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Project	Rate-regulated Activities		
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Purpose of this paper

1. A regulatory agreement may provide an entity with performance incentives for achieving (or failing to achieve) indicated performance criteria (eg targeted levels of service quality or reliability, customer satisfaction, etc). Once an entity becomes entitled to such a bonus or penalty, these amounts will generally be included as an adjustment to the rates charged to customers in the same or a subsequent period. The terms and conditions of the regulatory agreement covering such performance incentives are referred to in this paper as 'incentive schemes'.

2. The purpose of this paper is to analyse how the model for regulatory assets and regulatory liabilities would apply when, at the financial reporting date, it is not yet certain whether an entity will become entitled to such a bonus (or liable for such a penalty).

3. The paper is for information only and does not contain any recommendations or decisions for the Board.

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Structure of this paper

4. This paper is structured as follows:

   (a) Background (paragraphs 5-8);

   (b) Analysis in respect of:

      (i) The incentive performance period and the potential for uncertainty (paragraphs 9-15);

      (ii) Existence uncertainty and outcome uncertainty (paragraphs 16-20)

      (iii) Estimating the total allowed compensation (paragraphs 21-26);

      (iv) Precedents in other IFRS Standards ® (paragraphs 27-31);

      (v) Analogy to variable consideration (paragraphs 32-33);

      (vi) Apportionment (paragraphs 34-38); and

      (vii) Information received after the reporting date (paragraphs 39-45).

Background

5. The *Conceptual Framework for Financial Reporting (Conceptual Framework)* defines **existence uncertainty** as uncertainty about whether an asset or a liability exists.

6. Existence uncertainty is separate from both:

   (a) **outcome uncertainty**—which relates to uncertainty about the timing or amount of any inflow or outflow of economic benefits that will result from an asset or liability; and

   (b) **measurement uncertainty**—which arises when monetary amounts in financial reports cannot be observed directly and must instead be estimated.

7. In March 2018, the Board tentatively decided that the model should:

   (a) require the recognition of regulatory assets or regulatory liabilities if it is 'more likely than not' that they exist (ie a symmetrical recognition threshold in cases of *existence* uncertainty); and

(b) should not set thresholds that would prevent recognition of a regulatory asset or regulatory liability for which there is:

(i) a low probability of an inflow or outflow of economic benefits; or

(ii) high measurement uncertainty.

8. As a result of this tentative decision, any **outcome uncertainty**—ie uncertainty about the amount or timing of an inflow or outflow—**is to be reflected in the measurement of the regulatory asset or regulatory liability**.

Analysis

The incentive performance period and the potential for uncertainty

9. In the accounting model for regulatory assets and regulatory liabilities (the model), bonuses or penalties which are included in the rates charged to customers **are related to the supply of goods or services** and form part of the **total allowed compensation** that an entity becomes entitled to for those goods or services.

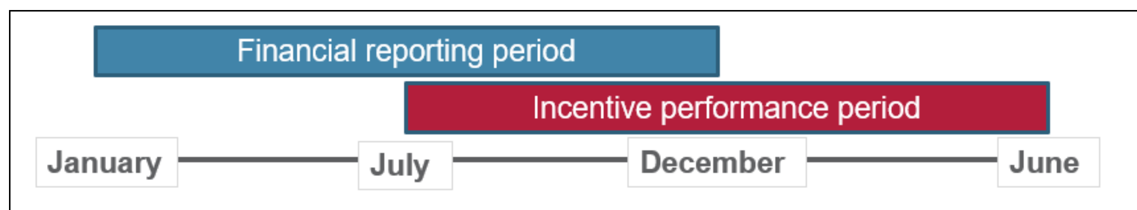
10. A **regulatory asset or a regulatory liability** would be recognised if this total allowed compensation is **higher or lower than the amount already charged to customers**—that is, an entity would generally recognise a regulatory asset in the period that it acquired a right to include a bonus in the total allowed compensation for goods or services already supplied, or a regulatory liability in the period that it incurred an obligation to deduct a penalty.

