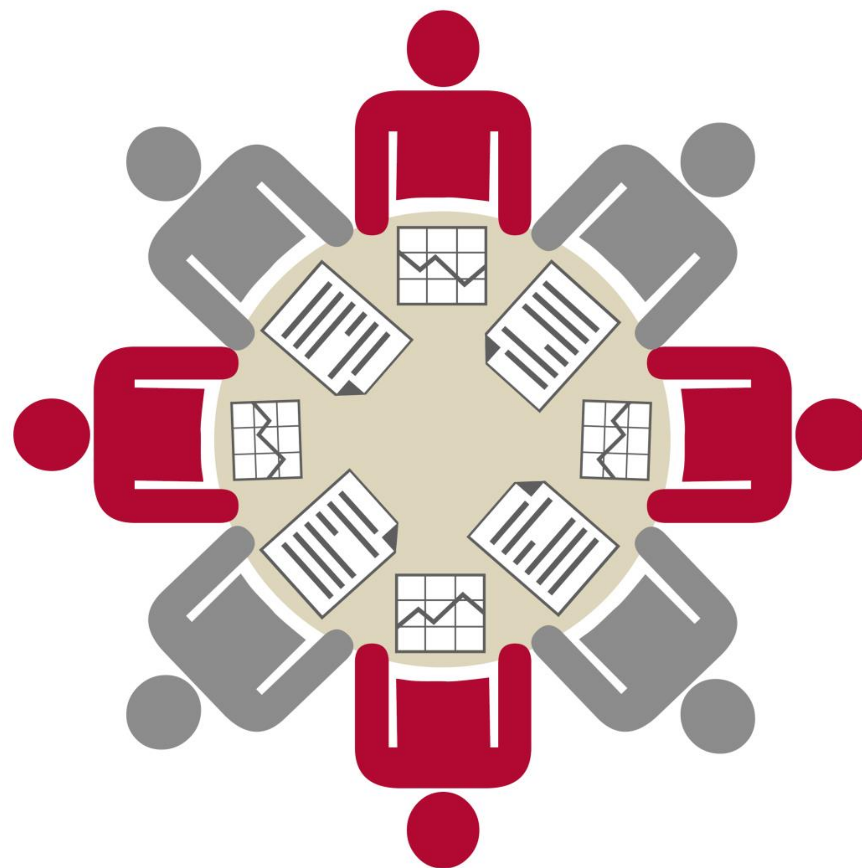
Agenda ref: AP2

Rate-regulated Activities:

Overview of the model and Board discussions

Consultative Group
October 2017



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Content

- Background
- The Board's discussions so far:
  - scope of the model
  - rights and obligations
  - uncertainty
  - effects of timing on cash flows
  - presentation and disclosure
- Appendix

