International Financial Reporting Standards

ASAF Agenda Paper 2B
Appendix 2

Implications of the *Conceptual Framework* proposals for the Rate-regulated Activities project

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Purpose of the Discussion

- In this meeting, we are seeking feedback from ASAF members about how the direction of the Rate-regulated Activities project should be shaped by the Exposure Draft *Conceptual Framework* for *Financial Reporting* (the *Conceptual Framework* ED).

- Questions for ASAF members are contained in the accompanying ASAF Agenda Paper 2B.

Rate-regulated Activities: why we are doing the project

- Many stakeholders have told the IASB that, for entities that are subject to **defined rate regulation,**
  - current **predominant IFRS practice** does not reflect the economic substance of defined rate regulation; and
  - IFRS financial statements currently **do not provide** investors and lenders with **relevant information** needed to make investing and lending decisions.

Current predominant IFRS practice

- Except for specified first-time adopters that apply IFRS 14 *Regulatory Deferral Accounts,* almost all entities eliminate regulatory deferral account balances when adopting IFRS and do not recognise such balances in IFRS financial statements.

- Revenue is recognised using the quantity of goods or services delivered to customers and the regulated rate, without any adjustment for amounts included in the regulated rate related to:
  – goods or services delivered to customers in a different period;
  – other specified activities carried out in a different period; or
  – adjustments for variances from estimates relating to past periods.

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Conceptual Framework:

Objective and qualitative characteristics

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Conceptual Framework ED:
Objective and qualitative characteristics

The objective of general purpose financial reporting is to provide **useful financial information**

Relevance

- Relevant financial information is capable of making a difference in a decision made by users

Faithful representation

- Representation of relevant economic phenomena and faithful representation of the phenomena that it purports to represent
- Complete, neutral and free from error

Enhancing characteristics

Comparability • Verifiability • Timeliness • Understandability

Cost constraint

Conceptual Framework ED paragraphs 1.2, 2.6, 2.14-2.15 and 2.22.

Conceptual Framework ED:
Faithful representation

Faithful representation	To be useful, financial information must faithfully represent the phenomena that it purports to represent.

- A faithful representation provides information about the **substance** of an economic phenomenon instead of merely providing information about its **legal form**.
- All terms in a contract are taken into consideration
  - whether explicit or implied
- In some cases:
  - a group or series of contracts may achieve, or be designed to achieve, an overall commercial effect; and
  - the terms of a group or series of contracts require detailed analysis to identify the substance of the rights and obligations.

Conceptual Framework ED paragraphs 2.14 and 4.53-4.56.

Conceptual Framework ED:
Applying the qualitative characteristics

- The most efficient and effective process for applying the fundamental qualitative characteristics would usually be:

  1. identify an economic phenomenon that is capable of being useful to users of the financial information;
  2. identify the type of information about that phenomenon that would be most relevant; and
  3. determine whether that information is available and can be faithfully represented.
  4. If not, repeat the process with the next most relevant type of information.

Conceptual Framework ED paragraph 2.21.

Rate Regulation DP:
evidence gathered

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Purpose of the Rate Regulation DP

- The Rate Regulation DP focussed on identifying:
  - the financial effects of rate regulation (ie what is the economic phenomenon); and
  - what information about the financial effects of rate regulation is most useful to users of financial statements.

What we heard—defined rate regulation (1)

- **defined rate regulation** establishes:
  - The entity's **obligations** to:
    - ensure the rate-regulated services are available without disruption to supply;
    - deliver rate-regulated services on demand;
    - carry out other specified activities to achieve other government policies, eg social, environmental, fiscal policies.
  - The entity's **right** to charge customers a determinable amount of consideration in exchange for satisfying its regulatory obligations (the **revenue requirement**).
- The rights and obligations are set out in a '**regulatory agreement**' between the rate regulator and the entity.

What we heard—defined rate regulation (2)

- The **regulatory agreement**
  - establishes the revenue requirement for a defined period (which may cover several years);
  - identifies the estimated level of demand for the regulated services over that period;
  - determines the **regulated rate** for the period, based on the combination of:
    - estimated revenue requirement;
    - estimated demand; and
    - timing of billing to customers.
  - includes a **rate adjustment mechanism** to:
    - 'correct' for variances from estimates
    - adjust the timing of when the revenue requirement is billed to customers to enable the rate regulator to moderate rate fluctuations/ cash flows

Regulated rate comprises:
a rate per unit, and/or
a 'standing charge', ie a fixed amount.