11. The regulatory agreement may establish a period over which an entity's performance against incentive criteria is monitored and evaluated (the '**incentive performance period**') and this period may or may not align with the entity's financial reporting period.

12. When the incentive performance period concludes within, or at the same time, as the financial reporting period, there will generally be little or no uncertainty as to whether the entity has earned a bonus or incurred a penalty and thus, whether it should recognise a regulatory asset or a regulatory liability.

13. However, if the incentive performance period differs from the financial reporting period, it may be uncertain at the reporting date whether the entity will ultimately achieve the incentive target. This would happen, for instance, if an entity had a calendar year-end, but the incentive performance period ran from July to June, as illustrated in Figure 1:

Figure 1



14. When an incentive scheme requires consistent or cumulative performance throughout the entire incentive performance period to achieve a bonus or avoid a penalty[1], it will be **unclear** what, if any, adjustment should be made to the estimate of the total allowed compensation **for the portion of the incentive performance period falling within the current reporting period** (ie July-December in Figure 1).

15. Furthermore, even if annual financial reporting periods are coterminous with the incentive performance period, it may be unclear whether a regulatory asset or regulatory liability should be recognised at an interim financial reporting date.

Existence uncertainty and outcome uncertainty

16. The regulatory agreement establishes the mechanism for the incentive scheme which results in the *right* to add an amount to (or the *obligation* to deduct an amount from) future rates, subject to the outcome of the entity's performance against the incentive criteria—thus there is little or no uncertainty regarding the *existence* of a right or an obligation.

17. This concept was discussed in Agenda Paper 9C presented to the Board in March 2018, which supported the current tentative decisions made regarding the recognition

[1] For example, an electricity generation company might have an incentive target to minimise minutes of customer outages below a specified target—in such a situation, performance to date is not 'accrued' because poor performance in the latter part of the incentive performance period could result in the entity failing the target for the entire period.

principles of the model. The conclusion was reached that there is typically little or no existence uncertainty for such ‘automatic’ rate adjustments, when the terms of the regulatory agreement are enforceable and are sufficiently explicit that the specified item(s) (in this case the performance bonus or penalty) will be reflected in future rate adjustments.

18. However, in this situation there is still uncertainty as to the *outcome* of the entity’s performance against the incentive criteria, and thus the amount of the inflow or outflow of economic benefits that will result.

19. Hence, the issue at hand appears to be an example of *outcome* uncertainty rather than existence uncertainty, and in this case, the outcome uncertainty leads to *measurement* uncertainty for any resulting regulatory asset or regulatory liability.

20. Thus, in accordance with the *Conceptual Framework* and the principles of the model set out in paragraph 8, this outcome uncertainty would be reflected in the *measurement* of the regulatory asset or regulatory liability.

Estimating the total allowed compensation

21. The model’s principles have been developed around the fact that an entity becomes entitled to an amount of total allowed compensation for goods or services supplied in a given period.

22. Regulatory assets or regulatory liabilities arise as a result of differences between the total allowed compensation earned for a period and the amounts already charged to customers.

23. When the incentive performance period concludes after the financial statements are authorised for issue, the entity will have supplied goods or services in the current period but, as a result of the outcome uncertainty regarding the incentive amounts, the amount of total allowed compensation for these goods or services will not be known with certainty.

24. The fact that the supply of goods or services has already taken place underlines the fact that this is not a question of existence uncertainty—that is, *some* right or obligation has been generated because an amount of total allowed compensation has been earned and an amount has been charged to customers—however**, the total**

allowed compensation must be estimated, taking into account the expected outcome of the entity's performance against the incentive criteria, in order to measure the resulting regulatory asset or regulatory liability.

25. In accordance with the measurement principles of the model, an entity estimates the cash flows using the 'most likely amount' method or the 'expected value' method, depending on which method the entity concludes would better predict the amount of the cash flows.[2]

26. The following example illustrates these principles;

Example 1

Fact pattern

A regulatory agreement specifies that the regulated entity will receive a bonus of CU100 if a performance indicator score is more than 105 and must pay a penalty of CU100 if the performance indicator is less than 95. The entity estimates that there is a 60% probability that indicator will be more than 105 and 5% that it will be less than 95.

