

STAFF PAPER

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Project	Rate-regulated Activities		
Paper topic	The model's general approach		
CONTACT(S)	Jane Pike	jpike@ifrs.org	+44 (0)20 7246 6925
	Michael Stewart	mstewart@ifrs.org	+44 (0)20 7246 6922

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Purpose of the paper

1. This paper summarises the objective, underlying principle and general approach of a new accounting model to more faithfully represent financial effects of **defined rate regulation**. It outlines the basis for the approach and asks the Board whether it agrees with our analysis and suggested approach.

Summary of the objective, underlying principle and general approach

2. The objective of the model is to inform users of financial statements about the nature, amount, timing and uncertainty of 'regulatory performance adjustments' and cash flows arising from a regulatory agreement between the entity and a rate regulator.¹
3. To meet this objective, the core principle of the model is that an entity recognises 'regulatory performance adjustments' to depict the transfer of rate-regulated goods or services to the customer base (see paragraphs 16-20) in an amount that reflects the compensation to which the entity expects to be entitled in exchange for those goods or services.

¹ The objective and core principle described in paragraphs 3-4 are based on those in paragraphs 1-2 of IFRS 15 *Revenue from Contracts with Customers*, except 'revenue' is replaced with 'regulatory performance adjustment' and 'contract with a customer' is replaced with 'regulatory agreement between the entity and a rate regulator'.

4. The premise of the model is that, at the start of a regulatory agreement, neither the entity nor the customer base has performed under the regulatory agreement and so the agreement is executory. At this time, the entity records the regulatory agreement as a net zero position, consistently with the existing IFRS treatment for executory contracts. Subsequently, as one party performs in a way that is disproportionate to the other, the agreement ceases to be executory and an asset or liability is recognised to reflect this imbalance in performance.
5. The model supplements existing IFRS Standards. This means that a regulatory asset or regulatory liability will be recognised using the model only to the extent that it is not already recognised by applying other IFRS Standards. Consequently, a rate-regulated entity will apply the requirements of other IFRS Standards without amendment, before applying the model.
6. As a result, we suggest that the model be contained in a separate IFRS Standard to replace IFRS 14 *Regulatory Deferral Accounts*, instead of being developed as an amendment to, or interpretation of, any existing IFRS Standard.

Overview

7. This paper contains the following information:
 - (a) Summary of the objective, underlying principle and general approach (paragraphs 2-6);
 - (b) Background (paragraphs 8-20):
 - (i) The regulatory agreement (paragraphs 10-15); and
 - (ii) The customer base (paragraphs 16-20).
 - (c) Staff analysis (paragraphs 21-29):
 - (i) Using the *Conceptual Framework* and IFRS 15 to develop a principle-based model (paragraphs 21-25); and
 - (ii) Using the principles of IFRS 15 (paragraphs 26-29).
 - (d) The supplementary approach (paragraphs 30-32);
 - (e) Relationship between the model and IFRS 15 (paragraphs 33-40); and
 - (f) Question for the Board.

Background

8. As noted in paragraph 7 of Agenda Paper 9 *Cover note and summary of the model*, the message we received from stakeholders is clear that an accounting model developed to improve the financial reporting for the distinguishable rights and obligations created by defined rate regulation should:
- (a) recognise as regulatory assets and regulatory liabilities only those regulatory adjustments that are consistent with the definitions of assets and liabilities in the *Conceptual Framework*;
 - (b) use the principles of IFRS 15 *Revenue from Contracts with Customers* to provide a principle-based framework for recognising regulatory adjustments; and
 - (c) provide transparent and understandable information about the effects of the rate regulator's intervention on the entity's financial position, performance and cash flows.
9. Consequently, we have looked to apply the principles of IFRS 15 (and other IFRS Standards), together with the Board's latest thinking in the *Conceptual Framework* project. The following paragraphs explain in more detail how the model's general approach reflects the stakeholder feedback.

Background—the regulatory agreement

10. The regulatory agreement establishes the entity's right and obligation to exchange resources with its customer base. The regulatory agreement:
- (a) imposes obligations on the entity to transfer specified goods and services to the entity's customers collectively, the rate regulator or other designated parties; and
 - (b) gives the entity the right to a determinable amount of compensation in exchange for satisfying these regulatory obligations. This determinable amount of compensation is often referred to as the 'revenue requirement'.

