *Conceptual Framework* ED.

Questions for ASAF members

7. We are interested in hearing ASAF members views about any of the aspects of the project—this can include views about:

   (a) the financial effects of defined rate regulation;

(b) how the proposed concepts in the Conceptual Framework ED would apply to defined rate regulation, and

(c) whether the proposed concepts are considered to make a difference to ASAF members' views when compared to using the concepts in the existing *Conceptual Framework for Financial Reporting*.

8. In particular, we are interesting to hear members views about the following issues. We do not plan to go through each of these questions in detail, but have set them out here to provide some direction for the discussion.

Question 1: Commercial substance

The regulatory agreement establishes both the entity's:

(a) obligations to carry out specified activities; and

(b) right to charge a determinable amount of consideration in exchange for carrying out those activities.

The regulated rate that is billable to customers reflects the mechanism used by the rate regulator to ensure that the entity can collect the consideration that is chargeable to customers.

When considering the commercial substance of the entity's contracts with customers, should the accounting reflect the 'overlay' of the regulatory agreement? Why or why not?

(a) Could the regulatory agreement be considered to be analogous to an executory contract in which, at the start of the agreement, neither the rate regulator, the customers nor the regulated entity has fulfilled any of their obligations?

(b) Does the fact that the customers are not a direct party to the regulatory agreement prevent the entity from considering the terms of the regulatory agreement and the contracts with customers as a group when assessing and reporting the financial effects of the rate regulation?

(c) Does the rate regulator need to guarantee the cash inflows or outflows in order to link the accounting for the regulatory agreement with the contracts with customers?

Question 2: Regulatory liabilities

The regulated rate that is billable to customers may include amounts of consideration that relate to activities to be performed in a future period. Neither the rate regulator nor the customers can enforce the performance or the transfer of services or economic benefits until the future date.

When customers have been billed in advance for amounts that relate to activities to be performed in future periods, does the entity's obligation to perform the specified activities in the future satisfy the definition of a liability in the *Conceptual Framework* ED? Why or why not?

Question 3: Regulatory assets

The regulatory agreement may oblige the entity to perform specified activities in the current period that it will not be able to bill to customers until a future date.

When the entity has performed the specified activities for which it is entitled to bill customers a determinable amount of consideration at a later date, does the entitlement to bill customers at the later date satisfy the definition of an asset in the *Conceptual Framework* ED? Why or why not?

In particular:

(a) Is the right to charge consideration created when the entity performs the specified activity in accordance with the regulatory agreement, or is the right created at a later date when the entity transfers additional rate-regulated services and is able to bill customers using the regulated-rate for the future period?

(b) Does the entity's right to bill customers for performing the specified activities have to be unconditional for it to:

   (i) exist; or

   (ii) meet the recognition criteria in the *Conceptual Framework* ED?

(c) Does the inability of the entity to enforce its right to bill customers until a future time prevent an asset from existing?

Background information—slide presentation in Appendix 2

9. To support the discussion, we provide a slide presentation that summarises:

   (a) how defined rate regulation works;

   (b) the views of many respondents to the Rate Regulation DP; and

   (c) some of the concepts proposed in the *Conceptual Framework* ED that the project staff consider to be most relevant to developing an accounting model for reporting the financial effects of defined rate regulation.

10. During the meeting, the staff do not propose to go through the slide presentation in full—it is provided as background information.

Appendix 1: Extract from the July 2015 ASAF Meeting summary

Rate-regulated activities

76. At this meeting, the ASAF members provided views about possible accounting approaches that could be developed to reflect the financial effects of a type of rate regulation described as 'defined rate regulation' in the Discussion Paper *Reporting the Financial Effects of Rate Regulation*, published in September 2014. ASAF members used a simplified numerical example to consider how to account for a situation in which three specified activities carried out by the entity during a period were reflected in the revenue billed to customers in a different period. The example is contained in ASAF Agenda Paper 8.

77. The example highlighted three specified activities for which the consideration was included in the revenue requirement calculation, and, consequently, in amounts billed to customers, either in arrears or in advance of the entity incurring the costs involved in carrying out the activities. The specified activities are:

    (a) repairing damage to the entity's own assets caused by a flood, with the associated consideration being billed in a later period;

    (b) carrying out a research project, with the associated consideration being billed partly in advance; and

    (c) constructing property, plant and equipment (PPE), with the associated consideration being billed partly in advance and partly in arrears.

78. ASAF Agenda Paper 8 asked ASAF members to comment on whether it would be appropriate to amend the existing predominant IFRS practice. This practice focuses only on the contractual relationship between the entity and its customers. It makes no adjustment to reflect the effects of the regulatory agreement between the entity and the rate regulator. As a result, the revenue that the entity recognises in its IFRS financial statements reflects the quantity (Q) of rate-regulated goods or services delivered to customers during the period (that is, the satisfaction of the entity's performance obligations to its customers), multiplied by the regulated rate per unit (P).

79. ASAF members expressed mixed views about whether any adjustment to the existing predominant IFRS practice is needed at all. Some who considered that there should be no adjustment were not convinced that the regulatory relationship between the entity and the rate regulator was sufficiently strong to override the accounting provided by the existing practice. This is particularly so in situations in which the rate regulator provides no guarantee that any shortfall in the cash flows provided through amounts billed to customers would be made up in cash by the rate regulator.

80. Others who did not support an adjustment to the existing practice did not object on conceptual grounds. Instead, they suggested that the population of entities that may fall within the scope of defined rate regulation could be so small that the cost of developing an accounting model that adjusted the existing predominant IFRS practice would outweigh the benefits.

81. ASAF members who supported making adjustments to the existing predominant IFRS practice had mixed views about when, and why, adjustments should be made. However, most ASAF members who support an adjustment would prefer to see an adjustment to the timing of recognition of income, with little support for an adjustment to the timing of recognition of costs. Many ASAF members also expressed a preference for any adjustment to be presented as a separate 'regulatory adjustment' in the financial statements, instead of being offset against the amount of revenue recognised from contracts with customers (P x Q).

82. Some ASAF members who supported making adjustments to the existing predominant IFRS practice were comfortable with recognising a 'regulatory liability' in cases in which the consideration was included in amounts billed to customers in advance of the entity carrying out the specified activity. This would be analogous to treating the specified activity as satisfying a 'performance obligation' to the customers and recognising a 'contract liability' for the unsatisfied portion of the obligation.. In contrast, they were not comfortable with recognising a 'regulatory asset' when the activity was carried out in advance of billing to customers. This suggested a preference for recognising the related consideration at the later of:

    (a) billing customers; and

    (b) carrying out the specified activity.

83. In one example, the amounts billed to customers relate to construction of the entity's own PPE. That example raised some questions about the nature of the activity to which the relevant consideration related. Some considered it to be the actual construction activity itself. Others considered that it may be the subsequent delivery of goods or services to customers using the constructed property, plant and equipment. In the latter case, the consideration would be recognised as a regulatory liability and subsequently released to profit or loss account systematically over time, as the PPE is consumed in the production and delivery of goods or services to customers.

Next steps

84. The IASB staff will bring proposals for an accounting model (or models) to a future ASAF meeting, together with an analysis of how the model(s) fit(s) the *Conceptual Framework* and existing IFRS.

Appendix 2: Presentation—implications of the Conceptual Framework proposals for the Rate-regulated Activities project

See separate powerpoint presentation.