Application of the model

If the entity uses the most likely amount method, its estimate of the total allowed compensation will include an amount of CU100. If the entity uses the expected value method, that estimate will include an amount of CU55.[3]

As discussed in paragraphs 34-38, if necessary, the entity would then apportion a part of this total allowed compensation to the current reporting period to determine the amount of any regulatory asset or regulatory liability to recognise.

[2] See Agenda Paper 9C presented to the Board in June 2019.
[3] (CU100 x 60%) + (CU(-100) x 5%) = CU55

Precedents in other IFRS Standards ®

27. Supporting this reasoning, staff have also identified precedents in other Standards where similar uncertainties are addressed:

28. For example, paragraph 72 of IAS 19 *Employee Benefits* states (emphasis added):

> Employee service gives rise to an obligation under a defined benefit plan even if the benefits are conditional on future employment (in other words they are not vested). Employee service before the vesting date gives rise to a constructive obligation because, at the end of each successive reporting period, the amount of future service that an employee will have to render before becoming entitled to the benefit is reduced. In measuring its defined benefit obligation, an entity considers the probability that some employees may not satisfy any vesting requirements. Similarly, although some post-employment benefits, for example, post-employment medical benefits, become payable only if a specified event occurs when an employee is no longer employed, an obligation is created when the employee renders service that will provide entitlement to the benefit if the specified event occurs. The probability that the specified event will occur affects the measurement of the obligation, but does not determine whether the obligation exists.

29. In addition, paragraph B7 of the Illustrative Examples accompanying IAS 34 *Interim Financial Reporting* states (emphasis added):

> Variable lease payments based on sales can be an example of a legal or constructive obligation that is recognised as a liability. If a lease provides for variable payments based on the lessee achieving a certain level of annual sales, an obligation can arise in the interim periods of the financial year before the required annual level of sales has been achieved, if that required level of sales is expected to be achieved and the entity, therefore, has no realistic alternative but to make the future lease payment.

30. Furthermore, paragraph B12 of the Illustrative Examples accompanying IAS 34 requires that (emphasis added):

> Interim period income tax expense is accrued using the tax rate that would be applicable to expected total annual earnings, that is, the estimated average annual effective income tax rate applied to the pre-tax income of the interim period.

31. Each of these examples illustrate precedents in IFRS Standards whereby an entity estimates the outcome of an ongoing item and incorporates this estimate into its financial reporting for the current period, reflecting the fact that the ongoing item gives rise to effects that accumulate with the passage of time.

Analogy to variable consideration

32. One could view the performance incentives discussed in this paper as being analogous to the concept of variable consideration addressed by paragraphs 50-59 of IFRS 15 *Revenue from Contracts with Customers*.

33. Staff considered whether the requirements of IFRS 15 for variable consideration should be incorporated into the model to account for performance incentive schemes in a regulatory agreement, but do not recommend this course of action. The reason for this is that such a requirement would constitute an ‘overlay’ to the underlying recognition and measurement principles of the model, adding complexity as separate requirements would have to be developed, as well as and guidance on when the separate requirements would apply.

Apportionment

34. An entity supplies goods or services in a period and becomes entitled to an amount of total allowed compensation under the regulatory agreement as a result. The entity must know or estimate the total allowed compensation for the current period in order to compare this to the amount charged to customers and determine whether it must recognise a regulatory asset or regulatory liability.

35. The amount of any bonus or penalty arising under an incentive scheme operating (at least partially) in the current period forms part of the total allowed compensation for the goods and services supplied in the current period. In some cases, it will be clear how much of the bonus or penalty relates to the current period, rather than to a future period containing part of the incentive performance period. This would be the case if, for example, the penalty is a set percentage of the selling price charged to customers or is a fixed price per unit supplied. However, in other cases, for example, if a bonus is a fixed monetary amount, it will be less clear how much of the bonus or penalty relates to the current period.

36. To illustrate, continuing with the illustration in Figure 1, the first six months of the incentive performance period fall within the current financial reporting period and thus a portion of any estimated bonus or penalty under this incentive scheme would form part of the total allowed compensation for the current reporting period.