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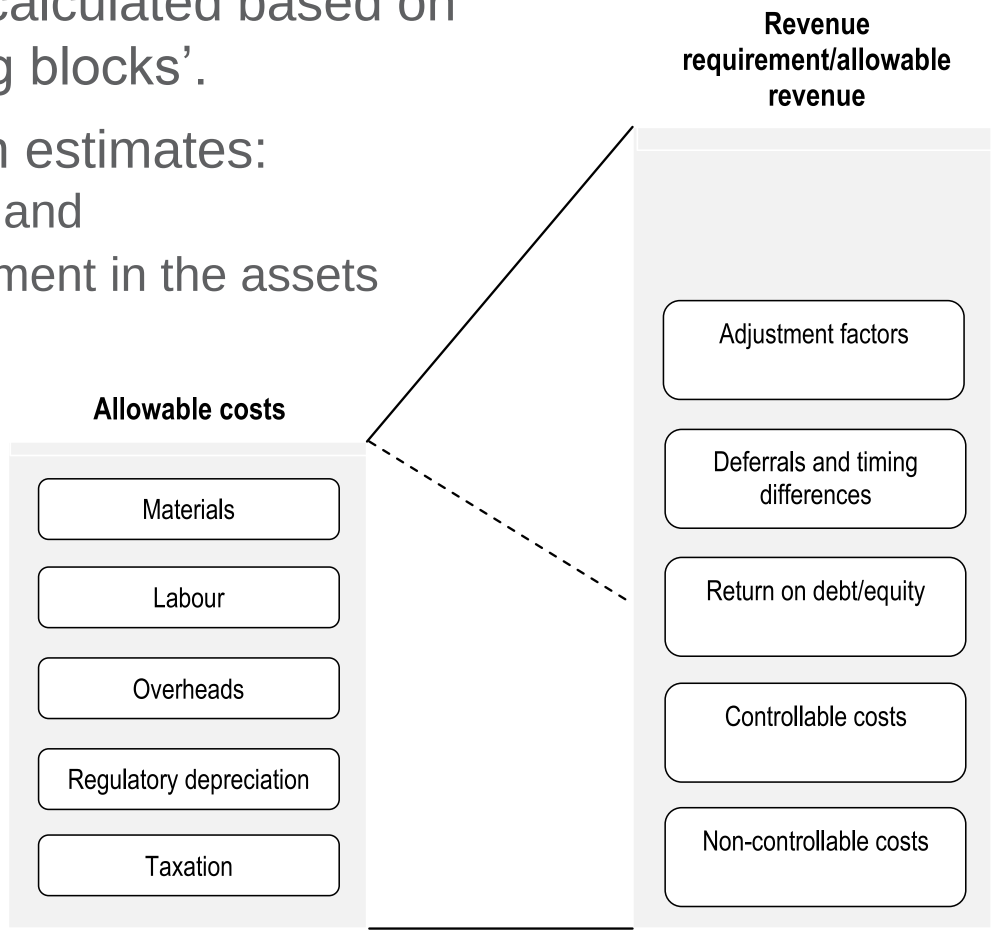
The revenue requirement

- The revenue requirement is calculated based on a number of steps or 'building blocks'.
- Allowable costs are based on estimates:
  - reasonably incurred costs; and
  - fair rate of return on investment in the assets used.
- The revenue requirement may include allowable costs relating to activities that:
  - were carried out in past periods; or
  - are planned to be carried out in future periods.



What we heard—defined rate regulation (3)

- Defined rate regulation operates in many (but not all) countries:
  - Regulatory agreement sets out the terms and formula for charging the consideration to customers
  - Track record of how defined rate regulation operates:
    - support for the entity’s rights through the courts;
    - relationship between rate regulator and entity (and customers);
    - enforcement of terms.
- Investors rely on regulatory effectiveness and stability to encourage investment.

