

# STAFF PAPER

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## IASB

Project	Rate-regulated Activities		
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### Purpose of the paper

1. This paper reproduces, the contents of Agenda Paper 3 *Responding to issues raised in ASAF discussions*, presented at the December 2016 meeting of the Accounting Standards Advisory Forum (ASAF).<sup>1</sup> The paper does not contain any specific questions for the Board. It is presented to provide further background to the core features of the model described in Agenda Paper 9A. This paper summarises:
  - (a) concerns expressed by members of ASAF in discussions about the development of a new accounting model intended to enhance the way that the financial effects of rate regulation are presented in IFRS financial statements; and
  - (b) how those concerns are addressed in the staff's preliminary proposals for the new accounting model.
2. To help ASAF members consider the proposals, the core principles and features of the model were further outlined in Appendix A to ASAF Agenda Paper 3. Appendix A is not reproduced here. Instead, the contents of Appendix A have been expanded in Agenda Paper 9A *Overview of the core features of the model* presented in the Board's December 2016 meeting. As a result, paragraph

<sup>1</sup> Paragraphs 5-40 of ASAF Agenda Paper 3 are reproduced as paragraphs 5-40 of this paper. Introductory paragraphs 1-4 of ASAF Agenda Paper 3 have been modified to introduce this paper.

references to Appendix A of ASAF Agenda Paper 3 have been updated in this paper to the equivalent content in Board Agenda Paper 9A.

3. In December 2016, staff are asking ASAF members whether the core principles and features of the model address their concerns raised in earlier discussions. At this time, staff will not ask the ASAF to consider detailed proposals to be included in the model. The Board will be asked to consider the detailed proposals in early 2017, after considering an overview of the model in its December 2016 meeting.

### Structure of the paper

4. The paper contains the following information:
  - (a) Background (paragraphs 5-6);
  - (b) A summary of the concerns expressed by ASAF members and how they have been addressed in the proposed new model;
    - (i) scope (paragraphs 7-10);
    - (ii) interactions with other IFRS Standards and the *Conceptual Framework* (paragraphs 11-32); and
    - (iii) segregating identifiable rate adjustments from the overall changes in value of the regulatory licence/agreement (paragraphs 32-36).
  - (c) Questions for ASAF members (paragraph 37);
  - (d) Next steps (paragraphs 38-40); and
  - (e) An overview of the core principles and features of the model (Appendix A) [as explained in paragraph 2, this appendix has been deleted in this paper—refer to Agenda Paper 9A for expanded content].

### Background

5. Since the publication of the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the DP) in September 2014, the Board has heard that the combination of rights and obligations created by the type of ‘defined rate regulation’ described in the DP may not always be faithfully represented by the

existing predominant IFRS practice.<sup>2,3</sup> In line with the feedback from the DP and subsequent outreach, the staff have been developing an accounting model that would result in the recognition of at least some regulatory assets and regulatory liabilities.

6. The ASAF has contributed to the staff's exploration of the issues through its meetings in December 2014, July 2015, October 2015, April 2016 and September 2016. In providing their advice, ASAF members have highlighted the need for staff to address a number of concerns when developing the accounting model.

## Concerns expressed by ASAF members

### Scope

7. ASAF discussions about scope have focused on the description of 'defined rate regulation' contained in the DP (see Appendix B of Board Agenda Paper 9A). ASAF members expressed concerns that this description is not sufficiently precise to determine the scope of an accounting model to recognise regulatory assets or regulatory liabilities. In particular, comments suggested that the scope should focus more precisely on the enforceable rights and obligations that are created by the rate regulation, with the key features described in the DP used as 'supporting factors or indicators'.
8. In response to these concerns, the model does not focus on the general rate-regulatory regime but, instead, focuses on specified regulatory adjustments that arise through the rate-setting mechanism. To ensure that the scope of the model is tightly drawn, it focuses on specified regulatory adjustments that:
  - (a) arise from identifiable timing differences between performance of the entity vs performance of customers; and

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<sup>2</sup> The overview of the features of 'defined rate regulation' contained in paragraphs 4.4-4.7 of the DP is reproduced in Appendix A of December 2016 Board Agenda Paper 9A *Overview of the core features of the model*.

<sup>3</sup> The existing predominant IFRS practice applies existing IFRS Standards without modification. As a result, few entities recognise regulatory assets or regulatory liabilities.

