

STAFF PAPER

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IASB Meeting

Project	Rate-regulated Activities		
Paper topic	Developing the model—recognition and uncertainty		
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Purpose of this paper

1. The purpose of this paper is to continue to develop the underlying basis for a new accounting model (the model) for rate-regulated activities. In particular, this paper considers the recognition criteria expected to be included in the forthcoming revised *Conceptual Framework for Financial Reporting* (the revised *Conceptual Framework*) and discusses the role of different types of uncertainty when deciding whether to recognise assets and liabilities.¹
2. This is an educational session to explore recognition issues. We will not ask the Board for any decisions.
3. Some of the issues around uncertainty raised in this paper also have an effect on measurement. We are seeking initial thoughts from Board members about these issues before bringing a paper to a future meeting that will cover the interaction between recognition and measurement.

¹ Some of the proposals in the Exposure Draft *Conceptual Framework for Financial Reporting* (the Conceptual Framework ED) have been updated for the Board's tentative decisions in subsequent discussions. Throughout this paper, all references to the Conceptual Framework ED are to those updated proposals. For ease of reference, paragraph numbers in footnotes refer to the location of the original proposals in the Conceptual Framework ED.

4. This paper contains:
- (a) Background (paragraphs 5–10);
 - (i) Recognition criteria (paragraphs 5-6); and
 - (ii) The Board’s tentative decisions to date (paragraphs 7-10).
 - (b) Staff analysis (Paragraphs 11–35):
 - (i) existence uncertainty (paragraphs 12–29);
 - (ii) outcome uncertainty (paragraphs 30–33); and
 - (iii) measurement uncertainty (paragraphs 34–35).
 - (c) Questions for the Board (paragraph 36); and
 - (d) Appendix A—illustrative examples.

Background

Recognition criteria

5. The Conceptual Framework ED notes that recognition is the process of capturing, for inclusion in the statement of financial position or the statement(s) of financial performance, an item that meets the definition of an element of the financial statements, ie an asset, a liability, equity, income or expenses. The Conceptual Framework ED identifies circumstances in which the recognition of a particular asset (or liability) may not provide useful information. Such circumstances include those in which there is uncertainty about the existence, outcome and measurement of the asset or liability.²
6. In October 2016, the Board tentatively decided that the revised *Conceptual Framework* should acknowledge that:
- (a) the exercise of prudence does not imply a need for asymmetry—for example, a systematic need to require more persuasive evidence to support the recognition of assets than of liabilities or to support the recognition of income than of expenses; and

² Paragraphs 5.2 and 5.9–5.21 of the Conceptual Framework ED.

- (b) in financial reporting standards such asymmetry may sometimes arise as a consequence of requiring the most useful information. In due course, we will ask the Board to decide whether any recognition criteria for the model are to be applied symmetrically to regulatory assets and regulatory liabilities or whether a higher threshold is to be applied for recognising regulatory assets than for recognising regulatory liabilities.

The Board's tentative decisions to date

7. The Board has tentatively decided not to develop an intangible asset model for the entire combination of rights and obligations arising from the regulatory agreement. Instead, the Board is developing a model that focuses on a defined narrow subset of those rights and obligations: the rights and obligations arising from temporary differences created by the rate-adjustment mechanism set out in the regulatory agreement.
8. In its June 2017 meeting, the Board discussed five examples that illustrate common types of temporary differences and related regulated rate adjustments. Each example showed how the model would recognise a regulatory asset or regulatory liability, together with a related regulated rate adjustment recognised in profit or loss. For each example, the Board tentatively agreed with the staff's conclusions about:
 - (a) the timing and amount of the originating adjustment; and
 - (b) the pattern and timing of the reversing adjustment(s).
9. The examples assumed the following simplifying assumptions, which meant that:
 - (a) there was no uncertainty that the regulatory asset or regulatory liability existed;
 - (b) there was a high probability that the regulatory asset or regulatory liability would result in an inflow or outflow of economic benefits; and
 - (c) the value of the economic benefit could be measured with a high level of certainty.