What we heard—why IFRS financial statements currently do not provide useful information (1)

Many respondents to the Rate Regulation DP suggested that, in cases in which defined rate regulation applies:

- The regulatory agreement has a significant effect on the financial position and performance of the entity;
- The regulated rate charged to customers does not reflect:
  - the ‘fair value’ of the regulated services transferred to customers; or
  - the performance of the entity during the period.
- The regulated rate used in contracts with customers reflects the mechanism used to collect the consideration chargeable (ie the revenue requirement).
- Some respondents suggested that reflecting amounts billed to customers in financial statements may be considered to be more akin to cash accounting than to accruals accounting.

What we heard—why IFRS financial statements currently do not provide useful information (2)

Many respondents to the Rate Regulation DP suggested that, in cases in which defined rate regulation applies:

- the entity's financial position and performance cannot be understood by looking in isolation at the contracts between the entity and its customers (either as individuals or as a group of customers).
- considering the entity's rights and obligations under both the regulatory agreement and the contracts with customers as a group would more faithfully represent the economic environment and provide more relevant information—ie:
  - the overlay of the regulatory agreement on the contracts with customers needs to be reflected.

What we heard—useful information

Many respondents to the Rate Regulation DP said that they need information about defined rate regulation that helps them to:

- distinguish between variability in performance that is adjusted for through the regulated rate and variability that is not adjusted for;
- identify the nature of regulatory rate adjustments;
- identify when the rate adjustments will affect cash flows;
- assess the risks associated with the recovery/ reversal of regulatory rate adjustments; and
- assess management's ability to manage regulatory risk.

Rate-regulated Activities project—current status (1)

- The Rate Regulation DP provided valuable feedback to help determine next steps
  - Confirmed that there is an accounting problem to try to resolve
  - Confirmed that there is demand from users of financial statements, as well as preparers, to resolve the problem
  - Helped to clarify the rights, obligations and financial effects that are contributing to the problem
  - Provided clear direction on the possible accounting approach that is most likely to:
    - address the issues involved; and
    - result in more relevant and faithfully representative information for users of financial statements

Rate-regulated Activities project—current status (2)

- We are currently developing specific proposals for an accounting model that will provide financial information that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.
- Such decisions depend on an assessment of
  - the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity; and
  - management’s stewardship of the entity’s resources.

Rate-regulated Activities work-flow

Agenda requests

Agenda Consultation

IFRS Interpretations Committee

Ad-hoc sources

Research project

Initial analysis

Request for information
Gathered factual evidence to help understand the problem before deciding to proceed to Discussion Paper

Problem and solution assessment

Discussion Paper

Discussion Paper
Confirmed understanding of different types of rate regulation and the financial effects. Obtained clear preference for a way forward.

Standards-level project

Discussion Paper
Intended to set out the proposed model with explanation of issues addressed, including interaction with *Conceptual Framework* and other Standards

Exposure Draft

Standard

Evidence-informed decision-making

Responding to the feedback from the Rate Regulation DP

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Responding to the feedback from the Rate Regulation DP—linking the relationships

- In May 2015, the IASB discussed implications of the tripartite relationships between:
  - the rate-regulated entity and its customers;
  - the rate-regulated entity and the rate regulator; and
  - the rate regulator and the rate-regulated entity's customers.
- The IASB noted that existing predominant practice in IFRS financial statements deals with the first of these relationships.
- All IASB members agreed to address the implications of the interaction with the other two relationships in a second Discussion Paper.

