

Board meeting—February 2018

Rate-regulated Activities: Unit of account and asset / liability definitions

Important Note:

The notes to these slides form an integral part of the presentation.

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board (the Board) or IFRS Foundation.

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1. To identify what **unit of account** provides the most useful information to users of IFRS financial statements about the **incremental rights and obligations** ([see slide 11](#)) arising from the regulatory agreement ([slides 13-16](#)).
2. To assess whether, within that unit of account:
 - a) the incremental **right** is an **asset** ([slides 18-21](#)); and
 - b) the incremental **obligation** is a **liability** ([slides 22-25](#)).

We provide some background information about defined rate regulation ([slides 4-10](#)) and an illustration of aspects of the model being developed ([slides 26-30](#)) to help achieve the objectives of the session.



Before starting... a brief reminder

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- The **nature of the goods and services** means that limitations in supply and / or poor quality of supply can cause hardship to customers.
- Constraints on constructing and placing infrastructure necessary to deliver goods / services can create barriers of entry into the industry:
 - physical constraints; and / or
 - financial constraints (high fixed costs or high levels of initial investment).
- Obstacles to new entrants can inhibit competition, innovation, efficiency or incentives to invest in necessary infrastructure, reducing incentives to maintain / improve quality and availability of supply.



DEFINED RATE REGULATION



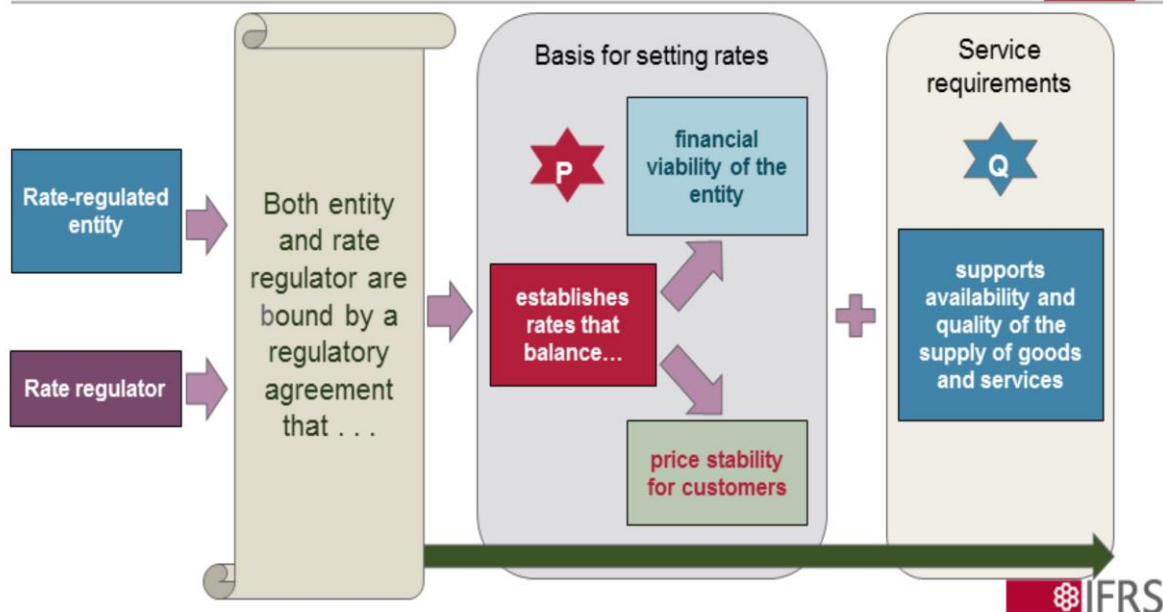
Many governments regulate the supply and pricing of particular types of goods and services by entities. These ‘rate-regulated activities’ usually involve providing goods and services that are considered in that jurisdiction to be essential to customers. The accounting model being developed in this project focuses on what we are calling **defined rate regulation**.

The **nature of the goods and services** is such that the rate regulator has objectives:

- to **protect customers** by ensuring:
 - **quality, quantity and availability of supply** (done through establishing service requirements in the regulatory agreement); and
 - **stability and affordability of pricing** (done through price controls, ie the basis for setting rates established by the regulatory agreement).
- to **protect the rate-regulated entity** by ensuring the rate established by the regulatory agreement supports the entity's **financial viability** by enabling it to charge customers rates that provide the entity with an adequate amount of compensation in exchange for fulfilling the service requirements established by the regulatory agreement.



Protecting the entity's financial viability is important for the well-being of customers because it facilitates continuing investment in the infrastructure and other resources used to supply the rate-regulated goods and services.



As mentioned in the previous slide ([slide 5](#)), the **nature of the goods and services** is such that the rate regulator has objectives to protect consumers by ensuring:

- **quality, quantity and availability of supply** (done through service requirements); and
- **stability and affordability of pricing** (done through price controls).

To achieve those objectives, there is a **binding** regulatory agreement through which:

- the **rate-regulated entity** has a right to:
 - supply the rate-regulated goods or services; and
 - charge a rate(s) for those goods or services that is designed to protect its **financial viability** such that the entity is able to fulfil the specified service requirements.

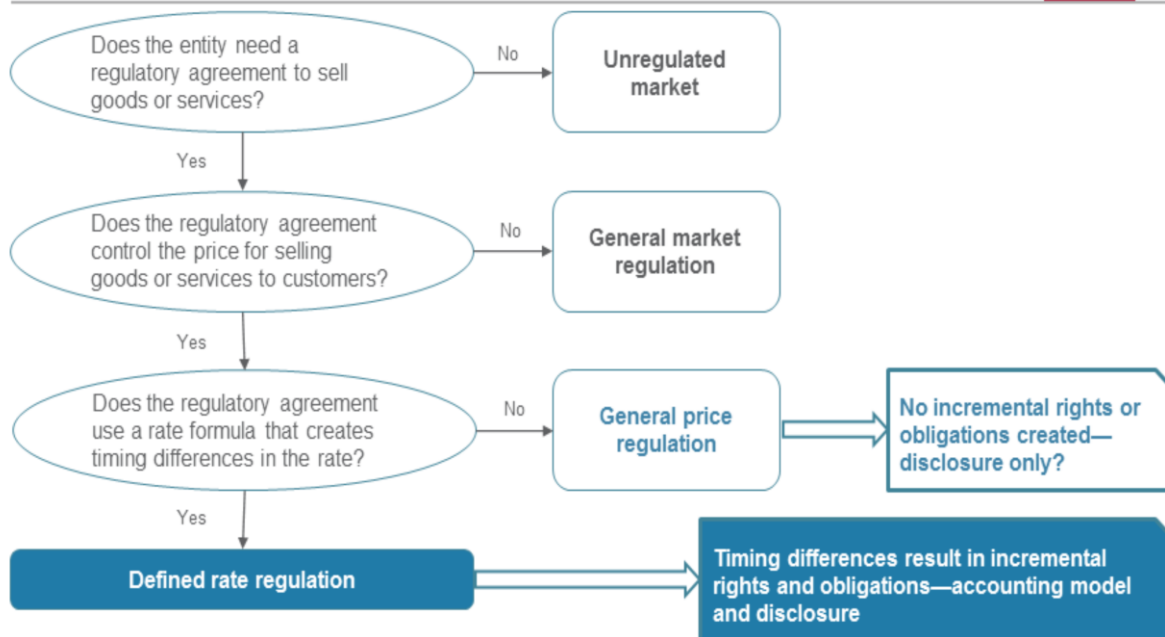
in exchange

- the **rate-regulated entity** is obliged to:
 - fulfil specified service requirements (usually related to **quality, quantity and availability of supply**); and
 - accept the pricing framework.