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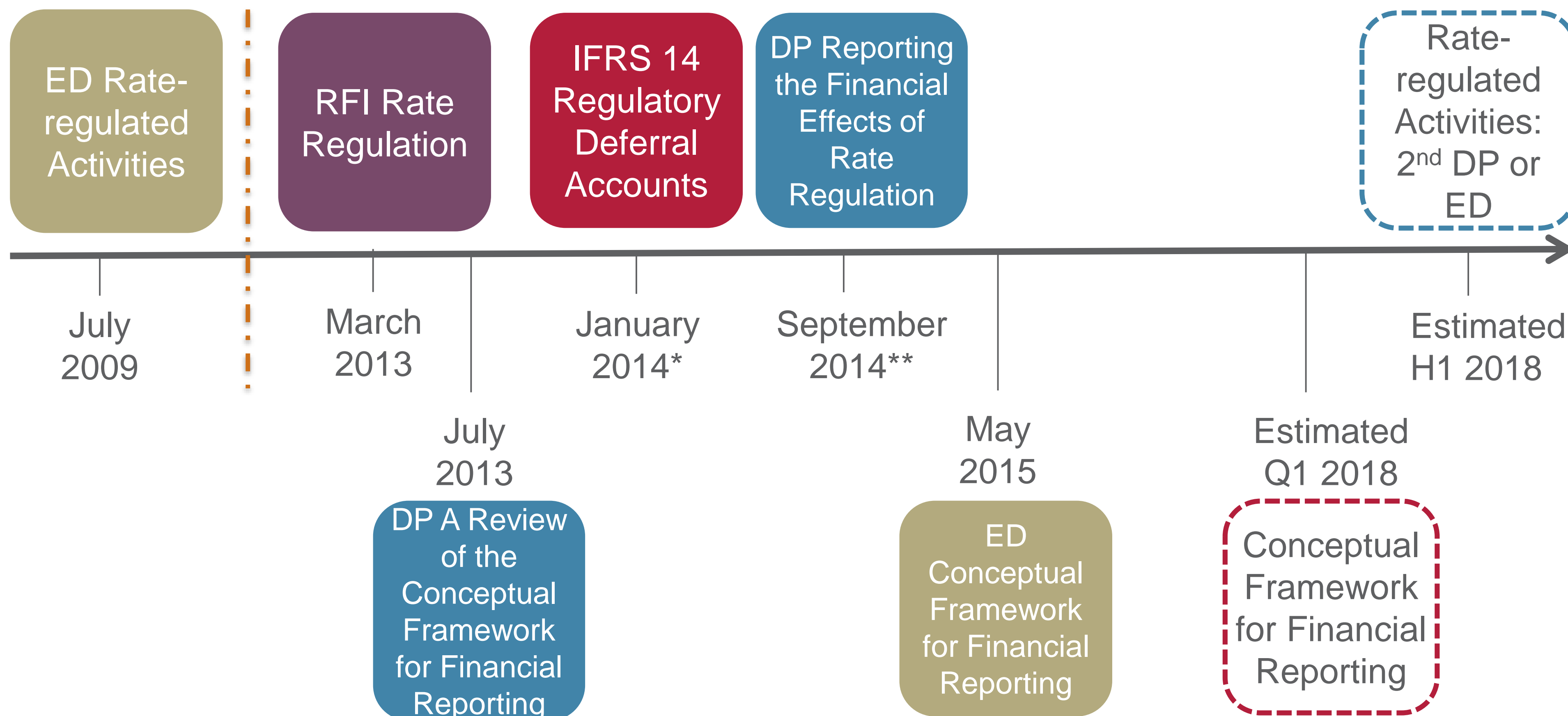
Purpose of project

- More fully understand the effects of rate regulation across different countries and companies
- Develop an IFRS Standard to **replace** IFRS 14 *Regulatory Deferral Accounts*
- Enable investors to more easily compare the effects of rate regulation on the financial position, performance and cash flows of companies with significant rate-regulated revenue