These simplifying assumptions meant that the Board could review the principles of the model and its basic application in straightforward situations.

10. In this paper, we remove those simplifications. We now consider the approach to decisions about recognition of regulatory assets and regulatory liabilities if there is uncertainty about the existence, outcome or measurement of the asset or liability. The analysis is the same for both assets and liabilities because the rate-adjustment mechanism applies equally to both situations.

Staff analysis

11. We discuss below three types of uncertainty that could arise in relation to a regulatory asset or regulatory liability:
- (a) existence uncertainty: uncertainty about whether the regulatory asset or regulatory liability exists;
 - (b) outcome uncertainty: uncertainty about the amount and timing of cash flows that may ultimately arise from the regulatory asset or regulatory liability; and
 - (c) measurement uncertainty: uncertainty about the measurement of the regulatory asset or regulatory liability.

Existence uncertainty

12. It may be uncertain whether a regulatory asset or regulatory liability exists. There are potentially two sources of existence uncertainty:
- (a) whether there is a binding regulatory agreement that creates for the entity a right to charge a favourable rate, or an obligation to charge an unfavourable rate; and
 - (b) whether a particular transaction or other event is captured within the rate-adjustment mechanism that creates the right to charge a favourable rate, or an obligation to charge an unfavourable rate.
13. We consider it unlikely that there will often be uncertainty about whether there is a binding regulatory agreement. Accordingly, we do not discuss that aspect further.

Amounts specified in the regulatory agreement

14. Amounts that have been approved by the rate regulator to be included in the favourable rate(s) to be charged to customers are usually evidenced in a formal notice from the rate regulator. This formal notice may take different forms but typically is included in a final ‘rate order’ or ‘rate determination’ document, which sets out the findings of fact and law supporting the rate regulator’s decisions. In some cases, the rate notice is merely issued by the rate regulator but in other cases it may be signed by both the rate regulator and the entity, forming a contractual agreement. Once such a formal notice exists, there is little or no uncertainty about the existence of the right.
15. However, at the time an entity is finalising its financial statements, it will commonly be ‘between rate reviews’. This means that, although the entity will have been tracking variances and other temporary differences through its record keeping system, some potential rate adjustments will not yet have been formally approved by the rate regulator.
16. In many circumstances the regulatory agreement is sufficiently precise that an entity is able to identify the temporary differences that the regulatory agreement specifies will be included in the rate-adjustment mechanism. For example, the regulatory agreement may specify that particular input costs will flow through to customers and any price variances from the amounts estimated in the previous rate determination will be included in the future rate through the rate-adjustment mechanism.
17. The regulatory agreement is binding on both the rate regulator and the entity. If the entity has maintained the appropriate records to provide sufficient evidence to support its calculation and its claim for an allowable estimation variance, then that evidence supports the existence of the entity’s right to charge the favourable rate. The right exists even if the entity has not yet submitted its regulatory returns to the rate regulator for formal ‘approval’.

Amounts not specified in the regulatory agreement

18. A regulatory agreement will not typically specify every transaction or event that it is intended to cover. Judgement may be needed to interpret the terms and conditions of the regulatory agreement to assess whether some items are within its

scope. For example, the regulatory agreement may explicitly allow for inclusion of ‘routine’ repair and maintenance costs in the calculation of the rate but a severe storm may result in the entity needing to incur significant ‘non-routine’ repair costs.