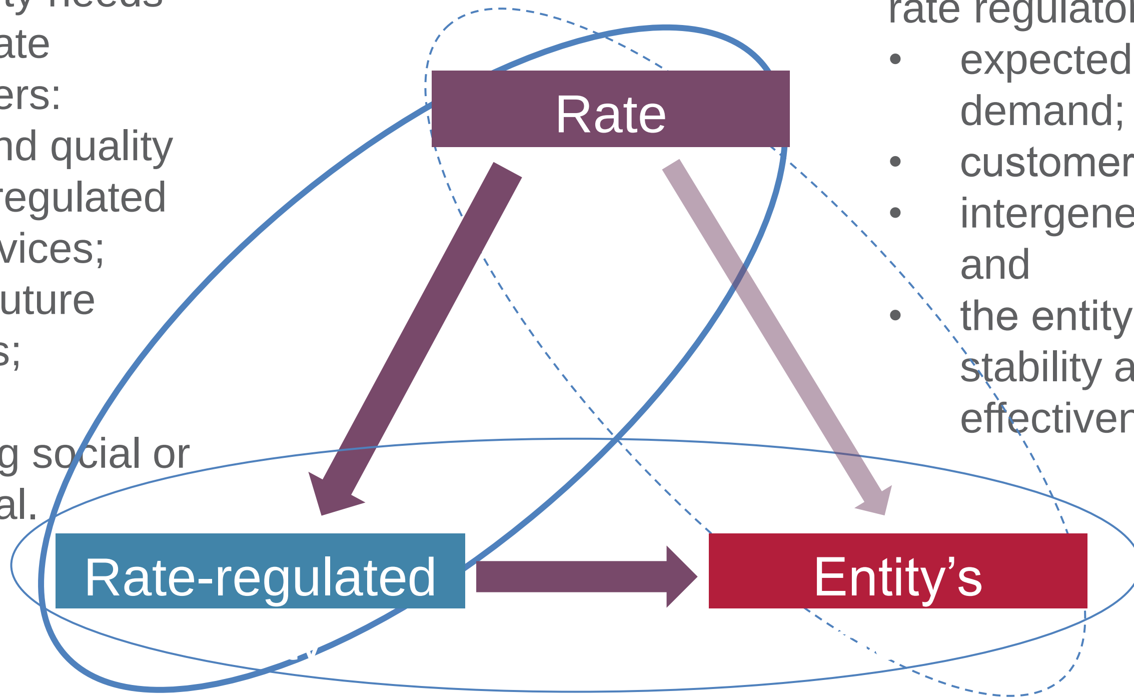
The three-way relationship

When establishing what activities the entity needs to perform, the rate regulator considers:

- availability and quality of supply of regulated goods or services;
- current and future supply needs;
- wider policy objectives, eg social or environmental.

When setting the rate, the rate regulator considers:

- expected levels of demand;
- customers' ability to pay;
- intergenerational equity; and
- the entity's financial stability and financing effectiveness.



The rate(s) used to bill customers for the regulated goods or services delivered reflect(s) the:

- estimated payment schedule for billing the revenue requirement; and
- adjustments for variances from estimates relating to past periods.

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Conceptual Framework: elements of financial statements

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Conceptual Framework ED:
Liabilities—present obligation

A liability is a present obligation of the entity to transfer an economic resource as a result of past events.

An entity has a present obligation to transfer an economic resource if both:

1. the entity has no practical ability to avoid the transfer; and
2. the obligation has arisen from past events, ie the entity has received the economic benefits, or conducted the activities, that establish the extent of its obligation.

For example:

- if the transfer is legally enforceable, or
- if action necessary to avoid the transfer would:
  - cause significant business disruption;
  - have economic consequences significantly more adverse than the transfer itself.

Conceptual Framework ED paragraphs 4.24 and 4.31-4.32.

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Conceptual Framework ED:
Implications of focus on 'practical ability'

Conditional obligations

- It is not necessary for the obligation to be unconditional.
- Liabilities may be conditional on the future actions of an entity . . . If the entity has no practical ability to avoid that action.

Constructive obligations

- It is not necessary for the obligation to be legally enforceable.
- Liabilities may arise from an entity's customary practices, published policies or specific statements . . .
  if the entity has no practical ability to act in a manner inconsistent with those practices, policies or statements.

Currently unenforceable obligations

- A present obligation can exist . . . even if the transfer of economic resources cannot be enforced until some point in the future.
  - For example, an obligation arising from a contract exists now if the counterparty has already paid for the work—see also '**executory contracts**'

Conceptual Framework ED paragraphs 4.34-4.35 and 4.38-4.39.

Conceptual Framework ED: Executory contracts

- An executory contract is a contract that is **equally unperformed**:
  - neither party has fulfilled any of its obligations, or
  - both parties have fulfilled their obligations partially and to an equal extent.
- An executory contract establishes a right and an obligation to exchange economic resources. The entity has:
  - an **asset** if the terms of exchange are **favourable**; or
  - a liability if the terms of exchange are **unfavourable**.
- To the extent that a party fulfils its obligations under the contract, the contract ceases to be executory.
  - If the reporting entity performs first under the contract, that **performance** is the event that changes the reporting entity's right and obligation to exchange economic resources into a right to receive an economic resource (ie an asset).