This exchange feature influences the design of the basis for setting rates. It is the design of the basis for setting rates that helps to distinguish defined rate regulation from other types of regulation.

Defined rate regulation vs other regulation

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General price regulation typically applies when competition in a market is insufficient to protect customers from suppliers making excessive profit. The rate regulator's intervention is usually restricted to imposing a cap on the price that can be charged for the specified goods or services. Consequently, an entity operating within a price regulated market is exposed to both input price risk and demand risk.

In contrast, **defined rate regulation** establishes, through the regulatory agreement, a basis for setting rates that is designed to give an entity subject to the regulation some protection against both input price risk and demand risk. The entity must use the rate formula established by the regulatory agreement to calculate the total amount of compensation that the entity can charge **in exchange** for fulfilling the service requirements established by the regulatory agreement. The rate formula contributes to the achievement of the regulatory objectives ([slide 6](#)) by using a **rate adjustment mechanism** that creates **timing differences** (previously termed temporary differences in staff papers used in recent meetings of the Board and IASB advisory bodies) between:

- when the entity fulfils the service requirements established by the regulatory agreement; and
- when it includes the related compensation in the rate(s).

The objective of the Rate-regulated Activities project is to develop an accounting model so that investors can assess the effects of defined rate regulation on the financial position, performance and cash flows of any entity with significant rate-regulated revenue. As explained in the following slides, the model focuses primarily on the timing differences created by the operation of the rate adjustment mechanism.

Scope of the model—defined rate regulation

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So far, we have used the following definition of defined rate regulation when discussing the model's scope.

Formal regulatory framework, binding on both entity and rate regulator*

there are limitations on entry into an industry (and on exit from it)

establishes basis for setting regulated rate (price)

The rate-setting basis includes a rate adjustment mechanism that creates timing differences in the rate

establishes service requirements

General
price regulation

Defined rate regulation

RAM

IFRS

Our research has found that the features described in this slide distinguish 'defined rate regulation' from other forms of rate regulation. A particularly important distinguishing feature within the basis for setting the rate(s) charged to customers is the use of a rate adjustment mechanism (**RAM**) that creates **timing differences** between:

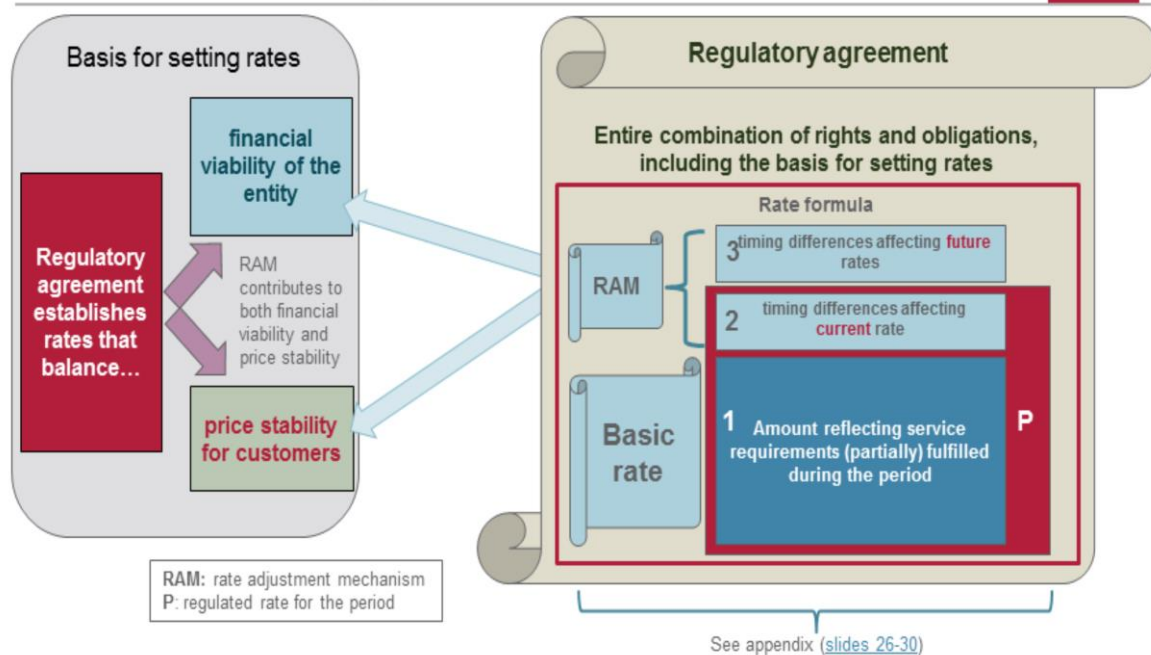
- when the entity fulfils the service requirements established by the regulatory agreement; and
- when it includes the related compensation in the rate(s) (see [slide 7](#)).

In a future meeting, we will ask the Board to decide which of these features are necessary and sufficient criteria to determine the scope of the accounting model.

(*): IFRS 14 *Regulatory Deferral Accounts* contains the following definition of '**rate regulator**': 'An authorised body that is empowered by statute or regulation to establish the rate or a range of rates that bind an entity. The rate regulator may be a third-party body or a related party of the entity, including the entity's own governing board, if that body is required by statute or regulation to set rates both in the interest of the customers and to ensure the overall financial viability of the entity'.

The Board has not yet discussed whether this definition should be retained or amended.

Basis for setting the rate



As described at [slide 7](#), the regulatory agreement establishes the rate formula that calculates **how much** compensation the entity is entitled to include in the regulated rate **in exchange** for fulfilling its service requirements. The rate formula also establishes **when** the entity can include the compensation in the rate charged to customers. Consequently, the rate formula creates a direct and specific **cause-and-effect** relationship between a rate-regulated activity and amounts included in the rate(s).

The rate regulator uses the rate formula, including the RAM, to affect the amount and **timing** of the rates charged to customers to help achieve both stability of prices for customers and financial viability for the rate-regulated entity. The rate formula establishes:

- 1) the amount of compensation included in the current rate in exchange for service requirements fulfilled in the current period (ie **the basic rate**);
- 2) adjustments to the current rate reflecting **incremental** compensation to be included in or deducted from the current period resulting from service requirements fulfilled in a different period; and
- 3) adjustments to future rate(s) reflecting **incremental** compensation to be included in or deducted from a future period (or periods) resulting from service requirements fulfilled in a different period.

The rate chargeable in the current period (P) consists of items 1 and 2. The resulting revenue (P x Q) is recognised in accordance with IFRS 15 *Revenue from Contracts with Customers* (see [slide 10](#)).

We are developing an accounting model to recognise separately the effects of:

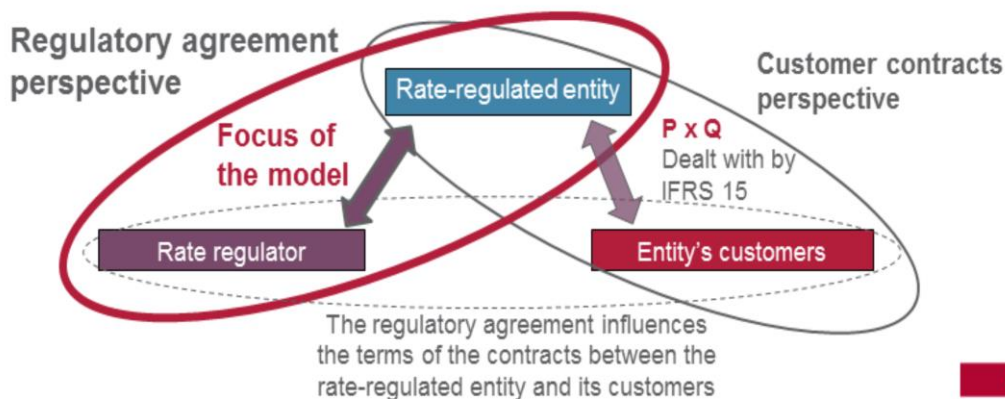
- item 3 in the statement of **financial position**, ie incremental rights and obligations arising from timing differences affecting **future** rates (see [slide 11](#)); and
- items 2 and 3 in the statement of **financial performance**, ie the origination and reversal of timing differences **during** the period.

