Case study: Rate-regulated Activities

25 September 2017

World Standard-setters Conference 2017

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Agenda

- Purpose of the project
  - Background about ‘defined rate regulation’
- Deliberations by the International Accounting Standards Board
  - Scope, definition of rate regulation
  - An accounting model of defined rate regulation
- Purpose and format of the session
- Case study

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Purpose of project

- Some companies are subject to regulations that define how much and when they can charge their customers.
- Different financial reporting requirements applied in different jurisdictions result in companies using different accounting models to report the effects of this rate regulation.
- Some of the different accounting models reflect incomplete information about how rate regulation affects a company's underlying financial position, performance and cash flows. This incomplete information hinders investors from understanding and comparing the effects of rate regulation across different countries and companies.
- The Board aims to develop an IFRS Standard to replace IFRS 14 *Regulatory Deferral Accounts* so that investors can more easily compare the effects of rate regulation on the financial position, performance and cash flows of companies with significant rate-regulated revenue.

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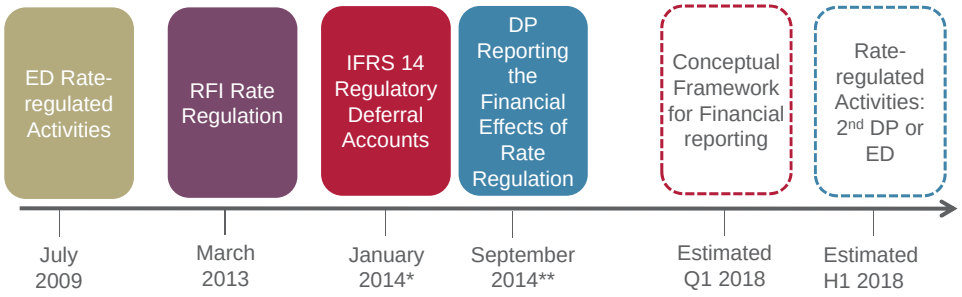
Rate-regulated accounting—background



*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.

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Scope—Defined rate regulation

- Established through formal regulatory framework, and:
  - is binding on both entity and rate regulator;
  - imposes limitations on entry into an industry;
  - establishes service requirements; and
  - establishes basis for setting regulated rate (price).
- Price setting basis includes a **rate-adjustment mechanism** that:
  - enables regulator to improve predictability and stability of prices, and
  - creates **temporary differences** between the event that gives rise to a rate adjustment and the period in which the adjustment to customer billing is made.

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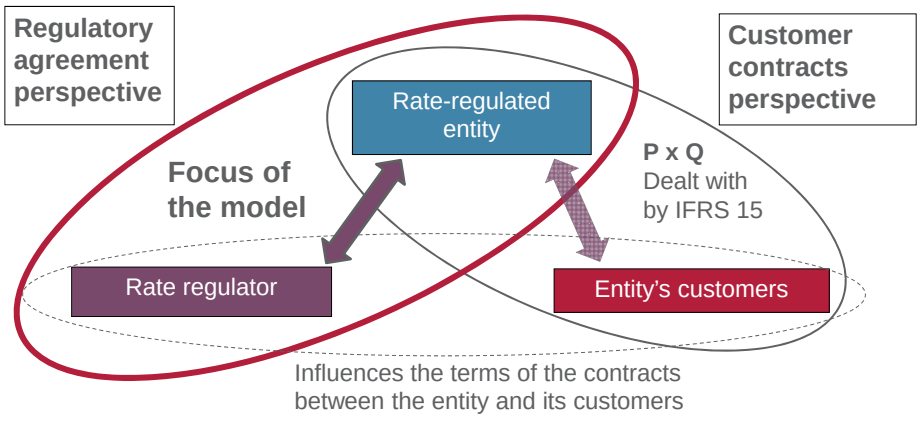
The regulatory agreement perspective

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



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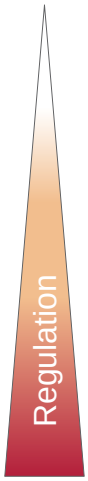
The regulatory agreement



Rights/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 externally driven

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

See slide 32 for more details.