11. The regulatory agreement identifies what goods or services are subject to the rate regulation. It also establishes quality, safety or other performance specifications for them. Such performance specifications commonly oblige the entity to deliver the specified goods or services continuously or *on demand*. This means that the entity needs to ensure that it has the assets and infrastructure in place to ensure that it is able transfer the rate-regulated goods or services to customers without disruption to supply.
12. The rate regulator establishes, usually in consultation with the entity, the necessary capital expenditure and operating expenditure that the entity is expected to incur over a specified period to satisfy its regulatory obligations. Such budgets and forecasts will be based on expected levels of demand for the regulated goods or services, together with targeted performance levels.
13. Having determined the expected costs to the entity of satisfying its regulatory obligations, the rate regulator establishes the revenue requirement and the payment schedule for the entity's reporting period(s) covered by the regulatory agreement. This determines the amount of the revenue requirement that the entity is entitled to bill customers in each period. In setting the payment schedule, the rate regulator typically looks to reduce rate volatility for customers collectively and to deal in an equitable way (for both the entity and customers) with changes in the cost of satisfying the entity's regulatory obligations. Establishing a payment schedule also provides greater predictability of cash inflows for the entity.
14. Consequently, the payment schedule may not reflect the timing of when the entity satisfies its regulatory obligations. This means that, at any point in time, the cumulative amount billed or billable to customers collectively (and recognised as revenue by applying IFRS 15), may not equal the amount to which the entity is entitled in exchange for satisfying, or partially satisfying, its regulatory obligations. The cumulative amount billed or billable may:
 - (a) include amounts that relate to regulatory obligations that will be satisfied in the future; or
 - (b) exclude amounts that relate to regulatory obligations that the entity has already satisfied but that will be billed in future periods.

15. In some cases, the rate regulator or other designated party may pay part of the agreed funding to the entity, for example, by providing a government grant. More commonly, the rate regulator imposes the obligation to pay on the entity's customers collectively, ie the customer base.

Background—the customer base

16. When establishing the overall terms of the regulatory agreement, the rate regulator views the entity's customers as a single body—the customer base. The notion of the customer base is an important feature in defined rate regulation. The term customer base is used to describe the entity's customers as a collective group, without distinguishing between old and new customers. Consequently, although the identity of individuals within the group may change, overall rights and obligations between the entity and the customer base remain unchanged.
17. As noted in paragraph 13, the rate regulator establishes a payment schedule for the revenue requirement. The rate regulator uses the regulated rate to allocate the total revenue requirement for each period between the individual customers within the customer base. This allocation may be based on the estimated number of customers within the customer base or the estimated volume of goods or services expected to be delivered through the specified period(s) of the regulatory agreement, or a combination of both.
18. Within the customer base, the rate regulator may identify sub-groups with different characteristics to whom a larger or smaller proportion of the total revenue requirement is allocated. However, within each sub-group, the rate regulator does not, as noted previously, distinguish between old or new customers. This means, for example, that if the entity has billed the customer base an amount that relates to regulatory obligations that it will satisfy in the future:
 - (a) a new customer will benefit when joining the customer base because that customer will pay a lower rate for future goods or services; and
 - (b) a customer that leaves the customer base will suffer because they have, in effect, pre-paid an amount for future goods or services that they will not receive.

19. The allocation of the revenue requirement is reflected in, and actioned through, the regulated rate that is contained in the individual contracts between the entity and the customer-base. As a result, the entity and its customer-base are not free to negotiate the pricing or payments terms of the contracts between them—both are bound by the terms imposed on them by the rate regulator.
20. The concept of the customer base transfers demand risk from the entity to the customer base. This is because, if individual customers cease, reduce, or increase their consumption of the regulated goods or services, the rate-setting mechanism adjusts the regulated rate to be charged to the members of the customer base in a future period. Consequently, although the identity of individual customers may change, the entity's overall obligation to perform and right to be compensated is unaffected.

Staff analysis—using the Conceptual Framework and IFRS 15 to develop a principle-based model

21. The core principle of the model is that an entity recognises regulatory performance adjustments to depict the transfer of rate-regulated goods or services to the customer base in an amount that reflects the compensation to which the entity expects to be entitled in exchange for those goods or services (see paragraph 3. The entity's performance obligations and its right to receive compensation in exchange for satisfying those obligations are established through the regulatory agreement.
22. At the inception of the regulatory agreement, the exchange of resources is equally unperformed, ie it is executory. 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 to which the entity is entitled during the period of the regulatory agreement; the liability would represent its wholly unfulfilled regulatory obligations.
23. 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 *Conceptual Framework* ED, 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. . . .²

24. As the entity or the customer base performs in a way that is disproportionate to the other, the agreement ceases to be executory and an asset or liability is recognised to reflect this imbalance in performance.³ Recognising these assets and liabilities gives rise to a corresponding entry in the income statement. An asset represents the entity's right to be compensated for past performance that satisfied, or partially satisfied, its regulatory obligations. A liability represents the entity's obligation to satisfy specified regulatory obligations for which no further compensation, or reduced compensation, is receivable from the customer base because some compensation has already been received.
25. In our view, this concept of an initially executory contract and the recognition of an asset or a liability to reflect an imbalance in performance forms the basis of the requirements of IFRS 15. As a result, we have looked to develop the model using similar principles.