Rate-regulated Activities project

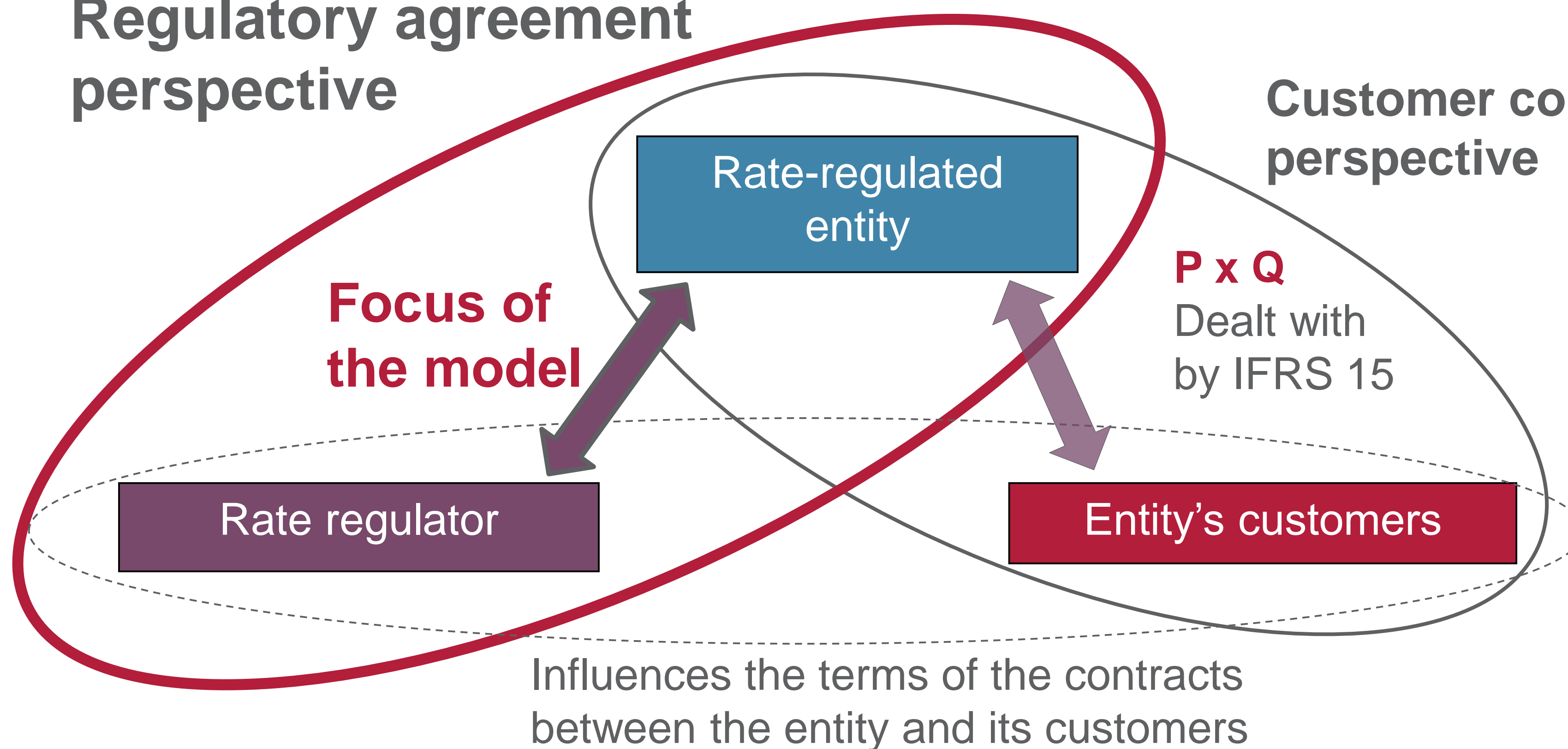


*Effective January 2016, only applicable for first-time adopters of IFRS Standards.

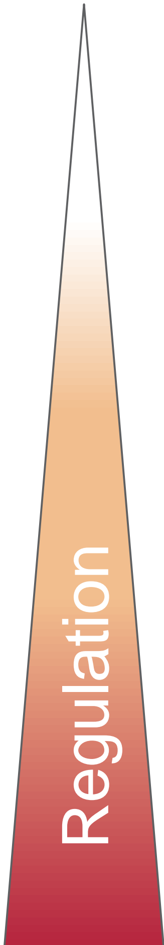
**The Board is focusing on developing a model for activities subject to 'defined rate regulation', described in the 2014 DP.

Defined rate regulation—the regulatory relationship

In **defined rate regulation**, the rate regulator intervenes to affect both the amount and the **timing** of the price 'P' billed to customers.



The regulatory agreement



Rights and obligations	Goodwill or brand value
• No barrier to entry • Determine product prices • Determine quantity of sales	• Determined by internal and external factors
• Some barriers to entry • Some limits placed on prices, quantity, quality	• Increased by barriers • Decreased by limits • More internally driven

• Strong barriers to entry
• Regulation determines:
  • Prices/volume/quality
  • **Timing of billing**
	• Increased by barriers
	• Decreased by limits
	• Mostly external (regulatory) factors

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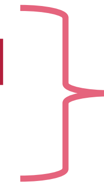
See slide 14 for more details.