Defined rate regulation—the regulatory relationship

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We have focused on developing an accounting model that reflects the 'regulatory agreement perspective', ie the relationship between the rate-regulated entity and the rate regulator.

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



If the customer contracts are looked at in isolation, there is a simple price (P) x quantity (Q) relationship. The entity satisfies its direct customer performance obligations by delivering goods or services (Q) in a specified period at a specified price (the regulated rate, P). When the entity delivers, the individual customers are obliged to pay, and the entity is entitled to receive, the amount charged (P x Q). The amount charged using this P x Q relationship is recognised as revenue in accordance with IFRS 15.

However, the rate-regulated entity must also comply with the regulatory agreement. As noted on the previous slide ([slide 9](#)), the operation of the RAM within the rate formula results in **timing differences** between:

- when the entity fulfils its service requirements; and
- when it includes the related compensation in the rate(s).

Consequently, reporting revenue and related expenses in accordance with IFRS 15 and other IFRS Standards, using only the customer contract P x Q relationship, does not give a complete picture of the effects of defined rate regulation on an entity's financial performance during the period or its financial position at the end of the period. This is because, when looking from the perspective of the regulatory agreement, **some** of those effects are reported in **a different period** than other effects of the transactions or other events that created them.

The model aims to provide users of financial statements with information about the timing differences between the regulatory agreement perspective and the customer-contract perspective. This information should enable users to assess more effectively the amount, timing and uncertainty of the entity's future cash flows.

The objective of the accounting model is to provide useful information to users of financial statements about incremental rights and obligations arising from differences between the timing of charging and the timing of fulfilment and their effects on the entity's financial performance.

- The accounting model aims to recognise separately amounts that reflect the **incremental rights and obligations** created (and later consumed or fulfilled) when an entity **fulfils** service requirements in a **different period** than the period in which those service requirements are **charged** to customers through the regulated rate.

If financial information is to be **useful**, it must be relevant and faithfully represent what it purports to represent. The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable [Guidance contained in the *Conceptual Framework**].



As described at [slide 10](#), existing IFRS Standards, including IFRS 15, report the effects of **some** of the rights and obligations created by the regulatory agreement in **a different period** than the transactions or other events that created them. Consequently, at the end of each reporting period, the entity may have some outstanding rights and obligations that are not recognised in the entity's statement of financial position, even though the transaction or other event that created them has already occurred. These outstanding rights and obligations are therefore **incremental** to those reported using existing IFRS Standards.

The new accounting model being developed aims to recognise those **incremental** rights and obligations after separating them from the other rights and obligations created by the regulatory agreement to provide more useful information than is currently provided to users of IFRS financial statements about:

- the entity's financial performance during each period;
- its financial position at the end of each period; and
- the related effects of the incremental rights and obligations on the timing, amount and uncertainty of cash flows.

In developing the model, the Board tentatively decided to use a '**supplementary approach**'. This means that existing IFRS Standards will be applied without modification (ie using the customer-contract perspective). The model will then be applied to provide additional information about the timing differences arising from the regulatory agreement.

*The Board is currently finalising revisions to the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*), which is expected to be published in March 2018. Throughout this presentation, references to the *Conceptual Framework* refer to a late draft of the document.



Q1. What is the unit of account?

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The regulatory agreement

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	Unregulated market	Defined rate-regulated market
Right to trade	In an open market, any entity has the right to operate and sell its goods or services at prices the market will bear	Regulatory agreement gives an entity the right to operate in the rate-regulated market and sell specified goods or services at prices established by the rate regulator
Right to charge more	-	Regulatory agreement creates the right to charge a specified incremental amount more in the future if specified past events have occurred
Obligation to trade	-	Regulatory agreement obliges the entity to operate in the rate-regulated market and sell specified goods or services at prices established by the rate regulator
Obligation to charge less	-	Regulatory agreement creates the obligation to charge a specified incremental amount less in the future if specified past events have occurred

We are not proposing to amend existing IFRS Standards to change how those Standards reflect the rights and obligations created by the regulatory agreement. This is because our research indicates that applying existing IFRS Standards, including IFRS 15, to transactions with customers and to most of the other rights and obligations established by the regulatory agreement provides users of financial statements with information that is both relevant and faithfully represents what it purports to represent.

For example, the regulatory agreement as a whole gives the entity the right to operate in the rate-regulated market. In some cases, the entity pays a fee to enter into or renew the regulatory agreement. In such cases, the regulatory agreement would normally be recognised as an intangible asset (measured on a cost basis) when applying IAS 38 *Intangible Assets*. In many cases, the entity does not pay a fee to obtain the right to operate and so, by applying IAS 38, does not recognise the regulatory agreement in its financial statements.

This is consistent with the treatment of an entity's right to operate in an unregulated market—if the entity pays for a licence to operate in the unregulated market, it will recognise the licence as an intangible asset. Otherwise, the value of the right to operate is part of the overall value of the business, ie internally generated goodwill or a brand. An entity would not recognise internally generated goodwill or a brand as an asset when applying IAS 38.

However, our research has also found that applying existing IFRS Standards, without adjusting for the timing differences highlighted in [slides 9-11](#), results in some of the effects of transactions and events being reported in an entity's statement of financial performance in a different period than the period in which the transaction or event takes place. Consequently, not accounting separately for the effects of the timing differences creates artificial volatility in the statement of financial performance that may mask any real economic volatility. This makes it difficult for users to assess the entity's performance for the period and the effects of that performance on the entity's ability to generate future cash inflows from its rate-regulated activities.

Consequently, we are proposing that the model focuses on recognising separately the effects of the timing differences created by the operation of the RAM, ie using a 'supplementary approach' ([slide 11](#)).

Conceptual Framework—unit of account

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The *Conceptual Framework* says that a **unit of account** is selected to provide the most useful information. Treating a group of rights and obligations as a single unit of account instead of treating each one as a separate unit of account may provide more relevant information if, for example, those rights and obligations:

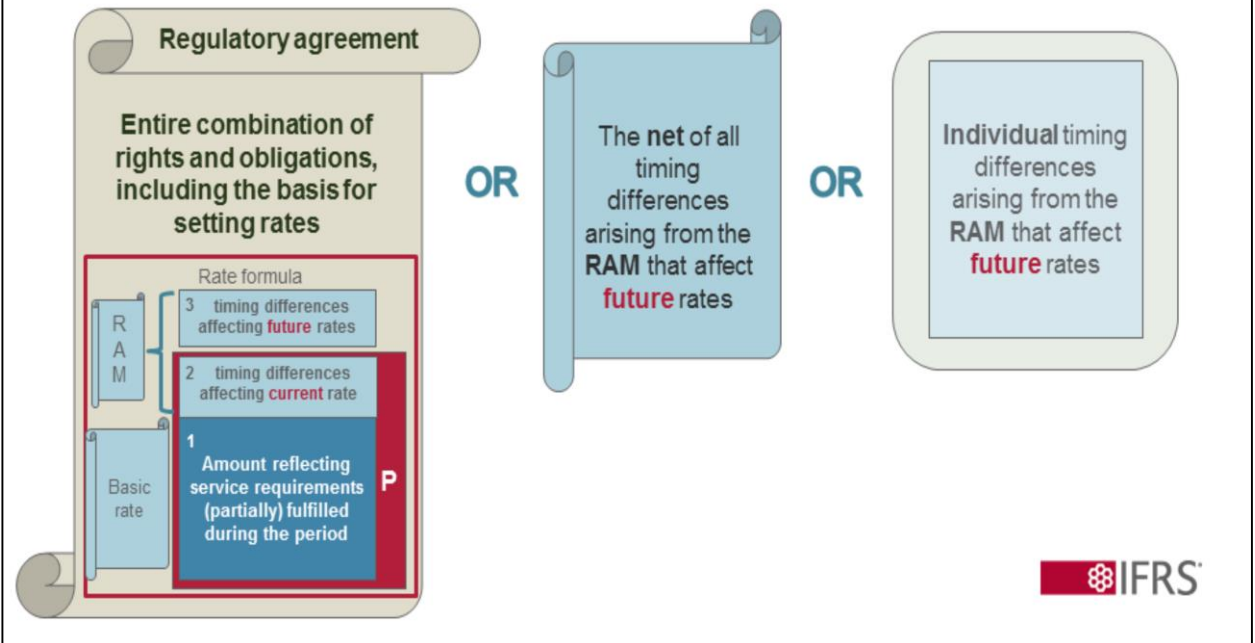
- cannot (or are unlikely to) be the subject of separate transactions;
- cannot (or are unlikely to) expire in different patterns;
- have similar economic characteristics and risks and hence are likely to have similar implications for the prospects for future net cash inflows to the entity or net cash outflows from the entity; or
- are used together in the business activities conducted by an entity to produce cash flows and are measured by reference to estimates of their interdependent future cash flows.



As described earlier, at the end of each period, any outstanding timing difference created by the operation of the rate adjustment mechanism results in an **incremental right** or an **incremental obligation** (see [slide 11](#)), ie:

- a **right to charge a rate increased by an incremental amount** because the entity has already (partially) fulfilled a service requirement **and**, under the regulatory agreement, the entity has a present right to include that incremental amount in the rate(s) in a future period; or
- an **obligation to provide goods or services at a rate reduced by an incremental amount** because the entity has already included that amount in the rate **but** has not yet fulfilled the related service requirement.

The model aims to recognise these incremental rights and obligations separately. However, this raises the question about what unit of account could provide the most useful information to help users of financial statements to assess the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity and to assess management's stewardship of the entity's economic resources.



Staff have observed that entities track the individual timing differences separately in accordance with regulatory agreement requirements. In previous Board discussions and papers, we have followed the same approach when using examples to illustrate both how individual timing differences originate and reverse and how the model would account for them. Consequently, for recognition and measurement purposes, we have been using implicitly the individual timing differences as the unit of account.

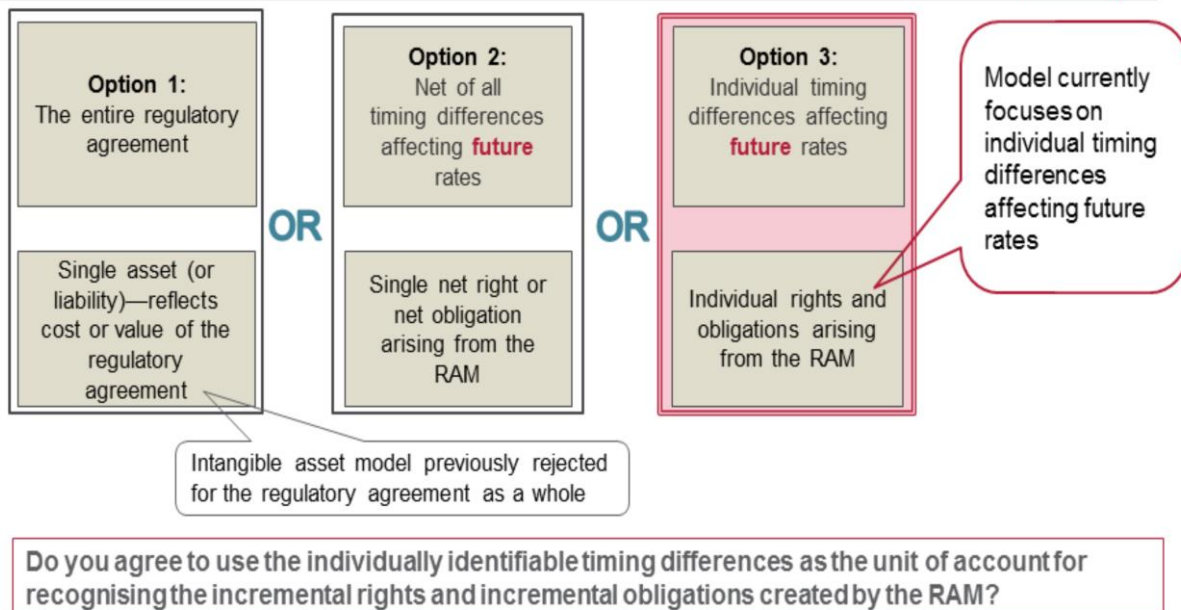
However, we have subsequently applied the guidance in the *Conceptual framework* to our analysis of the incremental rights and obligations to make a recommendation for the unit of account to be used in the accounting model. The Board has already tentatively decided not to develop a model for the regulatory agreement as a whole (ie a single intangible asset). Instead, the Board has decided to use a 'supplementary approach'. This means that existing IFRS Standards will be applied without modification before the model is applied to provide additional information about the timing differences arising from the regulatory agreement. Our analysis supports this tentative decision.

Consequently, we have focused the analysis about the unit of account on the choice between the:

- the **net of all** timing differences that arise from the RAM and affect future rates; and
- the **individual** timing differences that arise from the RAM and affect future rates.

Recommended unit of account—individual timing differences

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Staff recommend that the model uses, as its **unit of account**, the **individual** timing differences arising from the regulatory agreement. This is because, considering the unit of account guidance in the *Conceptual Framework* ([slide 14](#)):

- although there is some interdependency between the sum of all timing differences and the overall rate chargeable to customers over time, the individual timing difference items are assessed separately by the rate-regulated entity and the rate regulator and the effect of each timing difference on future rate calculations and cash flows can be identified;
- individual timing differences, and their subsequent effects on cash flows, expire in different patterns; and
- groups of timing differences reflecting rights to charge incremental amounts in future rate(s) for service requirements already (partially) fulfilled have sometimes been factored and used as security for borrowings, separately from other factoring or borrowing transactions.

Consequently, using the individual timing differences as the unit of account provides users of financial statements with useful information about the expected pattern of reversal of timing differences and the timing of their effect on the entity's future cash flows.

[Note: Groups of individual timing differences can have similar characteristics and risks, with similar implications for the prospects of future cash flows. Consequently, it may be appropriate to group some timing differences with similar characteristics and risks and similar expiry patterns for the purposes of presentation and disclosure. We will ask the Board to decide about aggregation criteria for presentation and disclosure in a future meeting.]