- (b) result in regulatory balances that are included, or expected to be included, by the rate regulator in establishing the rate(s) that can be charged to customers.
9. The regulatory adjustments are specified in the context of the rights and obligations contained in enforceable regulatory agreements. Those agreements need to establish a clear link between an entity's right to a determinable amount of compensation/funding in exchange for satisfying specified regulatory obligations.
10. Staff still consider that the description of defined rate regulation used in the DP is useful when assessing the strength or enforceability of the rate regulation. We intend to incorporate the key features from the DP into the model as factors or indicators to be considered when assessing how and when regulatory balances are likely to reverse.

### ***Interactions with other IFRS Standards and the Conceptual Framework***

11. ASAF discussions highlighted that any new accounting model to recognise regulatory assets and regulatory liabilities ought to:
- (a) focus on the 'customer-base', instead of individual customers (paragraphs 12-14);
  - (b) identify clear principles to define 'performance' in a rate-regulated context and to identify when revenue should be recognised for that performance. In particular, ASAF members suggested that the model should distinguish between revenue recognised in accordance with IFRS 15 *Revenue from Contracts with Customers* and any 'regulatory revenue' recognised, avoiding any double-counting of revenue (paragraphs 15-18);
  - (c) consider the 'balance sheet perspective' as well as the performance perspective. This means that any model developed should reflect the definitions of, and criteria for recognising, assets and liabilities (paragraphs 19-23);

- (d) apply caution when recognising regulatory assets, particularly when dealing with longer-term items that are intended to be recovered through rates over several years (paragraphs 24-27); and
- (e) address whether the situation in which an entity is prohibited from recovering the carrying amount of an asset from customers (eg because it has already received funding through a government grant or previous billings to customers) should result in:
  - (i) the asset being impaired; or
  - (ii) the recognition of a regulatory adjustment (paragraphs 28-32).

### *The customer-base*

12. The rate regulator has the power to impose a rate on customers that includes compensation/funding for the entity's past or future satisfaction of its regulatory obligations. The rate regulator uses this power, through the rate-setting mechanism, to smooth rate changes and fluctuations, and consequently cash flows, for individual customers. The regulator does this by imposing rate adjustments prospectively on customers as a group (ie as a single 'customer-base'), without distinguishing between old and new customers.
13. Commonly, the regulated rate shown on bills to customers does not distinguish between the different aspects of the rate calculation. From an individual customer perspective, the regulated rate is the contractual consideration payable in exchange for the goods or services received in the period. Consequently, the composition of the rate is not relevant to the terms of the contracts with customers.
14. Because the regulated rate may include adjustments that relate to goods or services transferred to customers in past periods, or to be transferred to customers in future periods, the customer-base may, at any point in time, have either 'underpaid' or 'overpaid' for the goods or services it has consumed in a period. If the customer-base has underpaid, the entity is not entitled, based on the terms of the contracts with individual customers, to bill individual customers retrospectively for the amount underpaid. Instead, this underpayment is included in the regulated rate chargeable to all individuals within the customer-base in the

future. Similarly, if the customer-base has overpaid, the individual customers within the customer-base are not entitled to a refund or credit for a proportion of the amount overpaid. Instead, this overpayment is included in the regulated rate chargeable to all individuals within the customer-base in the future.

*Principles to define 'performance' and distinguish revenue*

15. To address the concerns in paragraph 11(b), the model:
  - (a) applies a supplementary approach; ie an entity applies other IFRS Standards, including IFRS 15, before applying the model (paragraphs A2-A3 [paragraphs 16-17 of Board Agenda Paper 9A]);
  - (b) focuses on the transfer of goods, services or other economic benefits to define performance; and
  - (c) distinguishes between the transfer of goods and services to customers (ie the satisfaction of performance obligations identified in contracts with individual customers) and the satisfaction of other obligations created by the regulatory agreement, which may or may not involve the delivery of goods or services to the rate regulator or other parties (paragraphs A13-A17 [paragraphs 23-37 of Board Agenda Paper 9A]).
16. Before applying the model, revenue is recognised when (or as) the entity satisfies performance obligations in accordance with IFRS 15. Revenue is measured using the transaction price included in the contracts with individual customers, ie the regulated rate (paragraph A13 [paragraph 14 of Board Agenda Paper 9A]). This reflects the contractual rights and obligations between the entity and its individual customers.
17. The model then highlights the rate regulator's intervention in establishing the regulated rate. The rate regulator establishes the amount that the entity is entitled to charge the customer-base in exchange for satisfying its regulatory obligations. The rate regulator then determines when the entity can include, through the regulated rate used in bills to individual customers, the amount to be charged to the customer-base as a whole. This intervention by the rate regulator results in imbalances between the timing of performance of the entity (by satisfying its regulatory obligations) and the performance of the customer-base (by consuming

the regulated goods or services or by making payments). The model recognises regulatory assets and regulatory liabilities to reflect these timing differences.