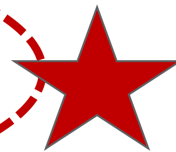
Scope of the model—Defined rate regulation

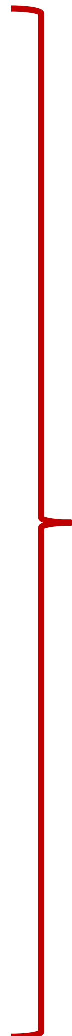
- Formal regulatory framework:
  - ***binding*** on both entity and rate regulator;
  - imposes ***limitations on entry*** *into an industry* (and on ***exit*** from it);
  - Establishes service requirements; and
  - establishes basis for setting **regulated *rate (price)***.



Market regulation

- The rate-setting basis includes a ***rate-adjustment mechanism***.

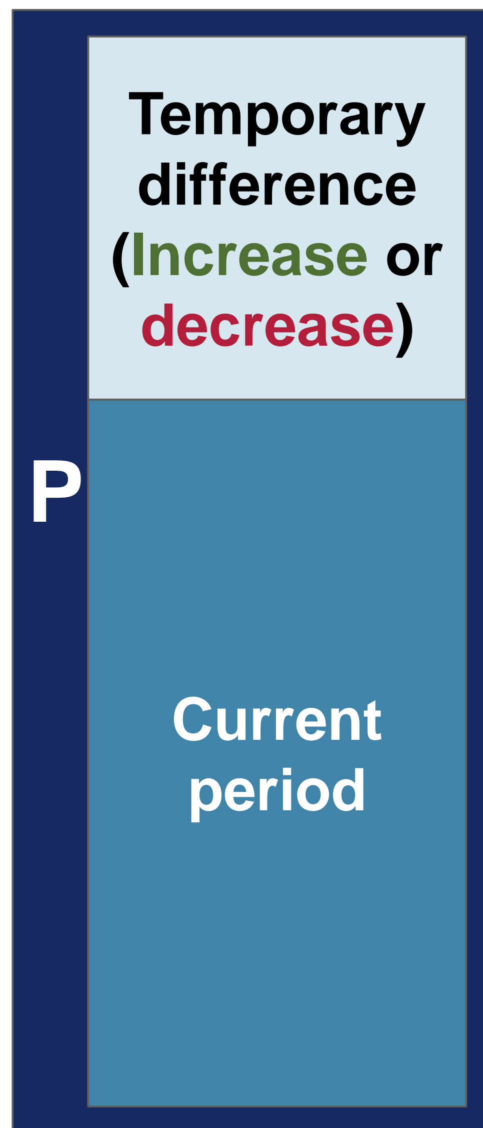




Defined rate regulation

Rights and obligations—basis for setting the rate

In defined rate regulation, the ***regulated rate* (P)** consists of two components:



Amounts reflecting compensation for fulfilling regulatory requirement **in different period** than goods or services delivered

Estimated amounts intended to compensate for fulfilling regulatory requirement **in same period** as goods or services delivered

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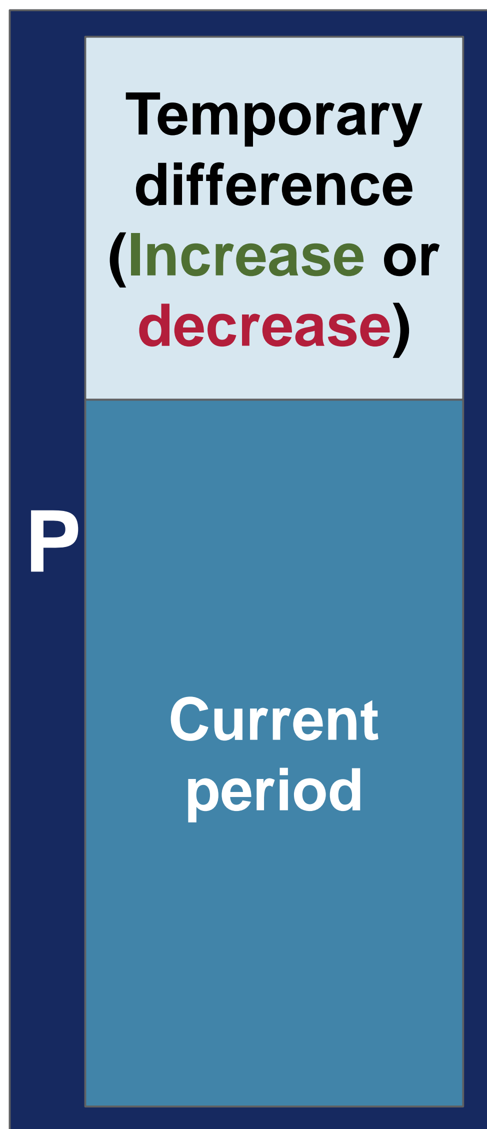
Rights and obligations—rate-adjustment mechanism