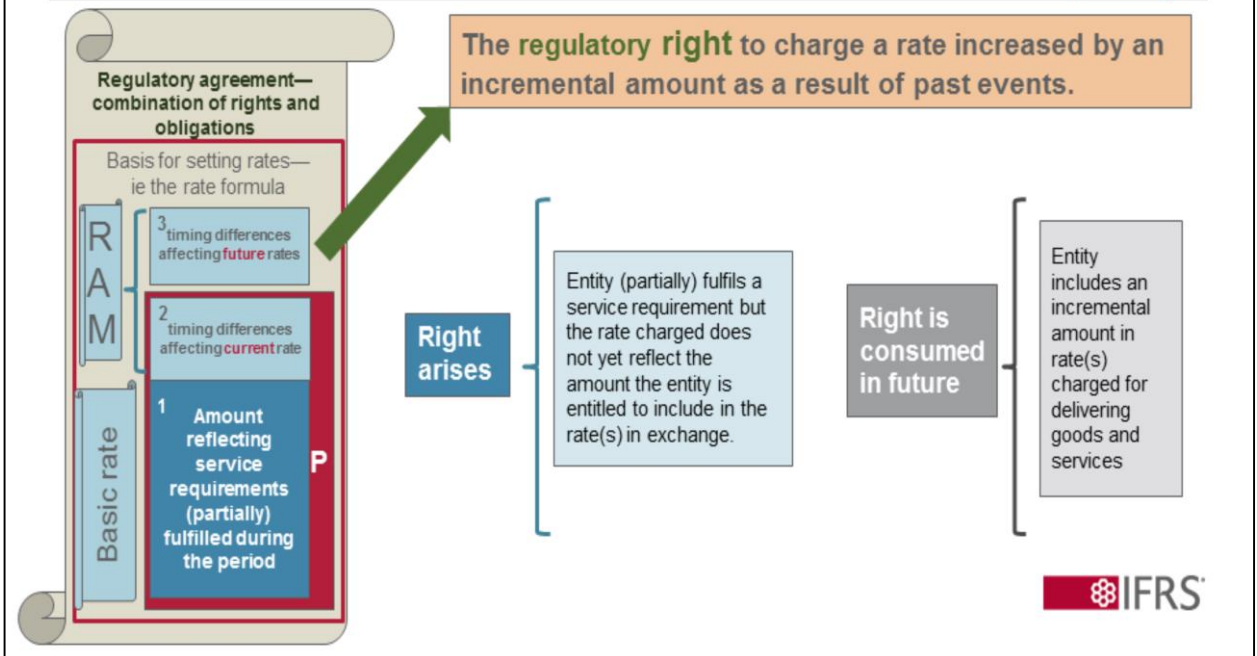


Q2. *Conceptual Framework* definitions

- a) Is the regulatory right an asset? ([slides 18–21](#))
- b) Is the regulatory obligation a liability? ([slides 22–25](#))

Rights arising from the RAM— timing differences affecting future rates

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The regulatory agreement establishes the service requirements the entity is obliged to fulfil. The regulatory agreement also sets out the rate formula that establishes **how much** compensation the entity is entitled to include in the regulated rate **in exchange** for fulfilling its service requirements, and establishes **when** the compensation is to be included in the rate(s). Consequently, the rate formula creates a direct and specific **cause-and-effect** relationship between a rate-regulated activity and amounts included in the rate(s) (see [slide 9](#)).

A **regulatory right** to charge a rate increased by an incremental amount is created when an entity (partially) fulfils the service requirements established by the regulatory agreement but the current rate does not yet reflect the amount of compensation that the entity is entitled to include in the rate(s) in exchange for fulfilling those service requirements. Such a right could arise from a variety of past transactions, activities and events, such as the entity:

- incurring expenses that the calculation of the regulated rate is intended to recover through amounts billed to customers (allowable expenses);
- meeting a bonus target (eg timing or quality of performance); or
- incurring a higher amount of actual allowable expenses than the estimated amount already included in the rate (ie an allowable estimation variance).

As a result of the past event, the incremental amount of allowable expenses, the bonus, or the allowable estimation variance not included already in the regulated rate(s) will be included in the regulated rate(s) to be charged in future periods.

The right arising from the past events above is consumed as the entity includes the incremental amount in rate(s) charged to customers when delivering goods and services in the future.

But does the **regulatory right** meet the definition of an asset in the *Conceptual Framework*...?

- 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**.

The *Conceptual Framework* states: 'For an entity to control an economic resource, the economic benefits arising from that resource must flow to the entity (either directly or indirectly) rather than to another party. This aspect of control does not imply that the entity can ensure that the resource will produce economic benefits in all circumstances. Instead, it means that if the resource produces economic benefits, the entity is the party that will obtain them (either directly or indirectly).'

This concept that control does not require certainty that the resource will generate economic benefits is not new. For example, IAS 2 *Inventories* has established that inventories are assets. This is true even though the entity cannot control whether any existing or potential customers will buy the inventory items. The entity has a right to sell the inventory and to retain any sale proceeds produced as a result.

Is the regulatory right an asset?

Right specified in the regulatory agreement

Entity controls the right—it is the only party that can use the right and obtain the benefits from it

The present regulatory **right** to charge a rate increased by an **incremental amount*** as a result of **past events**.

Economic benefits

Entity has fulfilled service requirements ([slide 18](#))

Considering the unit of account recommended in [slide 16](#), do you agree the present regulatory right to charge a rate increased by an incremental amount as a result of past events is an asset?

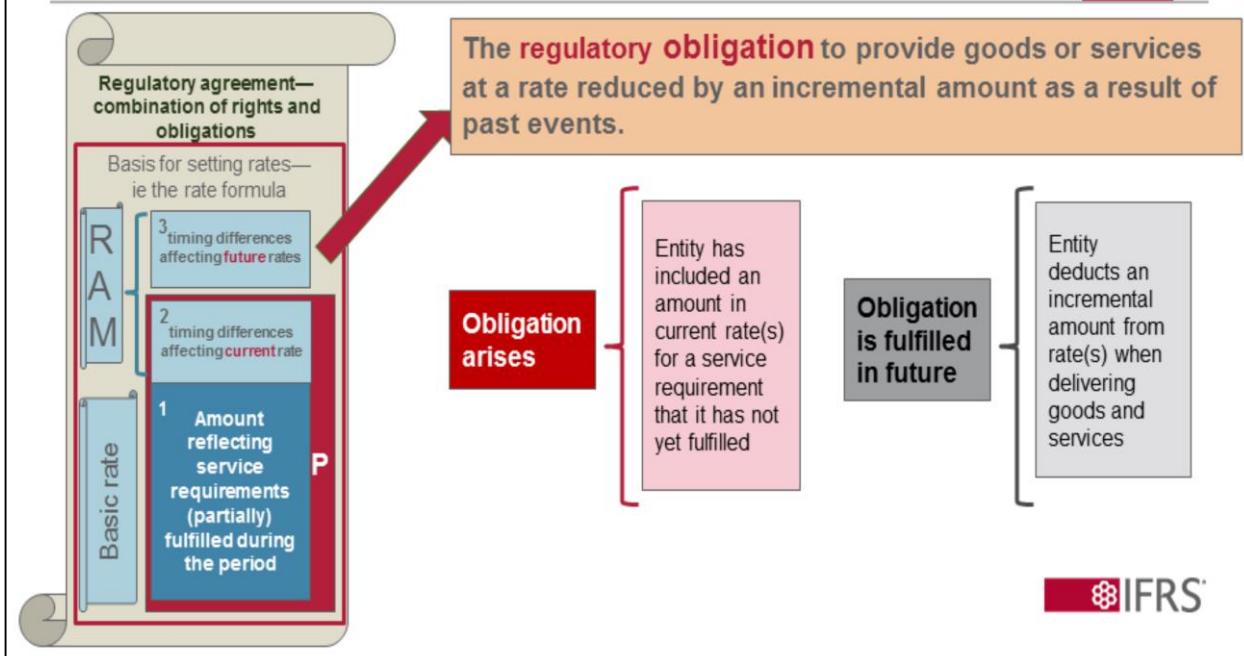
(*): The term 'incremental amount' is used to describe the monetary amount of the timing differences created by the regulatory agreement.