Staff analysis—using the principles of IFRS 15

26. IFRS 15 adopts a 'transfer model' in which revenue is recognised when, or as, an entity transfers a promised good or service to a customer. Paragraph BC20 of the Basis for Conclusions on IFRS 15 explains how the transfer model is consistent

² On 18 October 2016 the Board tentatively decided to confirm its decisions about executory contracts in the *Conceptual Framework* ED.

³ See paragraph 4.42 of the *Conceptual Framework* ED.

with the executory contract concept described in paragraphs 21-25.

Paragraph BC20 states that:

the boards decided that revenue should be recognised only when an entity transfers a promised good or service to a customer, thereby satisfying a performance obligation in the contract. That transfer results in revenue recognition, because in satisfying a performance obligation an entity no longer has that obligation to provide the good or service. Consequently, its position in the contract increases—either its contract asset increases or its contract liability decreases—and that increase leads to revenue recognition.

27. Paragraph BC21 of the Basis goes on to note that some stakeholders had asked the Board instead to develop an ‘activities model’ in which revenue would be recognised as the entity undertakes activities in producing or providing goods or services, regardless of whether those activities result in the transfer of goods or services to the customer. The Board’s reasons for rejecting such an approach are explained in paragraph 23 of the Basis for Conclusions on IFRS 15. Those reasons include:

. . . In an activities model, revenue arises from increases in the entity’s assets, such as inventories or work-in-progress, rather than only from rights under a contract. Consequently, conceptually, an activities model does not require a contract with a customer for revenue recognition, . . .

it would have been counterintuitive to many users of financial statements. . .

28. We think that these reasons are equally valid to reject an activities model for rate-regulated activities. Instead, using a transfer model that is consistent with the transfer model of IFRS 15 provides a principle-based framework for distinguishing between regulatory activities that:

- (a) create assets for use by the entity (which should not result in revenue or regulatory income recognition); and

- (b) transfer goods or services to the customer base or other parties (which should result in revenue or regulatory income recognition).

29. Consequently, we suggest that this supports the core principle of the model:

The core principle of the model is that an entity recognises regulatory performance adjustments to depict the transfer of rate-regulated goods or services to the customer base in an amount that reflects the compensation to which the entity expects to be entitled in exchange for those goods or services.

The supplementary approach

30. We recommend that the model supplements, but does not override, existing IFRS Standards. This means that a regulatory asset or regulatory liability will be recognised using the model only to the extent that the entity's rights and obligations arising from its rate regulated activities are not already recognised by applying other IFRS Standards. Consequently, a rate-regulated entity will apply the requirements of other IFRS Standards, including IFRS 15, without amendment, before applying the model.
31. We suggest this supplementary approach because, in our view, the entity's rights and obligations created by the regulatory agreement and those created by its contracts with individual customers, while being complementary, are distinct and subject to different risks. Consequently, we think that reporting the relationship between them separately would provide more relevant information to users of financial statements. This is because, in our view, such a supplementary approach:
- (a) enhances comparability of financial reporting across entities that are subject to different levels of rate regulation; and
 - (b) is more transparent in enabling users of financial statements to more clearly identify the recognised effects of the rate regulation.
32. We also think that the supplementary approach enables the Board to introduce the model within the scope of a separate IFRS Standard without making substantive

amendments to other IFRS Standards.⁴ This is beneficial because containing the specific requirements of the model within a separate IFRS Standard significantly reduces the risk of confusion and unintended consequences on the application of other IFRS Standards for entities outside the scope of the model. Such unintended consequences could include inappropriate analogies to the model being drawn by entities that are not subject to defined rate regulation.

Relationship between the model and IFRS 15

33. As a result of applying IFRS 15, an entity recognises revenue when (or as) it satisfies its contractual performance obligations (as defined in IFRS 15) by transferring a promised good or service to individual customers using the regulated rate. However, as previously noted, the regulated rate reflects the intervention of the rate regulator in establishing the payment schedule for the customer base. This means that the amounts billed to individual customers may not reflect the performance of the entity in relation to those individual customers during the period. This means that the imbalance between the performance of the entity and the customer base may differ from the imbalance in performance between the entity and the individual customers that is recognised as a receivable/ payable or a contract asset/ contract liability using IFRS 15. Consequently, the entity, by applying the model, may recognise regulatory assets or regulatory liabilities in addition to the contract assets/ liabilities and receivables/ payables that are recognised by applying IFRS 15. We explain further in the following paragraphs.