18. Staff propose that the net increase or decrease in the sum of regulatory assets and regulatory liabilities resulting from such timing differences is presented separately as a net regulatory adjustment in the statement(s) of profit or loss and other comprehensive income. To inform users of the financial statements about how the regulatory rights and obligations between the entity and the customer-base interact with the contractual rights addressed by IFRS 15, the entity discloses, in the notes, an analysis of the net adjustment showing:
- (a) originations and reversals of regulatory adjustments; and
  - (b) the nature of those adjustments (paragraphs A14-A15 [paragraph 47 of Board Agenda Paper 9A]).

*The balance sheet perspective*

19. The model focuses on the rights and obligations of the entity and the customer-base contained in the regulatory agreement (paragraphs A4-A8 [paragraphs 18-22 of Board Agenda Paper 9A]) in a similar way that IFRS 15 focuses on the rights and obligations of the entity and an individual customer in a contract with that customer. The rights and obligations in the regulatory agreement result in an exchange of resources that, at the inception of the agreement, is equally unperformed. The subsequent exchange involves:
- (a) the transfer by the entity of goods, services or other economic resources to customers, the rate regulator or other parties, thereby satisfying the entity's regulatory obligations; and
  - (b) the receipt by the entity of the compensation/funding to which it is entitled in exchange for satisfying those regulatory obligations. This compensation/funding is usually payable by the customer-base although, in some cases, the rate regulator or another party may also contribute an amount, eg through a government grant.
20. The model uses a historical cost measurement basis. It does not try to determine whether the amount of compensation/funding receivable from the customer-base represents the 'fair value' of the economic resources transferred in exchange for

that amount. Consequently, there is no ‘net’ asset or net liability to recognise at the inception of the regulatory agreement, because the exchange of resources set out in the agreement is equally unperformed; ie it is executory.<sup>4</sup>

21. It could be argued that, at the inception of the regulatory agreement, the entity could apply a gross presentation approach and recognise a regulatory asset and a regulatory liability of an equal amount. The asset would represent the overall compensation/funding to which the entity is entitled; the liability would represent its wholly unfulfilled regulatory obligations.
22. However, a gross presentation is not usually used in IFRS Standards for the asset and liability arising from the combined rights and obligations contained in an executory contract. The reason for this is explained in paragraph 4.41 of the Exposure Draft *Conceptual Framework for Financial Reporting* (the *Conceptual Framework* ED), published in May 2015, which states:

Entering into the contract [the regulatory agreement] is the activity that establishes the extent of the entity’s right and obligation to exchange economic resources. That right, and the obligation to exchange economic resources, are interdependent and cannot be separated. Hence, the combined right and obligation constitute a single asset or liability. The entity has an asset if the terms of the exchange are favourable; it has a liability if the terms are unfavourable. . . .

23. As either party performs, ie fulfils or partially fulfils its obligations, the agreement ceases to be executory to the extent that the performance of one party exceeds the performance of the other party (or parties). If the entity performs first in fulfilling its regulatory obligations, for example, by transferring goods or services to customers, 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). If the customer-base perform first, for example by paying in advance of the entity fulfilling its regulatory obligations, that

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<sup>4</sup> Appendix A and paragraph 4.40 of the Exposure Draft *Conceptual Framework for Financial Reporting*, published in May 2015, defines an executory contract as “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.”



performance is the event that changes the reporting entity's right and obligation to exchange economic resources into an obligation to transfer an economic resource (ie a liability).<sup>5</sup>

#### *Caution when recognising regulatory assets*

24. Some ASAF members advised that caution should be applied when recognising regulatory assets, particularly when dealing with longer-term items that are intended to be recovered through rates over several years.
25. In principle, there is no reason to treat regulatory liabilities and regulatory assets differently when they arise from the same rate-setting mechanism. Consequently, the criteria used to recognise and measure each regulatory adjustment identified using the model will be the same.
26. However, the longer the period over which a regulatory balance will be reversed through the regulated rate, the greater the risk that conditions may change before the balance fully reverses. The entity must therefore, when assessing whether a regulatory balance is expected to be included in establishing the future rate, consider the enforceability of the rate regulation through the period over which the balance is expected to be reversed (see paragraph A7 [paragraph 21 of Board Agenda Paper 9A]).
27. The model requires the reassessment of the entity's expectations at each reporting date. The regulated balances recognised will be adjusted, if appropriate, to reflect any changes in those expectations.