The rate formula within the regulatory agreement creates a direct and specific **cause-and-effect** relationship between a rate-regulated activity and amounts included in the rate(s) (see [slide 9](#)). The rate formula creates **timing differences** when **some** of the effects of a transaction or other event are reflected in the rate in a **different period** than the period in which that transaction or other event takes place. Those timing differences are specific to the entity.

The *Conceptual Framework* criteria for control within the asset definition are that the entity (rather than any other party) has the present ability to direct the use of the right and obtain the economic benefits that flow from it. In this case, the right has only one possible use and the entity is the only party that can obtain the benefits that flow from it. Consequently, the entity controls the right.

Obligations arising from the RAM—timing differences affecting future rates

22



A **regulatory obligation** to provide goods or services at a rate reduced by an incremental amount is created when an entity charges customers through the current rate for service requirements established by the regulatory agreement that the entity has not yet fulfilled. Such an obligation could arise from a variety of past events, such as the entity:

- receiving amounts from customers in advance of carrying out activities and incurring the allowable expenses that those amounts are intended to compensate it for;
- failing to meet a target (eg for timing or quality of performance) so that a penalty is imposed; or
- incurring a lower amount of actual allowable expenses than the estimated amount already included in the rate (ie a chargeable estimation variance).

As a result of the past event, the incremental amount received in advance, the penalty, or the chargeable estimation variance will be deducted in calculating the regulated rate(s) to be charged in specified future periods.

The regulatory obligations arising from the past events above are fulfilled as the entity fulfils service requirements to deliver goods and services and charges a rate(s) reduced by the incremental amount already included in the rate(s). Consequently, the rate charged for delivering those goods and services is less than the amount that reflects the service requirements fulfilled during that period. In effect, the entity gives customers a rebate in the rate(s) charged when those goods and services are delivered because:

- the entity has already charged customers an amount for those goods and services and, as a result, the entity cannot charge customers that amount again when those goods and services are delivered; or
- if the entity fails to fulfil the service requirements for which the incremental amount has already been included in the rate, the entity cannot retain that amount and is obliged to deduct it from rate(s) charged to customers when delivering other goods and services in the future.

But does the **regulatory obligation** meet the definition of a liability in the *Conceptual Framework*...?

- A **liability** is a **present obligation** of the entity to transfer an **economic resource** as a result of **past events**.
- An obligation is a duty or responsibility that an entity has **no practical ability** to avoid.
- Present obligation exists as a result of past events **only if**:
 - the entity has already **obtained economic benefits**, or **taken an action**; and
 - **as a consequence**, the entity will or may have to transfer an economic resource that it **would not otherwise have had to transfer**.

Is the regulatory obligation a liability?

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Obligations specified in the regulatory agreement

Entity has no practical ability to avoid

The present regulatory **obligation** to provide **goods or services at a rate reduced by an incremental amount*** as a result of **past events**.

Entity has received economic benefits for service requirements not yet fulfilled (slide 22)

The economic resource

Considering the unit of account recommended in [slide 16](#), do you agree the present regulatory obligation to provide goods or services at a rate reduced by an incremental amount as a result of past events is a liability?

(*): The term 'incremental amount' is used to describe the monetary amount of the timing differences created by the regulatory agreement.

As noted at [slide 9](#), the rate formula within the regulatory agreement creates a direct and specific **cause-and-effect** relationship between a rate-regulated activity and amounts included in the rate(s). The rate formula creates **timing differences** when **some** of the effects of a transaction or other event are reflected in the rate in a **different period** than the period in which that transaction or other event takes place. Those timing differences are specific to the entity.

When an entity includes in the rate charged to customers in a period an amount that relates to service requirements to be fulfilled in a future period, the regulatory agreement gives the entity an unconditional obligation to transfer goods or services in the future period at a lower price than it would have been able to charge had it not already received economic benefits that provided compensation for them.



Appendix: origination and reversal of incremental rights and incremental obligations



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As noted at [slide 9](#), the rate regulator uses the rate formula and the RAM to affect the **timing** of amounts charged to customers to help achieve stability of prices. The rate formula within the regulatory agreement creates a direct and specific **cause-and-effect** relationship between a rate-regulated activity and amounts included in the rate(s). The RAM within the rate formula creates **timing differences** when **some** effects of a transaction or other event are reflected in the rate in a **different period** than the period in which that transaction or other event takes place. Each individual timing difference results from either:

- the **right** to include an incremental amount in future rate(s) because the entity has already (partially) fulfilled a service requirement **and** the regulatory agreement entitles the entity to include that incremental amount in the rate(s) in a future period; or
- the **obligation** to deduct an incremental amount of compensation from future rate(s) because the entity has already included that amount in the rate **but** has not yet wholly fulfilled the related service requirement.

The objective of the accounting model is to provide useful information to users of financial statements about:

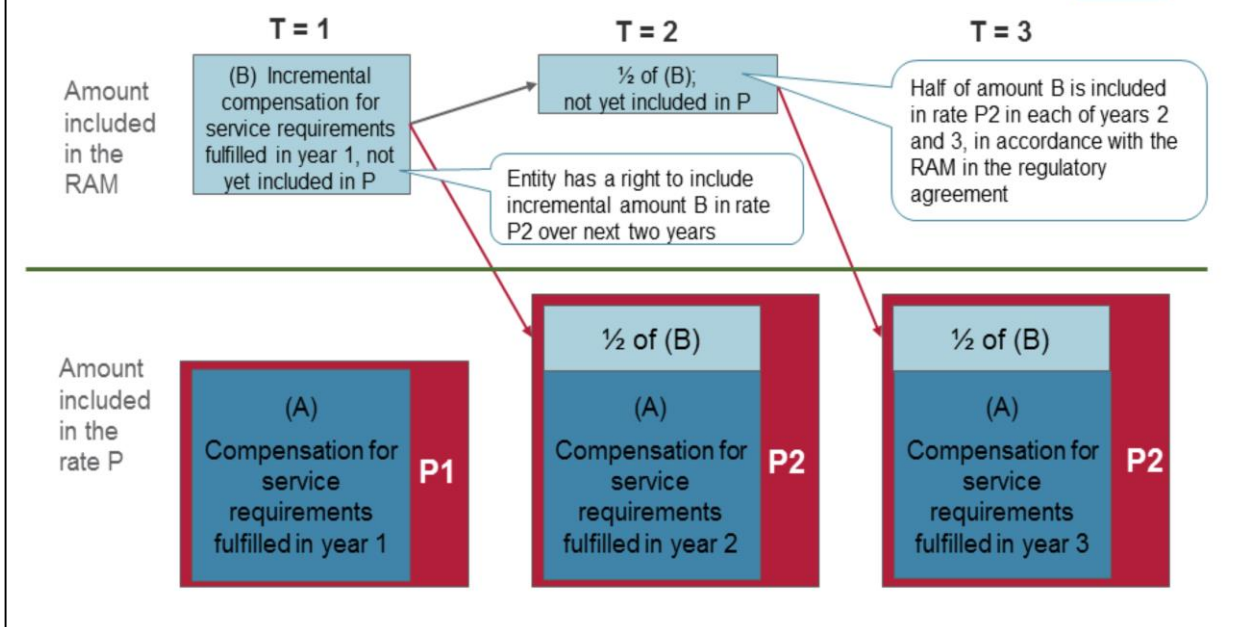
- incremental rights and obligations arising from timing differences between the timing of charging customers through the regulated rate and the timing of fulfilment of service requirements by the entity; and
- the effects of those timing differences on the entity's financial performance (see [slide 11](#)).