An accounting model for consultation

Focus on 'rate-adjustment mechanism'

Creates **temporary differences** when the regulated rate in **one period** includes amounts relating to required activities carried out by the entity in a **different period**

Right to increase a future regulated rate:
- allowable estimation variance
- entity fully or partially fulfils a regulatory requirement in the current period that has yet to be reflected in the regulatory rate

Obligation to reduce a future regulated rate:
- chargeable estimation variance
- regulated rate for the current period includes an amount relating to a regulatory requirement that has yet to be fulfilled

Analysing whether the right or obligation meets the revised *Conceptual Framework* definitions of an asset or a liability

Supplementary model—separate IFRS Standard that would operate in conjunction with existing IFRS Standards

Case study:
Summary information

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Case Study

- Case study
  - Questions
  - Background facts and assumptions
  - Summary financial information
  - 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

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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.

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Case study: background

- Entity W is a water utility company.
- W is sole supplier of water in Country X under a regulatory agreement (licence).
- W is within the scope of 'defined rate-regulation'.
- The fact patterns described in the case study are based on real-life examples seen in our research to date. The fact patterns are selected to help test different aspects of the principles underlying the model and how those principles are described.

Please use the fact patterns provided in the examples as the basis for your discussion.

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Case study: fact pattern

- Covers the 3 years 20X1-20X3.
- The price (rate) W charges customers is fixed for 3 years, except for defined price adjustments to reflect input cost variances, bonuses and penalties.* Adjustments to price are made the year after the item arises.
- Any balances remaining at the end of 20X3 will be included in the calculation of the rate for the next three-year period.
- You are provided with the following information:
  - Six items included in the rate-adjustment mechanism.
  - Each item results in a reconciling item between the profit or loss amount included in the rate calculation and the profit or loss reported using existing predominant IFRS practice.

* The defined price adjustments reflect the temporary differences presented in each case study example.

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Simplifying assumptions

1. The regulatory agreement states that W:
   - has right to charge price to recover 'allowable costs'; and
   - makes no profit or loss unless it gets a bonus, or incurs a penalty or 'disallowed' costs.
2. Other than the temporary differences being illustrated:
   - 'allowable costs' are recognised at the same time for both regulatory purposes and IFRS reporting purposes;
   - carrying amount of tangible and intangible assets are the same for regulatory purposes and for IFRS reporting purposes; and
   - there are no variances in the quantity of services sold.
3. No rate adjustment balances are brought forward at 1/1/20X1;
4. There is no uncertainty about the amount and timing of amounts billed to customers; and
5. Time value of money is immaterial.

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Case study:
Example reconciling items

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Item 1—input cost variances

- Allowable costs include actual input costs for chemicals to treat water.
- Any variances between estimated and actual costs decrease (chargeable variance) or increase (allowable variance) the rate charged to future customers. Adjustment is applied in the year following the variance.
- The estimated input cost of CU30k per year is included in price charged.
- In 20X1, actual input cost is CU32k creating an allowable variance of CU2k in 20X1, which is included in rate charged to customers in 20X2.
- No further input cost variances arise during the three-year period.

Model proposes to recognise the rate-adjustment variance:

a) Would including the originating adjustment in profit or loss in 20X1, with a reversing adjustment in 20X2, give a more faithful representation of the entity's performance in each year? Why or why not?

b) Would you describe the resulting balance at the end of 20X1 as an asset? Why or why not?

Item 1—input price variance

Year to 31 December	20X1 CU000	20X2 CU000	20X3 CU000	Total CU000
Existing IFRS Standards				
Revenue—amounts billed	30	32	30	92
Operating expenses—chemical costs	(32)	(30)	(30)	(92)
Profit / (Loss)	(2)	2	0	0
Proposed model—profit or loss				
Revenue—amounts billed	30	32	30	92
Regulated rate adjustment: income / (expense)	**2**	**(2)**	**0**	**0**
Operating expenses—chemical costs	(32)	(30)	(30)	(92)
Profit / (Loss)	0	0	0	0
Resulting rate-adjustment mechanism balance				
Regulatory asset / (liability)	**2**	**0**	**0**	**0**

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Question 1 to WSS: input price variance—suggested solution (a)

Would including the originating adjustment in profit or loss in 20X1, with a reversing adjustment in 20X2, give a more faithful representation of the entity's performance in each period? Why or why not?

The model proposes to apply accrual accounting to include a CU2,000 adjustment in profit or loss during 20X1 to reflect Entity W's right to adjust the price to the extent needed to recover the actual input cost of CU32,000 incurred for the chemicals used to treat water collected from and delivered to customers during 20X1.

