

STAFF PAPER

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Project	Rate-regulated activities		
Paper topic	Scope, definitions of regulatory assets and liabilities, recognition and derecognition		
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Purpose of this paper

1. The purpose of this paper is to further analyse:
 - (a) whether the tentative decisions made to date by the Board for scope, definitions of regulatory assets and regulatory liabilities, and recognition are consistent with the model's principles summarised in Agenda Paper 9A *Principles of the model: a summary* (paragraphs 4–24); and
 - (b) whether any specific requirements need to be developed for derecognition of regulatory assets and regulatory liabilities (paragraphs 25-27).
2. This paper is based on Agenda Paper 9B *Scope and recognition principles* for the May 2019 Board meeting with further analysis and a revised staff recommendation for fines payable through the rate(s) (paragraphs 19-21) considering the feedback from Board members in May 2019.

The staff have highlighted additional material by placing it in boxes (paragraphs 3, 19-21, 24 and 27).

Other changes have also been to paragraphs 4, 11 and 12(a) to help clarify the content. Other minor editorial changes have been made.

The papers discussed in May 2019 did not ask the Board to make any decisions. Revised questions have been included at the end of this paper to ask the Board whether it agrees with the staff's recommendations.

Staff recommendations

3. Staff recommend that:
 - (a) the Board update its previous tentative decisions about the scope criteria and the definitions of regulatory assets and regulatory liabilities to reflect refined descriptions (paragraph 14);
 - (b) explanatory guidance about the meaning of total allowed compensation for goods or services supplied should include a reference to fines payable through the rate(s), but there is no need to develop separate requirements for these fines (paragraph 21);
 - (c) the Board retain its previous tentative decisions about recognition (paragraph 24); and
 - (d) no further requirements need be developed for derecognition of regulatory assets and regulatory liabilities (paragraph 27).

Tentative decisions made to date

Scope

4. The Board tentatively decided, in its March 2018 meeting that the accounting model should apply to **defined rate regulation** established through a formal regulatory framework that:
 - (a) is **binding** on both the entity and the regulator; and
 - (b) establishes a **basis for setting the rate** that gives rise to rights to add amounts to, and obligations to deduct amounts from, future rate(s) because of goods or services already supplied or because of amounts already charged to customers. That basis gives rise to those rights and obligations by determining when (ie in which periods) the **total allowed compensation**

for specified goods or services supplied is included in the rate(s) charged to customers. ~~includes a rate-adjustment mechanism. That mechanism creates, and subsequently reverses, rights and obligations arising from timing differences when the regulated rate in one period includes amount related to specified activities the entity carries out in a different period.~~

Without mark-up, the refined scope criterion (b) reads:

(b) establishes a basis for setting the rate that gives rise to rights to add amounts to, and obligations to deduct amounts from, future rate(s) because of goods or services already supplied or because of amounts already charged to customers. That basis gives rise to those rights and obligations by determining when (ie in which periods) the total allowed compensation for specified goods or services supplied is included in the rate(s) charged to customers.

5. We understand the term ‘rate-adjustment mechanism’ used in some of our papers in 2018 was causing some confusion and the scope definition lacked clarity. Consequently, we suggest refining the scope definition as indicated in paragraph 4 (new text underlined, deleted text struck through) to reflect the refined description of the model summarised in Agenda Paper 9A. We consider the updates improve the specificity and clarity of the proposed scope and enhance the understandability of the model but do not represent a fundamental change to the tentative decisions or the anticipated outcomes of the model as previously discussed. The changes are intended to be consistent with the proposed refinements to the definitions of regulatory asset and regulatory liability discussed in paragraph 11.

Necessary features of the scope

6. A regulatory agreement may take the form of a contractual licensing agreement or may be imposed through statute. Regardless of its form, the terms of the regulatory agreement establish enforceable rights and obligations for the entity. The need for the terms of the regulatory agreement to be **binding** is a necessary feature that excludes from the scope of the model activities subject only to ‘self-regulation’ (ie an entity cannot create enforceable rights and obligations with itself). In some cases, the rate regulator and the entity are related parties because they are both controlled by the

same government. Such a relationship does not automatically exclude the entity from applying the model. Instead, facts and circumstances are considered to assess the enforceability of the regulatory agreement, including evidence from regulatory decisions and subsequent court rulings on those decisions.