Right to charge a higher rate

Right arises if:

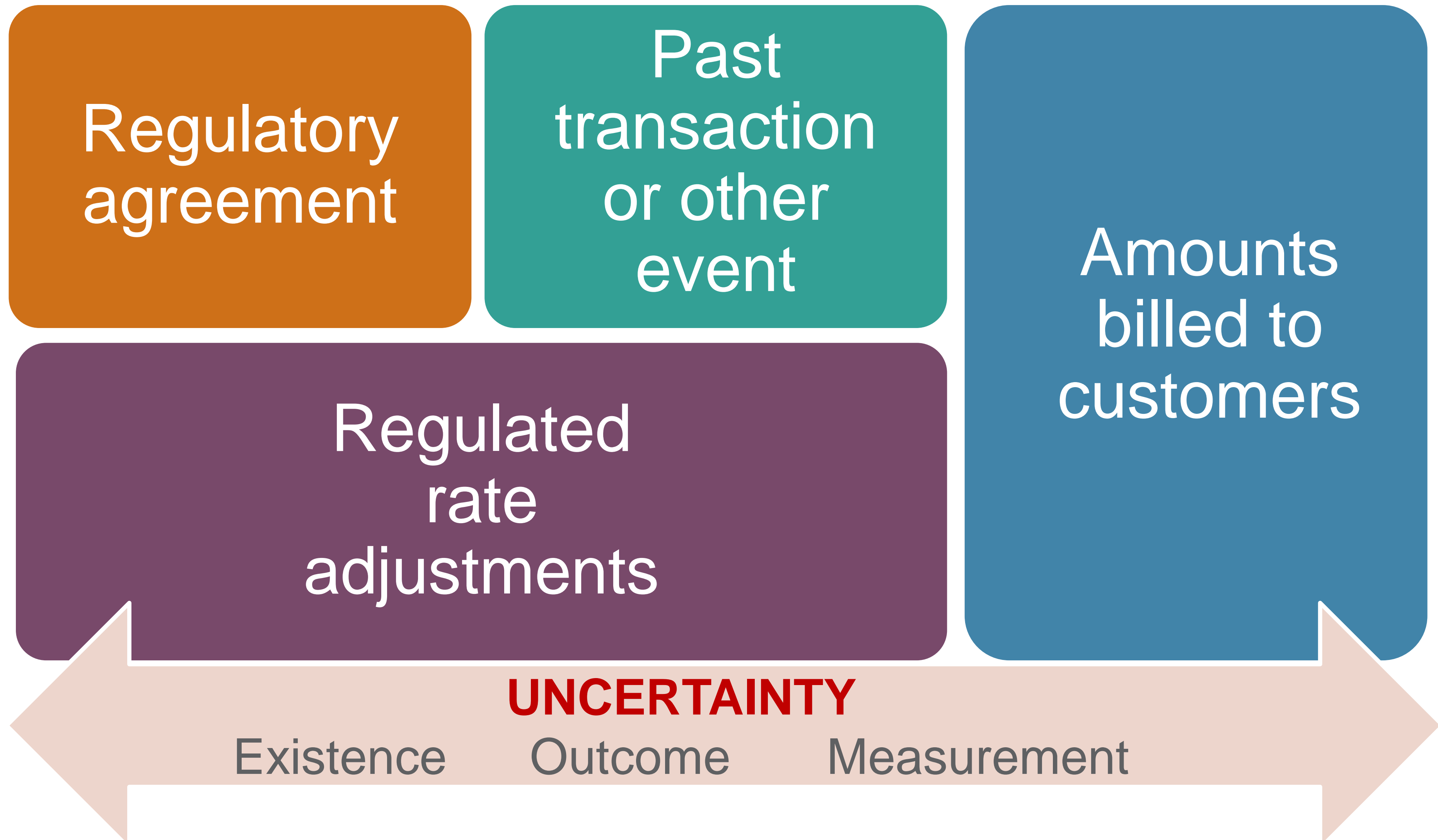
- allowable estimation variance occurs
- entity fully or partially fulfils a regulatory requirement that will be reflected in a future regulatory rate