- Entity W is entitled to set a price intended to recover actual input costs incurred for chemicals
- In 20X1, Entity W incurs CU32k actual input cost against an estimate of CU30k
- This regulated rate mechanism constrains **when** Entity W bill customers for the extra costs incurred but does not constrain Entity W's entitlement to bill the full amount.
- Incurring the CU32k costs during 20X1 is an event that creates Entity W's right to bill customers CU32k.
- The model proposes to recognise that right in full during 20X1:
  - CU30,000 is recognised in revenue (and cash / receivables) through amounts billed to customers; and
  - CU2,000 is recognised as a regulatory rate adjustment (and regulatory asset).

Paragraph 1.17 of the Conceptual Framework ED states: 'Accrual accounting depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period.'

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Question 1 to WSS: input price variance—suggested solution (b)

Would you describe the resulting balance on the rate-adjustment mechanism at the end of 20X1 as an asset? Why or why not?

- 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.

At the end of 20X1, the model proposes to recognise, in addition to the CU30,000 receivable / cash recognised through amounts billed to customers during 20X1, a CU2,000 regulatory asset to reflect Entity W's right to adjust the price to the extent needed to recover the actual input cost of CU32,000 incurred for the chemicals used to treat water collected from and delivered to customers during 20X1.

- During 20X1, Entity W incurred costs of CU32k on chemicals.
- As a result of these **past events**, Entity W has a **right** to bill customers for those costs. That right has the **potential to produce economic benefits** when the amounts to be recovered are included in amounts billed to customers.
- Entity W **controls** that right because it has the **present ability**, through the regulatory agreement, to bill customers at the price calculated to enable Entity W to recover its costs incurred. As a result, only Entity W has the present ability to **obtain the economic benefits** that flow from the right that is created as the chemicals were used to treat water during 20X1.
- The right to charge the higher price is consumed during 20X2 when the additional CU2k is billed to customers.

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Break-out groups

Reconciling item	Discussion Group
1. input cost variance	Plenary / all
2. maintenance timing difference	Group 1
3. regulatory cost capitalisation	Group 2
4. accelerated cost recovery	Group 3
5. performance penalty	Group 4
6. performance bonus	Group 5

Each group is asked to discuss the example reconciling item allocated in the list above. If you have enough time, you are welcome to discuss the other examples.

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Item 2—maintenance timing difference

- Entity W is required to carry out a programme of enhanced maintenance on its network of water pipes, estimated to cost CU150k. The cost will be spread evenly for customers through the regulated rate in each of the three years 20X1-20X3 (CU50k each year).
- W must complete the work at any time before the end of 20X3. Any 'unspent' amount remaining at the end of 20X3 will be adjusted through a decrease in the rate chargeable during 20X4-20X6.
- W completes all of the agreed work in 20X2, at the forecast cost of CU150k. This creates a temporary difference of CU50k in 20X1 (income), which is reversed in 20X2 when a further timing difference of CU50k (expense) is created.

Model proposes to recognise a rate-adjustment temporary difference as shown on the next slide.

a) Would including the originating and reversing adjustments in profit or loss to reflect the maintenance expense and related revenue in the same period give a more faithful representation of the entity's performance in each year? Why or why not?

b) Would you describe the resulting balance on the rate-adjustment mechanism at the end of 20X1 as a liability and the balance at the end of 20X2 as an asset? Why or why not?

Item 2—maintenance timing difference

Year to 31 December	20X1 CU000	20X2 CU000	20X3 CU000	Total CU000
Existing IFRS Standards				
Revenue—amounts billed	50	50	50	150
Operating expenses—enhanced maintenance costs	0	(150)	0	(150)
Profit / (Loss)	50	(100)	50	0
Proposed model				
Revenue—amounts billed	50	50	50	150
Regulated rate adjustment: income / (expense)	**(50)**	**100**	**(50)**	**(0)**
Operating expenses—enhanced maintenance costs	0	(150)	0	(150)
Profit / (Loss)	0	0	0	0
Resulting rate-adjustment mechanism balance				
Regulatory asset / (liability)	**(50)**	**50**	**0**	**0**

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Item 3—regulatory cost capitalisation

- Entity W built an extension to one of its water treatment plants during 20X1.
- In accordance with IAS 16, W recognises CU150k as the cost of a tangible asset that is then depreciated straight-line over its useful economic life of 10 years, beginning in 20X2.
- W recognises CU20k as an expense in its IFRS financial statements in 20X1 because that part of the cost relates to general overheads that do not qualify for inclusion in the cost of the tangible asset using IAS 16.
- W will recover the full cost of CU170k by including that amount in the regulated rate on a straight-line basis over the 10-year useful economic life of the plant, beginning in 20X2. This creates a temporary difference (loss) of CU20k in 20X1, which will be reversed on a straight-line basis over 10 years, beginning in 20X2.