7. The existence of a **basis for setting the rate** within the regulatory agreement is a necessary feature for activities to be subject to defined rate regulation. However, on its own, it is not a sufficient feature to differentiate defined rate regulation from other types of rate regulation. In some cases, the existence of a basis for setting the rate affects only the rate per unit that an entity is permitted to charge for its goods or services. In these cases, the regulatory intervention is limited to establishing a cap price but the entity's management is then free to manage the business in order to maximise its profitability. We have previously labelled this type of rate regulation as 'general price regulation' and have noted that such regulation would not result in the recognition of regulatory assets or regulatory liabilities.
8. The feature that distinguishes defined rate regulation from other forms of rate regulation is that the basis for setting the rate gives rise to rights to add amounts to, and obligations to deduct amounts from, future rate(s) because of goods or services already supplied or because of amounts already charged to customers. These rights and obligations arise because the basis for setting the rate establishes not only the **amount of total allowed compensation** for goods or services supplied in a period but also determines **when** (ie in which periods) that total allowed compensation is included in the rate(s) charged to customers. Consequently, the regulatory agreement creates a **direct cause-effect relationship** between the supply of goods or services, the total allowed compensation for supplying those goods or services and the rate charged to customers.
9. The presence of a **binding** regulatory agreement and a **basis for setting the rate** that gives rise to rights to add amounts to and obligations to deduct amounts from future rate(s) because of goods or services already supplied or because of amounts already charged to customers are both **necessary and sufficient** to give rise to regulatory assets and regulatory liabilities.

Incremental rights and obligations: regulatory assets and regulatory liabilities

10. When the total allowed compensation for goods or services already supplied differs from the amounts already included in the rate(s) charged to customers, the regulatory agreement gives rise to **incremental rights and incremental obligations** that are not currently accounted for using IFRS Standards.
11. The Board tentatively decided, in its February 2018 meeting, that these incremental rights and incremental obligations meet the definitions of assets and liabilities within the *Conceptual Framework*. Subsequently, we have refined our description of these rights and obligations and, as a result, we suggest that the definitions of regulatory asset and regulatory liability previously considered by the Board are updated to reflect those refinements (new text underlined, deleted text struck through):
- (a) **Regulatory asset**—a the present regulatory right to charge a ~~add an amount to the rate(s) to be charged to customers in future periods because the total allowed compensation for the goods or services already supplied exceeds the amount already charged to customers~~ increased by an amount as a result of past events.
- (b) **Regulatory liability**—a the present regulatory obligation to provide goods or services at a ~~to deduct an amount from the rate(s) to be charged to customers in future periods because the total allowed compensation for the goods or services already supplied is lower than the amount already charged to customers~~ reduced by an amount as a result of past events.

Without mark-up, the refined definitions read:

Regulatory asset—the present right to add an amount to the rate(s) to be charged to customers in future periods because the total allowed compensation for the goods or services already supplied exceeds the amount already charged to customers.

Regulatory liability—the present obligation to deduct an amount from the rate(s) to be charged to customers in future periods because the total allowed compensation for the goods or services already supplied is lower than the amount already charged to customers.

12. We consider the updated definitions enhance their understandability and consistency of application. These updates provide:

- (a) a clearer definition of the **past event** that gives rise to:
 - (i) an incremental right—ie when goods or services are supplied in the period but the rate charged in the period does not reflect the whole amount of total allowed compensation for those goods or services; or
 - (ii) an incremental obligation—ie when the rate charged in the period includes an amount of total allowed compensation for goods or services not yet supplied;

- (b) clarification of how the monetary **amount** of the right or obligation arising from the timing difference is determined—ie the difference between the right to the ‘**total allowed compensation**’ and the amount already charged to customers; and
- (c) clarification of the **obligation**—to deduct an amount from the future rate(s), rather than to provide goods or services.

13. We consider the updates made to the definitions improve the specificity and clarity of the definitions and enhance the understandability of the model but do not represent a fundamental change to the tentative decisions or the anticipated outcomes of the model as previously discussed. Consequently, we conclude that the updated definitions are consistent with, and clarify the original intention of, the definitions considered when the Board tentatively decided that the incremental rights and incremental obligations recognised by the model meet the definitions of assets and liabilities within the *Conceptual Framework*.

14. We recommend that the Board update its tentative decisions about the scope criteria and the definitions of regulatory assets and regulatory liabilities to reflect the refined descriptions.