Obligation to charge a lower rate

Obligation arises if:

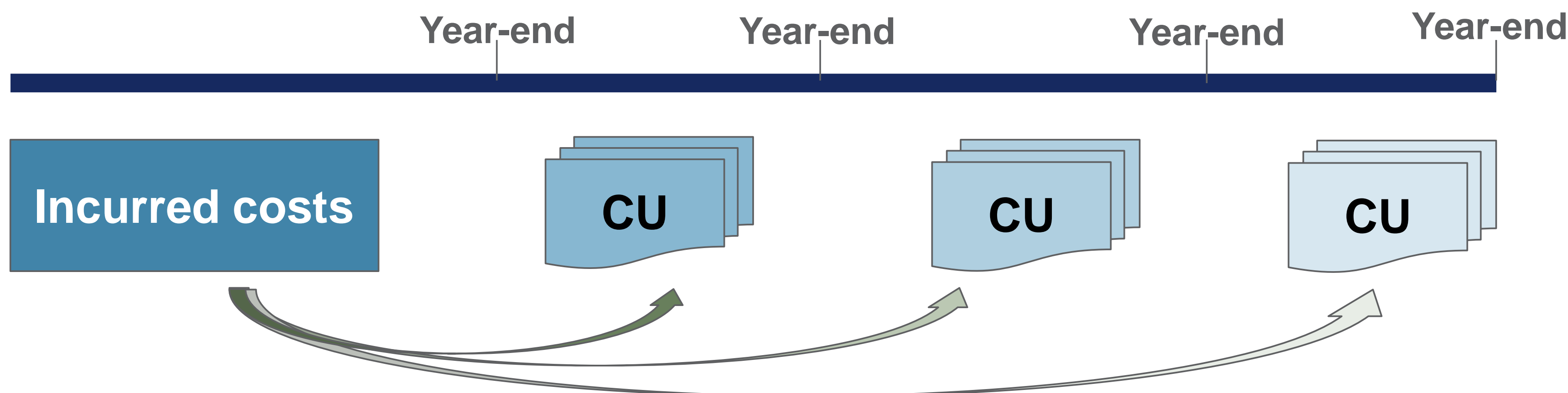
- chargeable estimation variance occurs
- regulated rate already billed to customers includes an amount that relates to a regulatory requirement yet to be fulfilled

Uncertainty



Effect of timing on cash flows

- Initial discussions to explore a measurement basis for **regulatory assets**



- Do regulators **compensate or charge** for time-lag between originating period and recovery / reversal periods?
- If so, what **interest rate** do regulators apply?
- Does the rate reflect merely interest or also a **return**?

Presentation and disclosure

- Likely to present **separate** line items: location and titles not yet decided

Statement of financial performance			
Year to 31 December	**20X1 CU000**	**20X2 CU000**	**20X3 CU000**
Revenue (amounts billed)	20	21.6	21.2
Regulatory rate adjustment:			
income/ (expense)	80	(21.6)	(21.2)
'interest' income	0	1.6	1.2
Operating expenses	(100)	(0)	(2)
Profit/ (Loss)	0	1.6	1.2
Statement of financial position			
Regulatory (liability)/ asset	80	60	40

Factors to consider

- Nature and level of disaggregation:
  - Primary financial statements
  - Disclosure notes
- Rate adjustments:
  - Originating and reversing amounts
  - Maturity periods
- Supporting disclosures
  - Uncertainties
  - Regulatory interest rates
  - Regulatory asset base/ value