Model proposes to recognise the rate-adjustment temporary difference as shown on the next slide.

a) Would including the originating and reversing adjustments in profit or loss to reflect the entity's right to include the cost of the general overheads through the rate over the plant's useful economic life give a more faithful representation of the entity's performance in each year? Why or why not?

b) Would you describe the resulting balance on the rate-adjustment mechanism as an asset? Why or why not?

Item 3—regulatory cost capitalisation

Year to 31 December	20X1 CU000	20X2 CU000	20X3 CU000	Total CU000
Existing IFRS Standards				
Revenue—amounts billed	0	17	17	34
Operating expenses—overheads and depreciation	(20)	(15)	(15)	(50)
Profit / (Loss)	(20)	2	2	(16)
Proposed model				
Revenue—amounts billed	0	17	17	34
Regulated rate adjustment: income / (expense)	**20**	**(2)**	**(2)**	**16**
Operating expenses—overheads and depreciation	(20)	(15)	(15)	(50)
Profit / (Loss)	0	0	0	0
Resulting rate-adjustment mechanism balance				
Regulatory asset / (liability)	**20**	**18**	**16**	**16**

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Item 4—accelerated cost recovery

- Entity W purchased new software in January 20X1 at a cost of CU24k.
- W uses the software over its three-year economic life and recognises an amortisation expense on a straight-line basis over the three years 20X1-20X3.
- The rate regulator approved the cost of CU24k but decided that it would be recovered straight-line through the regulated rate over two years (20X1 and 20X2).
- This creates a temporary difference between the periods that W recovers the cost of the software through its bills to customers and the period that W uses the software to deliver services to its customers.

Model proposes to recognise the rate-adjustment temporary difference as shown on the next slide.

a) Would including the originating and reversing adjustments in profit or loss each year to reflect the timing difference between the expense recognised for consuming the software and the amounts billed to customers to recover that cost give a more faithful representation of the entity's performance in each year? Why or why not?

b) Would you describe the resulting balance on the rate-adjustment mechanism as a liability? Why or why not?

Item 4—accelerated cost recovery

Year to 31 December	20X1 CU000	20X2 CU000	20X3 CU000	Total CU000
Existing IFRS Standards				
Revenue—amounts billed	12	12	0	24
Operating expenses—amortisation	(8)	(8)	(8)	(24)
Profit/ (Loss)	4	4	(8)	(0)
Proposed model				
Revenue—amounts billed	12	12	0	24
Regulated rate adjustment: income/ (expense)	**(4)**	**(4)**	**8**	**0**
Operating expenses—amortisation	(8)	(8)	(8)	(24)
Profit/ (Loss)	0	0	0	0
Resulting rate-adjustment mechanism balance				
Regulatory asset / (liability)	**(4)**	**(8)**	**0**	**0**

Item 5—performance penalty

- During 20X1, Entity W caused contamination in a local river. As a result, W incurred:
  - clean-up costs during 20X1 of CU9k; and
  - a penalty of CU6k, which was included in the rate-adjustment mechanism in 20X1 and deducted from the rate charged to customers in 20X2.
- Neither the clean-up costs nor the penalty are 'allowable costs' as specified in the terms of the regulatory licence.
- W recognised the clean-up costs in profit or loss when incurred during 20X1 but made no accounting entry in its IFRS financial statements for the penalty. The penalty was reflected in revenue through the reduced amounts billed to customers in 20X2.

Model proposes to recognise the rate-adjustment temporary difference as shown on the next slide.

a) Would including the penalty in profit or loss in 20X1 give a more faithful representation of the entity's performance in the year? Why or why not?

b) Would you describe the resulting balance on the rate-adjustment mechanism at the end of 20X1 as a liability? Why or why not?