The slides in the appendix are intended to illustrate the **origination and reversal** of an incremental right ([slides 27-28](#)) and an incremental obligation ([slides 29-30](#)) arising from the entity's activities and the operation of the RAM, together with the accounting entries that could implement the model. The proposed accounting entries recognise:

- a regulatory adjustment to increase net income when the entity (partially) **fulfils** a service requirement during the period but the rate **charged** in that period does not yet include an amount relating to that service requirement; and
- a regulatory adjustment to decrease net income when the rate **charged** during the period includes an amount relating to a service requirement that will be **fulfilled** in a different period.

Example 1—incremental right arising from the RAM: amounts included in the RAM / rate

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This slide illustrates the origination and reversal of an **incremental right** arising from the entity's activities and the operation of the RAM.

The regulatory agreement establishes the rate chargeable (P1) in year 1, based on the service requirements the entity is expected to fulfil during that period.

During period 1, the entity fulfils additional service requirements for which compensation is not included in the rate P1. As a result, an incremental amount of CU20 (amount B) is included in the RAM to compensate the entity for fulfilling those additional service requirements. In accordance with the regulatory agreement, the entity adjusts the rate (P2) for the next two years so that half of the originating timing difference of CU20 (ie CU10) is charged to customers in each of years 2 and 3.

Using existing IFRS Standards, **without** the new accounting model, would result in the entity recognising in its financial statements:

- in year 1—the costs of fulfilling the additional service requirements, with no related compensation; and
- in both years 2 and 3—the incremental compensation included in the rate P2, with no related costs.

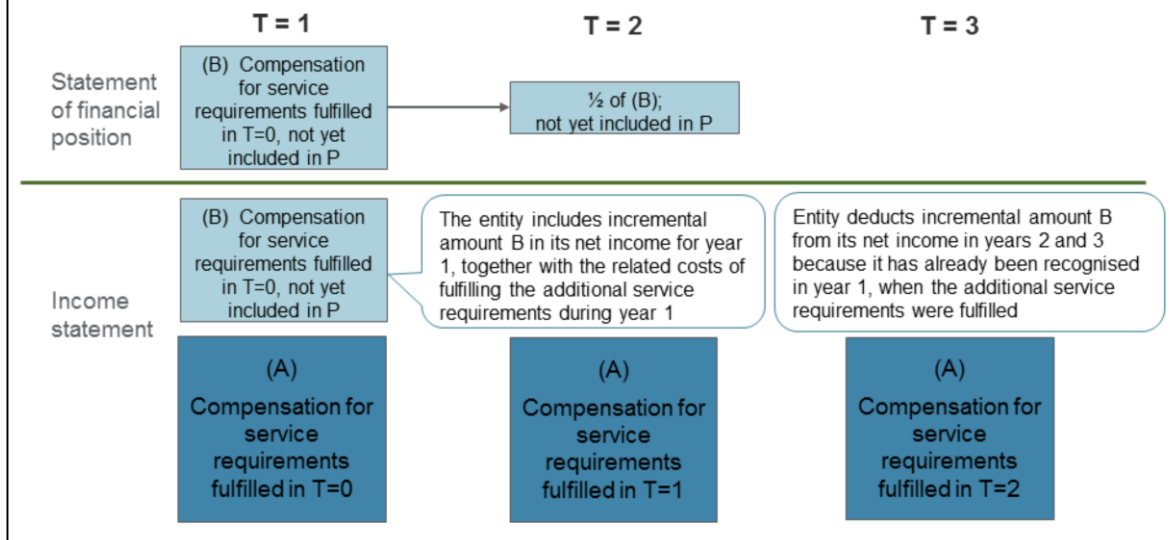
Using the model, the entity recognises, in year 1, the incremental compensation for fulfilling the additional service requirements, as well as recognising the related costs of fulfilling those service requirements. As a result, the entity recognises:

- the origination of the incremental right to include an additional amount of CU20 in exchange for fulfilling additional service requirements during year 1; and
- the reversal of that incremental right during years 2 and 3 when the right is consumed by including the incremental amount in the rate P2 charged for service requirements fulfilled during those years.

The accounting entries are illustrated on the following slide (ignoring the time value of money for ease of illustration).

Example 1—incremental right arising from the RAM: amounts included in the financial statements

28



This slide illustrates the net compensation recognised in the income statement using the proposed new accounting model to recognise the origination and reversal of the **incremental right** arising from the entity's activities and the operation of the RAM.

At time T=1

The entity has, during the period, charged customers price P1 for service requirements that it has fulfilled during that period (amount A = 100). However, the regulatory agreement establishes that the entity is entitled to include compensation of CU120 in the rate for fulfilling those service requirements—CU100 has been included in the rate during year 1, CU10 will be included in the rate in each of years 2 and 3.

The entity uses IFRS 15 to recognise revenue using the regulated rate P1 (which equals A = CU100).

	Dr	(Cr)
Accounts receivable/ cash	100	
Revenue		(100)

In addition, the model recognises at T=1 the right to charge the incremental compensation for fulfilling the additional service requirements during year 1 (ie amount B, which equals CU20):

	Dr	(Cr)
Regulatory asset	20	
Regulatory adjustment (P+L)		(20)

At time T=2 (and similarly at time T=3)

The entity has, during the period, charged customers price P2, which:

- compensates the entity for service requirements that it has fulfilled during the period (amount A = 100); **and**
- partially compensates the entity for the additional service requirements fulfilled in year 1, for which compensation is included in the rate P2 during year 2 (and year 3).

The entity will use IFRS 15 to recognise revenue using the regulated rate P2 (which equals A (= 100) **PLUS** CU10, ie half of the CU20 incremental compensation included in the RAM, which is included in the rate in equal amounts over two years, in accordance with the regulatory agreement).

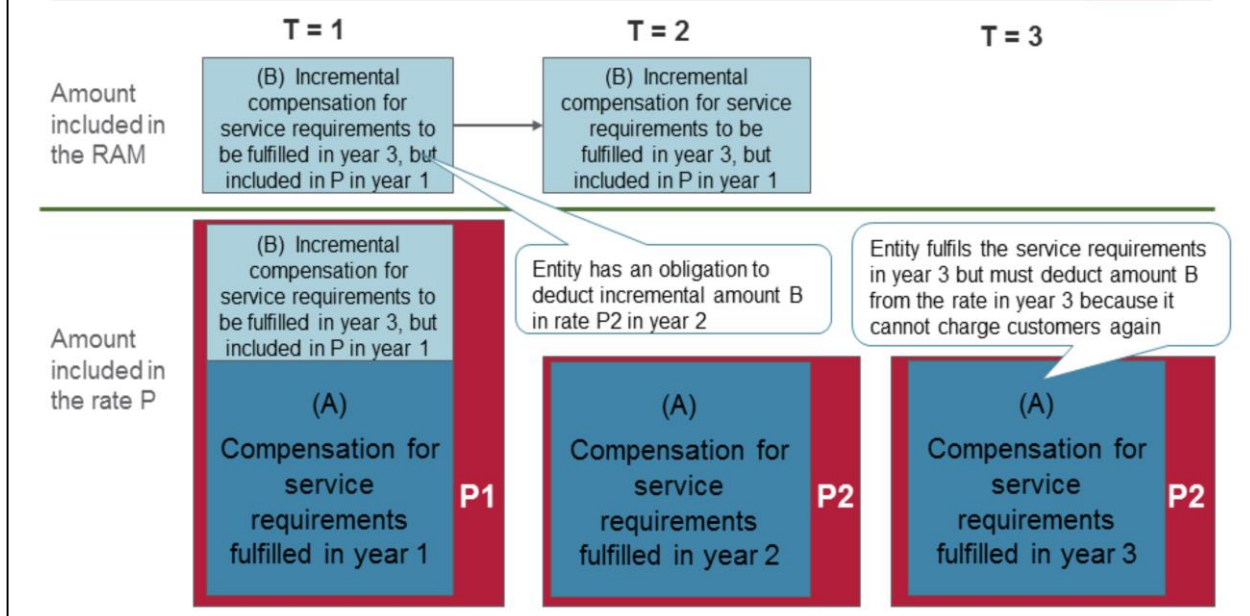
	Dr	(Cr)
Accounts receivable/ cash	110	
Revenue		(110)