Relationship between contract assets, receivables and regulatory assets

34. In accordance with IFRS 15, when an entity performs first by satisfying a performance obligation in a contract with a customer before the customer performs by paying consideration, the entity has a contract asset—a right to consideration from the customer in exchange for goods or services transferred to the customer. Part of this contract asset may be recognised as a receivable, as

⁴ This is consistent with the approach used in IFRS 14 *Regulatory Deferral Accounts*.

explained in paragraph BC323 of the Basis for Conclusions on IFRS 15, which notes:

In many cases, that contract asset is an unconditional right to consideration—a receivable—because only the passage of time is required before payment of that consideration is due. However, in other cases, an entity satisfies a performance obligation but does not have an unconditional right to consideration, for example, because it first needs to satisfy another performance obligation in the contract. The boards decided that when an entity satisfies a performance obligation but does not have an unconditional right to consideration, an entity should recognise a contract asset in accordance with IFRS 15. The boards noted that making the distinction between a contract asset and a receivable is important because doing so provides users of financial statements with relevant information about the risks associated with the entity's rights in a contract. That is because although both would be subject to credit risk, a contract asset is also subject to other risks, for example, performance risk.

35. The model applies a similar principle to the relationship between the entity's satisfaction of its regulatory obligations and the performance of the customer base. When an entity performs first by satisfying a regulatory obligation before the customer base performs by making payments, the entity has a regulatory asset—a right to charge the customer base in exchange for goods or services transferred to the customer base or other designated parties. If part of that right is already recognised by applying IFRS 15, the entity uses the model to recognise the remaining right separately as a regulatory asset.⁵

Relationship between contract liabilities, payables and regulatory liabilities

36. Paragraph BC325 of the Basis for Conclusions on IFRS 15 notes that the act of invoicing the customer for payment does not indicate whether the entity has an unconditional right to consideration. That paragraph provides an example of

⁵ We discuss recognition criteria in more detail in Agenda Paper 9C *Recognition*.

when an entity can have an unconditional right to consideration before it has satisfied a performance obligation.

For example, an entity may enter into a non-cancellable contract that requires the customer to pay the consideration a month before the entity provides goods or services. In those cases, on the date when payment is due, the entity has an unconditional right to consideration. (However, in those cases, the entity should recognise revenue only after it transfers the goods or services.)

37. If an entity has an unconditional right to consideration but has not yet transferred the goods or services, the entity recognises a contract liability instead of revenue. When it subsequently transfers the goods or services, the contract liability is settled and the entity recognises revenue at that time.
38. In some cases, the entity may have an unconditional right to consideration from the customer base that includes amounts related to the future satisfaction of a regulatory obligation. Although the entity would recognise a receivable for the amount due, it would recognise:
- (a) a contract liability for any amount related to goods or services not yet transferred to the customer base (by applying IFRS 15); and
 - (b) a regulatory liability for any further amount related to regulatory obligations to be satisfied in a future period.
39. Paragraph BC326 of the Basis for Conclusions on IFRS 15 goes on to note:
- The boards observed that in some cases, an entity will have an unconditional right to consideration, even though the entity may be required to refund some or all of that consideration in the future. In those cases, the possible obligation to refund consideration in the future will not affect the entity's present right to be entitled to the gross amount of consideration. In those cases, the boards observed that an entity may recognise a receivable and a refund liability (for example, when a right of return exists).
40. In some cases, the entity may have an unconditional right to consideration from the customer base that includes amounts that will reduce, or are expected to

reduce, the regulated rate in a future period. This could arise when, for example, the entity has failed to meet a performance target and a penalty has been incurred to reflect the shortfall in performance. In such cases, the entity would recognise, by applying IFRS 15, revenue and a receivable for the unconditional amount due. The entity has no obligation to give individual customers a credit note or to refund cash for the regulatory penalty adjustment or variance adjustment.⁶ Instead, the entity recognises, using the model, a regulatory debit adjustment in profit or loss and a regulatory liability to reflect its obligation to deliver goods or services to the customer base at a reduced rate in a future period.

Question for the Board

Question for the Board

As noted in paragraph 9, we have looked to apply the principles of IFRS 15 (and other IFRS Standards), together with the Board's latest thinking in the *Conceptual Framework* project to develop the model's core principle and general approach, which are summarised in paragraphs 2-6.

Do you agree with our analysis and suggested approach?

⁶ If the entity has an obligation to give individual customers a credit note or to refund cash, this would be recognised as a provision or a financial liability by applying IAS 37 *Provisions, Contingent Assets and Contingent Liabilities* or IFRS 9 *Financial Instruments*.