Item 5—performance penalty

Year to 31 December	20X1 CU000	20X2 CU000	20X3 CU000	Total CU000
Existing IFRS Standards				
Revenue—amounts billed	0	(6)	0	(6)
Operating expenses—clean-up cost	(9)	(0)	(0)	(9)
Profit / (Loss)	(9)	(6)	0	(15)
Proposed model				
Revenue—(reduction in) amounts billed	0	(6)	0	(6)
Regulated rate adjustment: income / (expense)	**(6)**	**6**	**0**	**0**
Operating expenses—clean-up cost	(9)	(0)	(0)	(9)
Profit / (Loss)	(15)	0	0	(15)
Resulting rate-adjustment mechanism balance				
Regulatory asset / (liability)	**(6)**	**0**	**0**	**0**

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Item 6—performance bonus

- During the three-year period 20X1-20X3, Entity W was incentivised to meet a performance target, measured in terms of the number of minutes customers are left without water. W's performance against the target in each year was as follows:
  - 20X1—target met: no penalty or bonus;
  - 20X2—target exceeded: bonus of CU5k awarded, included in the rate-adjustment mechanism and added to the rate charged to customers in 20X3; and
  - 20X3—target met: no penalty or bonus.
- W made no accounting entry in its IFRS financial statements for the bonus. The bonus was reflected in revenue through the increased amounts billed to customers in 20X3.

Model proposes to recognise the rate-adjustment temporary difference as shown on the next slide.

a) Would including the bonus in profit or loss in 20X2 give a more faithful representation of the entity's performance in each year? Why or why not?

b) Would you describe the resulting balance on the rate-adjustment mechanism as an asset or a liability? Why or why not?

Item 6—performance bonus

Year to 31 December	20X1 CU000	20X2 CU000	20X3 CU000	Total CU000
Existing IFRS Standards				
Revenue—amounts billed	0	0	5	5
Operating expenses	(0)	(0)	(0)	(0)
Profit / (Loss)	0	0	5	5
Proposed model				
Revenue—amounts billed	0	0	5	5
Regulated rate adjustment: income / (expense)	**0**	**5**	**(5)**	**0**
Operating expenses	(0)	(0)	(0)	(0)
Profit / (Loss)	0	5	0	0
Resulting rate-adjustment mechanism balance				
Regulatory asset / (liability)	**0**	**5**	**0**	**0**

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Some background information to support the case study

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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.**

Case study: fact patterns

- In addition to the fact patterns and assumptions given in slides 12-30, you are provided with the following information:
  - how W's regulatory licence meets the features of defined rate regulation (slides 34-35);
  - forecast allowable costs for the three-year period 20X1-20X3, which supports the calculation of the rate through that period (slide 36);
  - actual costs incurred and amounts billed to customers, as included in the rate calculation each year (slide 37); and
  - a summary of the overall effects of the six items that are included in the rate-adjustment mechanism. Each item results in a reconciling item between the profit or loss amount included in the rate calculation and the profit or loss reported in the IFRS statement(s) of financial performance using the existing predominant IFRS practice (slides 38-39).

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How Entity W's licence meets the features of defined rate regulation (1)

Features of defined rate regulation	Features of Entity W's regulatory licence
Economic regulation established through a formal framework	Regulation is established by the government of Country X.
Binding on both the entity and the rate regulator	• Rate regulator can only terminate the regulatory licence if Entity W persistently fails to satisfy the terms of the licence. • Entity W can only terminate the regulatory licence if rate regulator persistently fails to approve a regulated rate intended to recover Entity W's 'allowable cost'.
Imposes limitations on entry into an industry (and on exit from it)	Regulatory licence grants Entity W the right to be the sole supplier of clean and waste water services in Country X. If the licence is terminated, the licence, together with the assets needed to operate the network will be transferred to a new licensee entity to avoid disruption to services.
Establishes minimum service levels or other service requirements	The regulatory licence specifies the services that Entity W must provide and to whom it must provide them.

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How Entity W's licence meets the features of defined rate regulation (2)

Features of defined rate regulation	Features of Entity W's regulatory licence
Establishes a basis for setting the regulated rate (price) an entity can charge its customers for specified goods or services	Regulatory licence sets out a formula for setting the rate, which is sufficiently precise that Entity W is able to identify and measure amounts that relate to different components of the regulated rate for the period.
Basis for setting the regulated rate includes a rate-adjustment mechanism that: – improves predictability and stability of prices, – creates temporary timing differences between the rate-adjustment event and the period in which the adjustment to customer billing is made.	The basis for setting the rate includes a rate-adjustment mechanism that: – corrects past estimation variances; and – creates, and subsequently reverses, temporary differences that originate before the end of the current period when: – the entity fully or partially fulfils a regulatory requirement but the related compensation amount has not yet been included in the regulatory rate; or – the regulated rate for the current period includes a compensation amount relating to a regulatory requirement that has yet to be fulfilled.