However, the incremental compensation being charged through the rate P2 in exchange for the additional service requirements fulfilled in year 1 has already been recognised in the income statement in year 1. As a result, the model recognises a regulatory adjustment to show the incremental compensation is charged to customers through the rate P2 **in arrears** of the related service requirements being fulfilled by the entity. The model also reduces the carrying amount of the regulatory asset to reflect the consumption of the right to charge the incremental amount as it is billed in each of years 2 and 3:

	Dr	(Cr)
Regulatory asset		(10)
Regulatory adjustment (P+L)	10	

Example 2—incremental obligation arising from the RAM: amounts included in the RAM / rate

29



This slide illustrates the origination and reversal of an **incremental obligation** arising from the entity's activities and the operation of the RAM.

The regulatory agreement establishes the rate chargeable (P1) in year 1, based on the service requirements the entity is expected to fulfil during that period. In addition, the rate P1 includes an incremental amount of CU20 (amount B) which is included in the RAM because it is intended to compensate the entity for fulfilling additional service requirements in year 3. (In accordance with the regulatory agreement, if the entity does not fulfil the prefunded service requirements in year 3, it will reduce the rate to refund the CU20 to customers.)

Using existing IFRS Standards, **without** the new accounting model, would result in the entity recognising in its financial statements:

- in year 1—incremental compensation included in the rate P1 for the additional service requirements not yet fulfilled, with no related costs; and
- in year 3—the costs of fulfilling the additional service requirements, with no related compensation.

Using the model, the entity recognises, in year 1, a regulatory adjustment to show the incremental compensation charged to customers through the rate P1 was for the additional service requirements not yet fulfilled. As a result, the entity recognises:

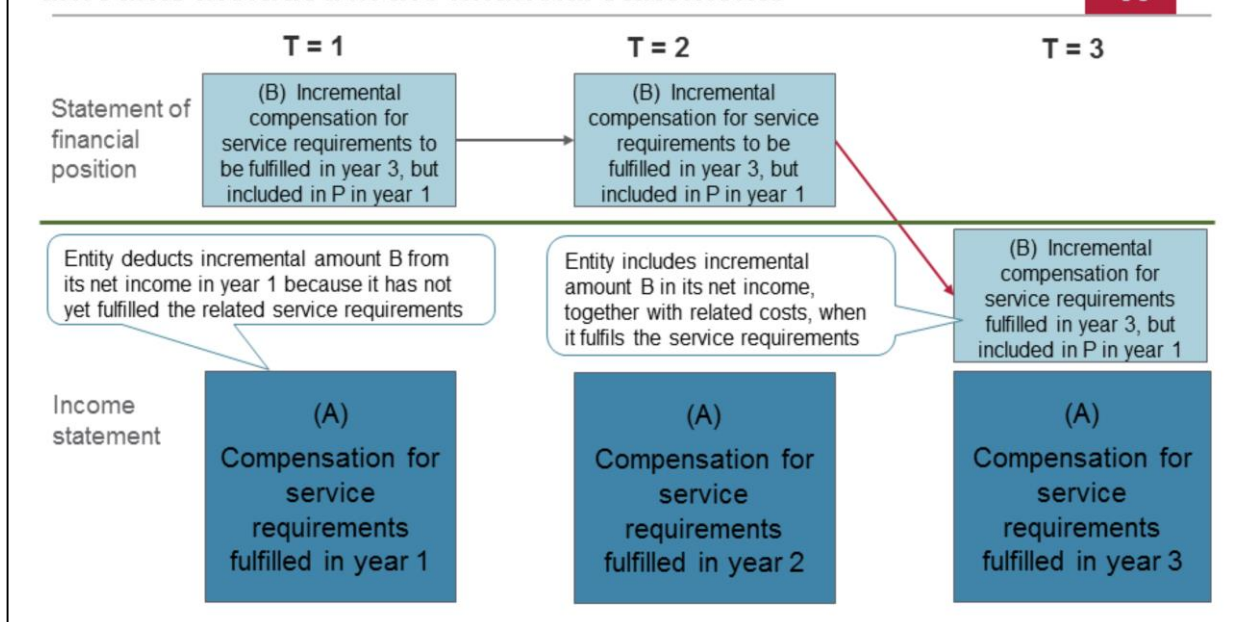
- the origination of the incremental obligation to deduct the amount of CU20 charged through rate P1 when it fulfils the additional service requirements during year 3; and
- the reversal of that incremental obligation during year 3 when the obligation is fulfilled by deducting the incremental amount from the rate P2 charged for service requirements fulfilled during year 3.

The accounting entries, and the resulting net compensation recognised in the income statement, are illustrated on the following slide (ignoring the time value of money for ease of illustration).

Note: The model makes no adjusting entries at time T = 2 because, during year 2, the entity charges customers the rate P2, which compensates the entity for the ongoing service requirements that it fulfils during that period (amount A = CU100). The entity will use IFRS 15 to recognise revenue using the regulated rate P2 (which equals A = 100).

Example 2—incremental obligation arising from the RAM amounts included in the financial statements

30



This slide illustrates the net compensation recognised in the income statement using the proposed new accounting model to recognise the origination and reversal of an incremental obligation arising from the entity's activities and the operation of the RAM.

At time T=1

The entity has, during year 1, charged customers rate P1, which compensates the entity for:

- the service requirements fulfilled during that year (amount A = CU100), **PLUS**
- the additional service requirements that it will fulfil in year 3 (amount B = CU20).

The entity will use IFRS 15 to recognise revenue using the regulated rate P1 (which equals A + B, ie CU120).

	Dr	(Cr)
Accounts receivable/ cash	120	
Revenue		(120)

In addition, the model recognises a regulatory adjustment to show the incremental compensation was charged to customers through the rate P1 **in advance** of the related service requirements being fulfilled by the entity and to recognise the obligation to deduct from the future rate P2 the incremental compensation charged through rate P1:

	Dr	(Cr)
Regulatory liability		(20)
Regulatory adjustment (P+L)	20	

At time T=3

The entity has, during the period, charged customers the rate P2, which compensates the entity for the ongoing service requirements that it has fulfilled during that period (amount A = CU100). The entity will use IFRS 15 to recognise revenue using the regulated rate P2 (which equals A = 100).

	Dr	(Cr)
Accounts receivable/ cash	100	
Revenue		(100)


The entity has also fulfilled additional service requirements in year 3 in exchange for which it is entitled to CU20 compensation (amount B). However, because it has already included the incremental amount B in the rate P1 charged in year 1, the entity cannot bill customers again for those additional service requirements when it fulfils them during year 3. As a result, the model recognises a regulatory adjustment to recognise the fulfilment during year 3 of the obligation to deduct the incremental amount B from the rate P2 when fulfilling service requirements in year 3:

	Dr	(Cr)
Regulatory liability	20	
Regulatory adjustment (P+L)		(20)

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