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Appendix 1

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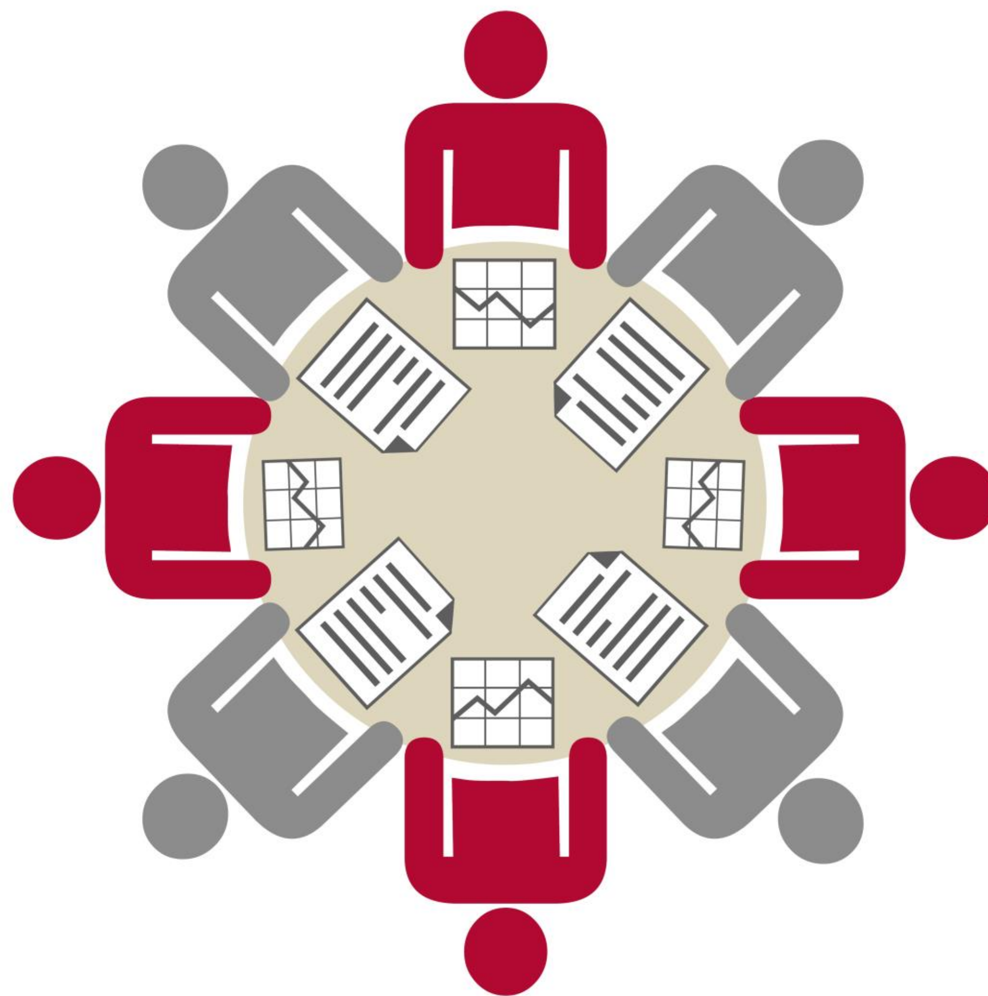

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The regulatory agreement—a package of rights and obligations

Regulation

Rights include rights to:	Obligations include obligations to:	Goodwill or brand value
• charge a 'fair price' to customers; • increase prices for any reason; • make a profit; and • use marketing and customer-relationships to gain competitive advantage and to encourage demand for goods or services.	• comply with regulations such as environmental protection, employment law, tax laws, consumer protection laws, etc.	Generally considered to be within 'goodwill' or the value of the business so **not usually recognised** as assets or liabilities using existing IFRS Standards, **unless** acquired or assumed in a **business combination**.
• receive economic benefits from inventories and from tangible and intangible assets used in the business; • receive cash from customers in exchange for delivering specified goods or services to those customers; and • receive cash or other financial assets.	• clean-up environmental damage; pay fines, pay taxation, etc. • deliver goods or services to specified quality standards to specified customers in exchange for a right to receive cash from those customers; and • refund specified customers or carry out warranty repairs.	**Recognised** as assets or liabilities using **existing IFRS Standards** covering inventories, PPE, intangible assets, provisions, financial instruments, taxation, revenue, etc.
• increase the regulated rate for a future period as a result of the rate-adjustment mechanism.	• decrease the regulated rate for a future period as a result of the rate-adjustment mechanism.	**Focus of the model being developed.**