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Setting the rate based on forecast amounts

- Water utility company, Entity W, reports its profit or loss to the rate regulator and prepares IFRS financial statements for each annual period ending 31 December.
- Estimated amounts used to calculate the regulated rate for each year ending 31 December during the current three-year rate review period are:

	Year to 31 December	20X1	20X2	20X3	Total
Item	*	CU000	CU000	CU000	CU000
	Regulatory report—forecast				
	Allowable revenue—allowable costs plus zero allowable return	**500**	**500**	**500**	**1,500**
	Allowable costs				
1	Chemical costs	30	30	30	90
2	Enhanced maintenance	50	50	50	150
	PPE recovery in line with IAS 16 depreciation (excluding item 3)	270	250	250	770
3	PPE addition—overhead included in cost with recovery over 10 years	-	17	17	34
4	Software addition recovery over two years	12	12	-	24
	Other allowable costs	138	141	153	432
	Total allowable costs	**(500)**	**(500)**	**(500)**	**(1,500)**
	Allowable profit / (loss)	**0**	**0**	**0**	**0**

* In this presentation, currency amounts are denominated in 'currency units' (CU).

Calculating the regulated rate based on actual amounts

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	Year to 31 December	20X1	20X2	20X3	Total
		CU000	CU000	CU000	CU000
	Revenue—amount billed	**500**	**496[1]**	**505[2]**	**1,501**
Item	**Allowable costs**				
1	Chemical costs—actual	32	30	30	92
1	Chemical costs—variance (adjusted in the rate during 20X2)	(2)	2	-	-
2	Enhanced maintenance—actual	-	150	-	150
2	Enhanced maintenance—variance	50	(100)	50	-
	PPE recovery in line with IAS 16 depreciation (excluding item 3)	270	250	250	770
3	PPE addition—overhead included in cost with recovery over 10 years	-	17	17	34
4	Software addition recovery over two years	12	12	-	24
	Other allowable costs	138	141	153	432
	Total allowable costs	**(500)**	**(500)**	**(500)**	**(1,500)**
5	Disallowed costs—refunds to customers	(9)	-	-	(9)
5	Penalty (adjusted in the rate during 20X2)	(6)	-	-	(6)
6	Bonus (adjusted in the rate during 20X3)	-	5	-	5
	Profit / (loss) per regulated rate calculation	**(15)**	**5**	**-**	**(10)**

1. Amount billed = estimated CU500 + 20X1 cost variance CU2 (Item 1) – 20X1 penalty CU6 (item 5) = CU496
2. Amount billed = estimated CU500 + 20X2 bonus CU5 (item 6) = CU505

IFRS financial results

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	Year to 31 December	20X1	20X2	20X3	Total
Item	Profit or loss per IFRS financial statements—existing IFRS predominant practice	CU000	CU000	CU000	CU000
	Revenue—amount billed	**500**	**496**	**505**	**1,501**
	Costs incurred				
1	Chemical costs	32	30	30	92
2	Enhanced maintenance	-	150	-	150
	PPE depreciation (excluding item 3)	270	250	250	770
3	PPE addition—overhead treated as expense per IAS 16	20	-	-	20
3	PPE addition—depreciation per IAS 16	-	15	15	30
4	Software addition amortisation per IAS 38	8	8	8	24
5	Clean-up costs	9	-	-	9
	Other costs	138	141	153	432
	Total costs	**(477)**	**(594)**	**(456)**	**(1,527)**
	Profit / (loss) per IFRS financial statements	**23**	**(98)**	**49**	**(26)**

Reconciliation of the regulated rate calculation and IFRS financial report

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	Year to 31 December	20X1	20X2	20X3	Total
Item		CU000	CU000	CU000	CU000
	Profit or (loss) per IFRS financial statements—existing IFRS predominant practice	**23**	**(98)**	**49**	**(26)**
	Reconciliation to regulated rate calculation				
1	Chemical costs variances	2	(2)	-	-
2	Enhanced maintenance variance	(50)	100	(50)	-
3	PPE addition overhead recovery timing difference	20	(2)	(2)	16
4	Software addition recovery timing difference	(4)	(4)	8	-
5	Penalties	(6)	6	-	-
6	Bonuses	-	5	(5)	-
	Total reconciling adjustment	**(38)**	**103**	**(49)**	**16**
	Profit / (loss) per regulated rate calculation	**(15)**	**5**	**-**	**(10)**

IFRS

Before you start—a note about recognition of assets and liabilities

40

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 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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