19. In such cases, it may be uncertain whether the rate regulator will approve a rate adjustment to reflect the unanticipated transactions or other events. Thus, in these cases, judgement is needed to assess whether the entity already controls a right to charge a favourable rate as a result of the past transaction or other event.
20. To support its assessment of whether it controls such a right, the entity could consider a variety of evidence, such as:
 - (a) previous formal approvals from the rate regulator allowing for a substantially similar temporary difference to be adjusted through the rate(s) (ie precedents);
 - (b) written ‘tentative’ approval for the rate adjustment from the rate regulator, giving an ‘approval in principal’ prior to the formal rate review;
 - (c) regulatory accounting guidance providing for the accounting treatment of substantially similar temporary differences that the regulator typically approves in the rate-adjustment mechanism; and
 - (d) analysis of the expected regulatory treatment from internal or external legal counsel on the basis of regulations and past practice.
21. In developing the model, the Board will need to consider whether, and if so when, an entity should recognise a regulatory asset or regulatory liability if it is uncertain whether the rate regulator will approve a regulated rate adjustment. In particular, the Board will need to consider whether to include a ‘recognition threshold’. Possible thresholds the Board could consider include virtual certainty, highly probable, probable (or more likely than not) and expected.
22. We have heard in outreach on this project that many stakeholders are concerned about the possibility of regulatory assets being recognised for items that may subsequently be rejected by the rate regulator. Such stakeholders are looking for a high degree of confidence that ‘regulatory income’ recognised in one period will

flow through in the cash flows of a future period or periods. Similarly, some may be concerned about an entity recognising revenue arising from amounts already billed to customers that may subsequently be negated by reductions in the rate(s) for future periods. Consequently, another factor the Board may need to consider is whether the threshold for recognition (if any) should be the same for regulatory assets as for regulatory liabilities. We highlight below some existing IFRS Standards that include a different threshold for an asset than for a liability.

Recognition thresholds in some existing IFRS Standards

23. IAS 12 *Income Taxes* requires, with limited exceptions, a deferred tax liability to be recognised for all taxable temporary differences, but a deferred tax asset is recognised only to the extent that it is **probable** that it can be utilised.³ (IAS 12 does not contain an explicit recognition threshold for current tax assets and current tax liabilities. It requires them to be measured at the amount ‘expected’ to be paid or recovered.)⁴
24. Judgement may be needed to interpret tax law. In June 2017 the Board issued IFRIC 23 *Uncertainty over Income Tax Treatments* (IFRIC 23). IFRIC 23 covers both current tax and deferred tax. It defines an uncertain tax treatment as a tax treatment for which there is uncertainty over whether the relevant taxation authority will accept the tax treatment under the law. There seem to be similarities between interpreting income tax legislation and regulations and interpreting rate regulations. Consequently, it seems logical to consider the guidance in IFRIC 23 when developing requirements for rate-regulated activities.
25. IFRIC 23 requires an entity to reflect an uncertain tax treatment if the entity considers it probable that the tax authority will accept that treatment. If acceptance is not probable, an entity is required to use either the expected value or the most likely amount, whichever better predicts the resolution of the uncertainty. For each uncertain tax treatment, or grouping of uncertain tax treatments, paragraphs 10-11 of IFRIC 23 state:

³ See paragraphs 15 and 24 of IAS 12.

⁴ See paragraph 46 of IAS 12.

- 10 If an entity concludes it is probable that the taxation authority will accept an uncertain tax treatment, the entity shall determine the taxable profit (tax loss), tax bases, unused tax losses, unused tax credits or tax rates consistently with the tax treatment used or planned to be used in its income tax filings.
- 11 An entity could reflect the effect of uncertainty about the regulatory treatment by using either of the following methods, depending on which method the entity expects to better predict the resolution of the uncertainty:
- (a) the most likely amount—the single most likely amount in a range of possible outcomes. The most likely amount may better predict the resolution of the uncertainty if the possible outcomes are binary or are concentrated on one value.
 - (b) the expected value—the sum of the probability-weighted amounts in a range of possible outcomes. The expected value may better predict the resolution of the uncertainty if there is a range of possible outcomes that are neither binary nor concentrated on one value.
26. Appendix A contains examples to illustrate how the most likely amount method and the expected value method might be applied to regulatory assets or regulatory liabilities. The examples are based closely on the examples illustrating IFRIC 23.
27. IFRS 15 *Revenue from Contracts with Customers* includes a threshold to constrain the amount of consideration included in the transaction price when the consideration promised in a contract includes a variable amount. As a consequence, the cumulative amount of revenue recognised is also constrained. Paragraph 53 of IFRS 15 requires an entity to estimate an amount of variable consideration using either the most likely amount or the expected value, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled. Paragraph 56 of IFRS 15 requires an entity to include variable consideration in the transaction price only to the extent that it is **highly probable** that a significant reversal in the cumulative amount of

revenue recognised will not occur when the uncertainty associated with the variable consideration is resolved.⁵