37. Therefore, once an entity has made an estimate of the total allowed compensation it expects to become entitled to under an incentive scheme for the incentive reporting period (July X0 – June X1 in Figure 1), it would apportion a part of this total allowed compensation to the current period on a reasonable and systematic basis (eg the passage of time if that best represents the factors that drive the bonus).

38. This apportionment portrays the bonus or penalty as arising as the incentive period progresses, rather than only at a point in time (eg upon the conclusion of the incentive performance period once the entity's performance against the incentive criteria is known).

Information received after the reporting date

39. In estimating the total allowed compensation for the current reporting period and thus measuring the resulting regulatory asset or regulatory liability, an entity would consider all available information, including any information that becomes available after the reporting date.

40. IAS 10 *Events After the Reporting Period* requires an entity to adjust the amounts recognised in its financial statements to reflect *adjusting events* after the reporting period.[4] Adjusting events are defined as those that provide evidence of conditions that existed at the end of the reporting period.[5]

41. IAS 10 provides examples of adjusting events, including the determination after the reporting date of:

    (a) the proceeds of assets sold before the end of the reporting period; and

[4] Paragraph 8 of IAS 10 *Events After the Reporting Period*
[5] Paragraph 3 of IAS 10

(b) the amount of profit-sharing or bonus payments if the entity had a present legal or constructive obligation at the end of the reporting period to make such payments as a result of events before that date.

42. In addition, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that an entity considers any additional evidence provided by events after the reporting period[6] in forming its best estimate of the expenditure required to settle the present obligation existing at the reporting date.

43. Information received after the reporting date may provide additional insight into the entity's performance against the incentive performance criteria for the part of the incentive performance period that fell within the current financial reporting period. To the extent the subsequent event or information confirms or provides additional insight into the entity's performance against the incentive criteria, it would be incorporated into the estimate of the total allowed compensation for the incentive performance period.

44. If however, the subsequent event or information relates solely to the period after the reporting date, it would not be incorporated. An example of this would be an unanticipated storm subsequent to the reporting date which causes a service outage that results in the entity failing to meet its target for the entire incentive performance period. Such an event does not provide the entity with information for its estimate of the amount of total allowed compensation it became entitled to for goods or services supplied in the past performance period.

45. This concept can be illustrated by a simple example:

Example 2

Fact pattern

An entity subject to an incentive scheme has a 31 December X0 year-end for financial reporting purposes and finalises its financial statements for issue on 15 April X1. Performance against the incentive scheme is evaluated over the period 1 July X0 to 30 June X1. If successful against the relevant criteria, the entity will be entitled to a CU100 bonus (that can be included in the rates charged in X2).

[6] Paragraph 38 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

As at 31 December X0, the entity estimates there to be a 40% chance that it will earn the bonus. However, continued performance against the incentive criteria for the next three months, combined with other factors, results in the entity's estimated likelihood of obtaining the bonus for the incentive performance period increasing to 80% by 31 March X1.

Application of the model

The entity considers all available information up until the financial statements are authorised for issue (15 April X0) to develop its estimate of the total allowed compensation it will become entitled to under the incentive scheme, and the portion of that total allowed compensation related to X0.

There is an 80% likelihood of obtaining the bonus, therefore the entity estimates that the total allowed compensation it will become entitled to for the incentive performance period is CU100 (if it uses the most likely amount method) or CU80 (if it uses the expected value method). As discussed in paragraphs 34-38, the entity would then apportion a part of this total allowed compensation to the current reporting period and recognise a regulatory asset accordingly as at 31 December X0.

Summary

46. It is our view that the principles of the model, as already established, are sufficient to enable entities to account for the uncertainties arising from incentive schemes that are discussed in this analysis.

47. The staff will consider in drafting whether to provide application guidance on how the model's principles would be applied in situations where, at the financial reporting date, it is not yet certain whether an entity will become entitled to a bonus (or liable for a penalty).

Question for the Board

Incentive schemes
1. Does the Board have any comments on the analysis in this paper?