World Standard-setters Conference 2017

Reporting case study feedback: Rate-regulated Activities

26 September 2017

IFRS®

Case Study

- Case study
  - Questions
  - Example reconciling items
    1. input cost variance
    2. maintenance timing difference
    3. regulatory cost capitalisation
    4. accelerated cost recovery
    5. performance penalty
    6. performance bonus

Case study: questions

Purpose: **obtain your input and reasoning** on the following:

1. Do you agree that recognising the temporary difference in profit or loss arising from the rate adjustment examples in this case study gives a more faithful representation of the entity's performance in the year? Why or why not?
2. Do you agree that the resulting balance sheet item recognised at the end of each year is conceptually an asset or a liability? Why or why not?

You will be divided into **five break-out groups**. Each group is asked to discuss **one of five example reconciling items**.
If you have enough time, you are welcome to discuss the other examples.

An accounting model for consultation

Focus on 'rate-adjustment mechanism'	
Temporary differences when rate in **one period** includes amounts relating to activities carried out in a **different period**	
Right to increase future rate: • allowable variance • entity fulfils requirement not reflected in current rate	**Obligation** to reduce future rate: • chargeable variance • current rate includes amount for requirement not fulfilled
Analysing whether the right or obligation meets the revised *Conceptual Framework* definitions of an asset or a liability	
Supplementary model—not amending existing IFRS Standards	

Overview

- More comfortable with ‘yes’ to recognising in profit or loss

But

- Less comfortable with categorising resulting balance as conceptual asset or liability

However

- Easier to reach asset conclusion than liability

More faithful representation of performance

Support	Question
Better to reflect compensation and related event in same year	Looks like matching, contagion effect?
Reflect performance, not timing of cash flows	Not clear what performance is—the activity or a transfer to customers
Liked comparison to revenue outcome with a single customer	Would customers recognise a mirrored adjustment?
Reflects the economics of the tri-party relationship	Confusion in whether we are accounting for the tri-party relationship, or two separate relationships

Observations

More faithful representation of performance

- Groups typically struggled to split this argument from asset / liability discussion (holistic view)
- Discussion frequently lead to concerns about:
  - Matching for matching sake
  - Contagion to other areas of IFRS
- Gut feel support, but, but, but….
- A perception that we are starting with a desired outcome, and then trying to justify it (reverse engineering)

Asset

Support	question
Resource is a legal 'right to charge the customer more'—therefore an asset	Resource is customer base—population changes, no control of buying behaviour
Entity controls right to charge, and distribution of product	Entity cannot control customers' buying behaviour
Asset is identifiable component of a bigger asset we already acknowledge (don't recognise)	Can asset be separated from broader intangible (all rights/ obligations in reg. agreement)?
Event already occurred, linked compensation hasn't	Still some future performance required
Asset is incremental, ie it increases value of another asset	Arguments work for assets, not liabilities

Observations
Asset

- Groups focused on two possible resources:
  - The right to charge more
  - The customer base
- This affected outcome:
  - Groups focused on the right to charge more likely to support asset recognition
    - Right is easier to separately identify and quantify
    - Right is easier to control
  - Groups focused on customer base less likely
    - Liked analogy to IFRS 15, but
    - Struggled with control and separate quantification

Liability

Support	Question
Received benefit of cash from customers—obliged to take specific future action	Unit of account is problematic—what if one adjustment is onerous but another is profitable
Comfort with treating as a liability if onerous (unit of account issue)	Looks like lower profit, so <u>not</u> onerous
Obligation to charge lower price (existence vs outcome)	Can't see an outflow
The obligation is a stand alone component previously included in a bigger asset / liability we acknowledge (don't recognise)	Can liability be split from broader intangible asset or is in fact a negative asset / impairment of unrecognised asset

Observation
Liability

- Discussions focussed on 3 possible views of obligation:
  - – The obligation to charge less
  - – The obligation to accept a lower profit
  - – An obligation to deliver a product
- This affected discussion:
  - – Obligation to charge less:
    - – Obligation easier to separately identify and quantify
    - – Easier to distinguish from otherwise similar contracts
  - – Obligation to accept lower profit or deliver product
    - – Struggled with liability versus negative asset

Other comments

- Consider:
  - Whether a gross asset and gross liability exist on day one—obligation to incur costs on agreed activity and right to recover those costs (executory contract?)
  - Easier to get to the answer using IFRS 15? Definition of customer
  - Risk of contagion (matching), eg levy contracts or other contracts where is there is an intuitive mismatch
  - Counterparty asset / liability recognition
- Separate presentation is important
- Found the reference to temporary difference confusing

Other comments *continued*

- Concerns re complexity—this gets complicated fast
  - Timing of profit recognition (if excess reward), or loss recognition
  - Measurement should reflect time value
  - Multiple adjustments at any one time
  - Uncertainty

IASB To do list

- Be clear on why different from similar contracts
- Be clear on why IFRS 15 does not apply
- Be clear on what the asset and liability actually are:
  - right to charge more, and the obligation to charge less, as opposed to
  - the customer base, an onerous contract, or an obligation to deliver a product
- Be cautious of perception (outcome versus concepts)
- Be clear on what performance is
- Highlight effect of changes in Concepts
- Executory contract and timing
- Presentation considerations
- Scoping is important

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 40.)

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 40.)

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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