28. When the transaction price is estimated, an entity may receive consideration from a customer that it may not ultimately become entitled to. In such cases, paragraph 55 of IFRS 15 requires an entity to recognise a refund liability for any consideration received (or receivable) to which it does **not expect** to be entitled.

Disclosure

29. Whether or not an entity recognises a regulatory asset or regulatory liability that is subject to some existence uncertainty, it should consider what information to disclose. At a future meeting, the staff will present a paper for the Board to consider what disclosure requirements to include in the model.

Outcome uncertainty

30. Even after a rate regulator has formally approved a rate adjustment, it may be uncertain how much cash the entity will ultimately receive. In other words, although it may be certain that the entity controls an economic resource (a right that has the potential to generate economic benefits), the ultimate outcome (the amount and timing of those economic benefits) may be uncertain. Such uncertainty could arise when, for example:
- (a) the approved temporary difference is not expected to be fully recovered through rates before the next rate review. In this case there may be a risk that the rate regulator could renegotiate the remaining balance at the next rate review; or
 - (b) there is an unexpected fall in demand for the rate-regulated goods or services such that the remaining customers are unable to absorb the further increase in the rate that would be needed to recover the remaining approved rate adjustment balance.
31. The uncertainty about the amount of cash that the entity will receive may need to be reflected in the measurement of the regulatory asset or regulatory liability. We

⁵ The situation described in paragraph 56 of IFRS 15 is a case of outcome uncertainty. It is certain that the entity has the right to the variable consideration, but its ultimate amount is uncertain.

will ask the Board to consider at a future meeting how the measurement of a regulatory asset or regulatory liability should deal with uncertainty about the amount or timing of the future cash flows resulting from that asset or liability.

32. The Conceptual Framework ED states that in some (but not all) cases when there is a low probability of an inflow or outflow of economic benefits, recognising an asset or liability may not always provide useful information. Some commentators have expressed concern that, even after a rate regulator has formally approved a rate adjustment, there may be a low probability that an inflow of economic benefits will result. In such circumstances, they argue that recognising the regulatory asset or regulatory liability might not provide useful information. We have not seen evidence that this concern is valid.
33. Typically, the rate regulator takes into account the willingness and ability of customers to pay the favourable (higher) rate when approving the rate adjustment. The rate regulator assesses the expected level of demand for the rate-regulated goods or services and the anticipated effect of the approved change in the rate. In many rate-regulated environments, the rate regulator will use government statistics to evaluate the sensitivity of demand estimates. In addition, the entity's customers collectively form a sufficiently large base and, individually, have sufficiently limited ability to seek alternatives. Consequently, there is a high probability that a cash inflow or outflow will result from any approved regulated rate adjustment. Accordingly, we do not discuss that aspect of outcome uncertainty further.

Measurement uncertainty

34. The Conceptual Framework ED states that recognising an asset or liability might not always provide useful information if the level of measurement uncertainty would be so high that, even with supporting explanation, a single amount might not provide a sufficiently faithful representation of the measure. Although the formula for measuring the regulated rate adjustment may be reasonably clear, there may still be uncertainty about estimated inputs used in the calculation. However, we do not expect the level of uncertainty about those inputs to be any more significant than for estimates used to measure other types of assets and

liabilities recognised in financial statements. We do not, therefore, suggest that the model should include specific requirements to discuss whether to recognise regulatory assets or regulatory liabilities in conditions of high measurement uncertainty.