Revised Conceptual Framework

- Extracts from drafts of the revised *Conceptual Framework for Financial Reporting* (revised *Conceptual Framework*) are provided here for context to aid discussion
- Wording of the revised *Conceptual Framework* may be subject to change before the final version is issued

A note about recognition of assets and liabilities

Even if an item meets the definition of an asset or a liability, an entity would not necessarily be permitted or required to recognise that asset or liability in its statement of financial position. The applicable IFRS Standard could specify that the asset or liability should be recognised only if particular criteria are met.

Furthermore, there would be no automatic requirement for an entity to disclose information about an unrecognised asset or liability. However, IFRS Standards may specify disclosure requirements for some unrecognised assets and liabilities.

In making decisions about the circumstances in which a particular asset or liability would be recognised, the Board would consider the concepts for recognition in the revised *Conceptual Framework*.

Key aspects of the concepts for recognition proposed for the revised *Conceptual Framework* *

The Board would apply these concepts in developing IFRS Standards. Preparers of financial statements would apply these concepts in developing or selecting accounting policies for assets and liabilities when no IFRS Standard specifically applies.

An asset or a liability (and any related income, expenses or changes in equity) should be recognised if recognition provides users of financial statements with useful information, ie relevant information about, and a faithful representation of, the asset or liability and any resulting income, expenses or changes in equity.

Recognition of a particular asset or liability may not necessarily provide *relevant information*:

(a) if it is uncertain whether the asset exists, or is separable from goodwill, or whether the liability exists; or

(b) if the asset or liability exists but there is only a low probability that an inflow or an outflow of economic benefits will result.

Recognition of a particular asset or liability may not necessarily provide a *faithful representation*:

(a) if the level of measurement uncertainty is exceptionally high; or

(b) if related assets and liabilities are not recognised.

It will often be a combination of factors, instead of any single factor, that would mean that recognition does not provide useful information.

As with all other areas of financial reporting, cost constrains recognition decisions. Recognition of an asset or a liability (and any related income, expenses or changes in equity) is appropriate only if the benefits of the information provided to the users of financial statements are sufficient to justify the cost.

*Exposure Draft proposals, updated for refinements that the Board has tentatively decided upon in light of feedback on the Exposure Draft.

Proposed asset definition

Proposed definition and key supporting concepts

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

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

In principle, each of an entity's rights is a separate asset. However, for accounting purposes, related rights are often treated as a single asset, namely the '**unit of account**'.

For an economic resource to have the **potential to produce economic benefits**, it need not be certain or even likely that the economic 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 beyond those available to other parties . (However, if the probability of future economic benefits is low, the Board might decide in some cases that the applicable IFRS Standard should not require recognition of the asset—see slide 13.)

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

Proposed liability definition

Proposed definition and key supporting concepts

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

An entity's obligation to transfer an economic resource must have the **potential** to require the entity to **transfer an economic resource to another party**. It need not be certain, or even probable, that the entity will be required to transfer an economic resource, but the obligation must already exist and there must be at least one circumstance in which it will require the entity to transfer an economic resource. (However, if the probability of a transfer being required is low, the Board might decide in some cases that the applicable IFRS Standard should not require recognition of the liability—see slide 13.)

An entity has an **obligation** if it has no practical ability to avoid the transfer. An entity has no practical ability to avoid a transfer if, for example, the transfer is legally enforceable, or if any action necessary to avoid the transfer would cause significant business disruption or would have economic consequences significantly more adverse than the transfer itself.

An obligation is **a result of past events** (and hence a **present** obligation) if the entity has received the economic benefits or taken an action that may or will require it to transfer an economic resource that it would not otherwise have had to transfer.

An **executory contract** establishes a right and an obligation to exchange resources. The combined right and obligation give rise to a single asset or liability. The entity has a liability (an obligation to *transfer* an economic resource) only if the terms of the exchange are unfavourable.

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