#### *No future recovery of asset carrying amounts*

28. ASAF members discussed situations in which an entity is prohibited from recovering the carrying amount of an asset from customers through rates in the future. This situation arises when the entity has already been compensated for the cost of the asset, eg because it has already received funding through a government grant or previous billings to customers. Some ASAF members are concerned that there may be some overstatement of the entity's assets if the asset in point is not impaired.

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<sup>5</sup> See paragraph 4.42 of the *Conceptual Framework* ED.

29. In the case of an entity receiving a government grant, staff consider that the existing requirements of IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* adequately address this point. Paragraph 12 of IAS 20 requires:

Governments grants shall be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grant is intended to compensate.

30. In a defined rate regulation environment, an entity is typically not permitted to recover the cost of constructing an asset through rates if the entity has already been compensated for that cost through a government grant. By applying IAS 20, the compensation received will be recognised through profit or loss on the same basis that the cost of the related asset is recognised as an expense.<sup>6</sup> Paragraph 24 of IAS 20 permits an entity to apply either a net presentation or gross presentation approach.

(a) In the net presentation approach, the grant is deducted from the carrying amount of the asset.

(b) In the gross presentation approach, the grant is initially recognised in the balance sheet and then is recognised in profit or loss on a systematic basis, usually on the same basis as the depreciation of the asset to which it relates.

31. When the gross presentation approach of IAS 20 is applied, the inability of the entity to generate future cash inflows to recover the asset's carrying amount through the regulated rate does not require the entity to impair the asset. This is because the recoverable amount of the asset (or the cash-generating unit of which it forms a part) cannot be determined without considering the recognised balance of the related grant.<sup>7</sup>

32. The staff proposals for the new model apply a similar principle to IAS 20. If amount charged to customers includes an amount that prefunds the construction of an asset, the prefunded amount is recognised as a regulatory liability. It is then

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<sup>6</sup> See paragraphs 12 and 15-18 of IAS 20.

<sup>7</sup> See paragraphs 75-76 of IAS 36 *Impairment of Assets*.

recognised in profit or loss on a systematic basis, usually on the same basis as the depreciation of the asset to which the prefunding relates.

***Segregating amounts from the overall value of the regulatory licence/agreement.***

33. Some ASAF members suggested that the combination of rights and obligations created by the regulatory agreement/licence form a single intangible asset. They questioned why we have been looking to develop a model that recognises individual regulatory assets and regulatory liabilities, instead of looking to recognise a single intangible asset. The intangible asset approach was considered in the DP.<sup>8</sup>
34. Staff agree that the combination of rights and obligations created by the regulatory agreement/licence form part of an intangible asset. However, we consider that the intangible asset forms a part of, but is not separable from, the business as a whole or goodwill. This is because the rights and obligations created by the type of regulatory agreement within the scope of the proposed model are pervasive throughout the business. In addition, any changes in the value of such an intangible asset would, by their nature, include amounts that relate to future cash flows, transactions and events, including the associated profit of those future transactions.
35. Recognising the value of the intangible asset, and subsequent changes in the value, would require an accounting model that would be very different from the existing requirements of IAS 38 *Intangible Assets*. It would also involve a significant level of measurement uncertainty in respect of the future transactions of the entity. Consequently, few respondents to the DP expressed support for such a model to be developed, for both conceptual and practical reasons.
36. Although the model being proposed will not capture the full extent of the financial effects of the rate regulation, staff suggest that it will improve the relevance of the financial information provided to users of financial statements. This is because, by recognising regulatory adjustments that can be identified and measured with a reasonable level of certainty, the model will capture the variability in cash flows

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<sup>8</sup> Paragraphs 5.35-5.46 of the DP discussed a possible intangible asset model approach.

imposed on the entity by the rate regulator as a consequence of past actions by the entity.

### Questions for ASAF members

37. ASAF members are asked the following questions:

#### Questions for ASAF members

Do the core principles and key features of the model address ASAF members previously expressed concerns about:

- (a) scope;
- (b) interactions with other IFRS Standards and the Conceptual Framework; and
- (c) segregating identifiable rate adjustments from the overall changes in value of the regulatory licence/agreement?

If not, what concerns have not been addressed?

### Next steps

38. In an education session at the Board's December 2016 meeting, staff will present an overview of its preliminary proposals for the model. We will highlight the input received from ASAF members and other stakeholders and how that input has contributed to the development of our proposals.
39. Staff will continue to develop the core principles and features outlined in this paper and present further details of the proposals to the Board in early 2017. Staff will seek decisions from the Board about detailed proposals for the model on scope, recognition and derecognition, measurement, presentation and disclosure.
40. Staff will propose to the Board that the details of the proposed model, together with the Board's views on the model, are published for consultation with stakeholders in a second Discussion Paper.