Conceptual Framework ED paragraphs 4.40-4.42.

Conceptual Framework ED: Assets—control

An asset is a present economic resource controlled by the entity as a result of past events.

Control links the economic resource to the entity.

An entity controls an economic resource if it has the present ability to direct the use of the economic resource and obtain the economic benefits that flow from it.

This aspect of control does not imply that the entity can ensure that the resource will produce economic benefits in all circumstances.

Instead, it means that if the resource produces economic benefits, the entity is the party that will receive them.

Conceptual Framework ED paragraphs 4.5, 4.17-4.18 and 4.21.

Conceptual Framework ED: Assets—economic resource

An economic resource is a right that has the potential to produce economic benefits.

Rights that constitute economic resources may take many forms, including rights established by contract, legislation or similar means.

The economic resource is the existing right, not the future economic benefits

For the economic resource to have the potential to produce economic benefits, it need not be certain, or even probable, that the resource will produce economic benefits.

It is only necessary that the economic resource already exists and that there is at least one circumstance in which it would produce economic benefits.

Conceptual Framework ED paragraphs 4.6, 4.8, 4.13 and 4.15.

Conceptual Framework ED: Recognition

Recognition is the process of capturing an asset or a liability for inclusion in the financial statements

Exposure Draft

- Meet the definition of an asset or a liability
- Criteria to consider in deciding whether to recognise an asset or a liability:
  - relevance;
  - faithful representation; and
  - cost/benefit.

If one or more of the following factors apply, recognition might not provide relevant information:

- Uncertainty about the existence of an asset or liability
- Low probability of an inflow or outflow of economic benefits to/ from the entity
- Level of measurement uncertainty is so high that the resulting information has little relevance

Conceptual Framework ED paragraphs 5.2, 5.9 and 5.13.

Conceptual Framework ED:
What is prudence?

Does not prohibit recognition of unrealised gains - if that information is useful

Prudence - the exercise of caution when making judgements under conditions of uncertainty

- Supports neutrality:
  - means that assets and income are not overstated and liabilities and expenses are not understated
  - does not allow for the understatement of assets and income or the overstatement of liabilities and expenses

No ‘cookie jar’ reserves

Conceptual Framework ED paragraph 2.18.

Conceptual Framework ED:
What is neutrality?

A neutral depiction is without bias. It is not slanted, weighted, emphasised, de-emphasised or otherwise manipulated to increase the probability that financial information will be received favourably or unfavourable by investors.

Selection of neutral accounting policies:

- Permits, but does not require, accounting policies that treat assets differently to liabilities and gains different to losses (eg existing treatment of contingent assets and contingent liabilities)
- Requires impairment for assets measured at cost
- Does not require an entity to recognise the value of the entire entity in its balance sheet
- Does not require the recognition of all assets and liabilities
- Does not require fair value measurement of all assets and liabilities

Key question:
Does the accounting policy result in useful information for investors?

Conceptual Framework ED paragraphs 2.17 and BC2.13-BC2.14.

Conceptual Framework ED:
IASB rejects asymmetric prudence

Asymmetric prudence

- systematically requiring more evidence to support the recognition of gains (or assets) than of losses (or liabilities)
- systematically requiring the selection of cost-based measurements

The IASB supports neutrality and rejects asymmetric prudence because:

- Introducing a conservative bias in measurement would increase the subjectivity of financial statements (how much bias is a good thing?) and reduce comparability
- Measuring assets and liabilities at current value, even if those current values need to be estimated, can provide useful information (eg many financial instruments)

Conceptual Framework ED paragraph BC2.14.

Further information

- Discussion Paper *Reporting the Financial Effects of Rate Regulation*

  http://www.ifrs.org/Current-Projects/IASB-Projects/Rate-regulated-activities/Discussion-Paper-September-2014/Documents/Discussion-Paper-Reporting-Financial-Effects-Rate-Regulation-September-2014.pdf

- *Rate-regulated Activities* project page

  http://go.ifrs.org/Rate-regulation

- Exposure Draft *Conceptual Framework for Financial Reporting*

  http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/ED_CF_MAY%202015.pdf

- *Conceptual Framework* project page

  http://go.ifrs.org/Conceptual-Framework