35. In due course, the model will establish requirements for how any resulting regulatory asset (or liability) is to be measured. The amounts calculated may require the use of estimates. However, many amounts recognised as assets and liabilities in financial statements are based on estimates. Consequently, we do not consider that the model would need to provide specific requirements relating to measurement uncertainty.

Questions for the Board

36. We are not making recommendations at this stage so are not asking Board members for decisions. Instead, we are seeking tentative views to help build the analysis for a future session on measurement and its interaction with recognition.

Questions for the Board

1. Do Board members have any comments on whether to include a probability threshold in any recognition criteria in the model?
2. Do Board members have any comments on whether recognition criteria should apply symmetrically to both assets and liabilities or whether a higher threshold should apply to the recognition of assets?
3. Do Board members have any other comments on issues discussed in this paper?

Appendix A—illustrative examples: recognising a regulatory asset in conditions of existence uncertainty

A1. The following examples are based closely on the Illustrative Examples accompanying IFRIC 23 *Uncertainty over Income Tax Treatments*.

Example 1: Expected value method is used

- A2. The regulatory agreement entitles Entity A to recover a variety of input costs and to include any estimation variances in the rate-adjustment mechanism. During the year, the entity modified its production process to use more expensive materials than previously. When finalising its financial statements, the entity included the additional input cost of the new materials in its regulatory return but was still awaiting approval from the rate regulator.
- A3. Entity A notes that the rate regulator’s decision on one input cost matter could affect, or be affected by, other input cost matters. Applying paragraph 6 of IFRIC 23, Entity A concludes that considering the regulatory treatments of all input costs in the regulatory return together predicts the resolution of the uncertainty better than considering them separately. Entity A also concludes it is not probable that the rate regulator will approve all the input costs. Consequently, Entity A applies the reasoning in paragraph 11 of IFRIC 23 to reflect the effect of the uncertainty about the amounts that the regulator will accept for inclusion in the rate-adjustment mechanism.
- A4. Entity A estimates the probabilities of the possible additional amounts that might be included in the rate-adjustment mechanism, as follows:

	Estimated additional amount CU ^(a)	Probability %	Estimate of expected value CU
Outcome 1	–	5%	–
Outcome 2	200	5%	10
Outcome 3	400	20%	80
Outcome 4	600	20%	120
Outcome 5	800	30%	240
Outcome 6	<u>1,000</u>	<u>20%</u>	<u>200</u>
		100%	650

(a) In these Illustrative Examples, currency amounts are denominated in ‘currency units’ (CU)

- A5. Outcome 5 is the most likely outcome. However, Entity A observes that there is a range of possible outcomes that are neither binary nor concentrated on one value. Consequently, Entity A concludes that the expected value of CU650 predicts the resolution of the uncertainty better than the most likely outcome of CU800.

Example 2: Most likely amount method is used

- A6. The regulatory agreement entitles Entity B to recover routine repair and maintenance costs and to include any estimation variances in the rate-adjustment mechanism. During the year, a severe storm resulted in the entity incurring significant 'non-routine' repair costs of CU100. When finalising its financial statements, the entity included the additional storm repair costs in its regulatory return but was still awaiting approval from the rate regulator.
- A7. Applying paragraph 6 of IFRIC 23, Entity B concludes that considering the regulatory treatment of the storm repair costs separately from other estimation variances in the regulatory return predicts the resolution of the uncertainty better than considering them together. Entity B also concludes it is not probable that the rate regulator will accept the entire amount of the storm costs. Consequently, Entity B applies the reasoning in paragraph 11 of IFRIC 23 to reflect the effect of the uncertainty in determining its repair cost temporary difference. Entity B concludes the most likely amount that the rate regulator will accept as an allowable estimation variance is CU90 and that the most likely amount predicts the resolution of the uncertainty better than the expected value.
- A8. Accordingly, in recognising and measuring its regulatory asset, Entity B calculates an allowable temporary difference based on the most likely amount of CU90 to reflect the effect of the uncertainty, instead of the amount based on Entity B's regulatory return (CU100).