*Fines*¹

15. A regulated entity may, from time to time, be subject to fines imposed by the regulator or another government body. If the entity is obliged to pay the fine in cash, the obligation is typically recognised as a liability until payment, if the recognition requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are met. However, in some cases, the regulated entity may be required to deduct the amount of the fine from the future rate(s) to be charged to customers for the future supply of goods or services, instead of paying cash.
16. We understand that, in practice, some entities applying IFRS Standards do not recognise such fines until they are reflected in the rate charged to customers. At that time, the amount of the fine is reflected through the recognition of the lower revenue amount, rather than as an expense. This is consistent with the current predominant practice of entities that do not apply IFRS 14 *Regulatory Deferral Accounts* not to recognise the entity's rights or obligations to adjust the future rate to be charged to customers as an asset or liability.
17. Staff consider that users would receive more relevant information if an entity were to recognise a liability for the obligation to pay the fine, irrespective of the mechanism for payment. Consequently, we considered whether the tentative decisions made to date for the model would change the existing predominant practice and result in the recognition of a regulatory liability for a present obligation to pay fines through the mechanism of a deduction from the future rate.
18. As noted in paragraph 11, the model recognises as regulatory assets and regulatory liabilities the incremental rights and incremental obligations arising when the total allowed compensation for the goods or services already supplied either exceeds or is lower than the amount already charged to customers. We have previously identified that penalties imposed on an entity for failing to meet a performance target relating to goods or services supplied would be captured within the definition of a regulatory liability because such performance penalties relate to the total allowed compensation

¹ In Agenda paper 9B for the May 2019 Board meeting, the analysis of fines was included as a separate section at the end of the paper (paragraphs 16-22 of the May paper). We have moved the analysis into this section about the definitions of regulatory assets and regulatory liabilities to reflect our revised conclusion.

already charged. However, some fines may be imposed for actions that may not be seen to relate clearly to the total allowed compensation for goods or services already delivered, for example, this might be the case for a fine imposed for breaching employment law or health and safety regulations for employees.

19. In May 2019, the staff expressed an initial view that an obligation to ‘pay’ such fines through a reduction in the rate(s) for a future period may not be captured by the definition of a regulatory liability.² However, Board members asked staff to further clarify that the meaning of ‘total allowed compensation for goods or services supplied’ is intended to be sufficiently broad to capture such fines. Consequently, we have expanded the explanation in paragraphs 26-30 of Agenda Paper 9A to clarify that when the regulatory agreement includes an expense or item of income in the calculation of the rate, that expense or income is presumed to form part of the total allowed compensation for goods or services supplied in **some** period. The model then requires an entity to apply the judgements made in applying IFRS Standards to establish to **which** period that part of the total allowed compensation relates.
20. Consequently, if a fine imposed on an entity will be ‘paid’ through a deduction from the determination of the future rate charged to customers, that fine is presumed to relate to the total allowed compensation already charged for the goods or services supplied during the period in which the entity carried out the action triggering the fine. As a result, the obligation to ‘pay’ the fine would be captured within the definition of a regulatory liability.³
21. Accordingly, staff now conclude that no specific requirements need be developed for the recognition of fines payable through the rate(s). The staff suggest it would be helpful to include a reference to such fines in explanatory guidance about the meaning of total allowed compensation for goods or services supplied. The staff understand that recognising an obligation to pay such fines would result in a change of the existing predominant accounting practice for such fines.

² See paragraphs 19-22 of Agenda Paper 9B discussed at the May 2019 Board meeting.

³ For the avoidance of doubt, although the fine would be included as an expense in the determination of the rate, it would be included as an origination of a regulatory liability in the regulatory income/ (regulatory expense) in profit or loss, rather than as an expense in any other line item required by IAS 1 *Presentation of Financial Statements*.

Recognition

22. The Board tentatively decided, in its March 2018 meeting that the model:
- (a) should require the recognition of regulatory assets or regulatory liabilities if it is ‘more likely than not’ that they exist (ie the model sets 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) low probability of an inflow or outflow of economic benefits; or
 - (ii) high measurement uncertainty.
23. As a result of the Board’s tentative decision to set a recognition threshold only for existence uncertainty, an entity would reflect any outcome uncertainty—ie uncertainty about the amount or timing of an inflow or outflow—in the measurement of the regulatory asset or regulatory liability in the statement of financial position. Uncertainty about the amount or timing of the inflow or outflow would include any uncertainty arising from regulatory risk, demand risk or credit risk (see paragraph 25 of Agenda Paper 9C *Measurement principles*).

24. Staff have identified no reasons to suggest the Board should change its tentative decisions for recognition and so recommend the Board retain those tentative decisions.

Derecognition

25. It has been implicit in all our discussions of the model that when an entity recovers part or all of a regulatory asset by adding the related amount to the rate(s) charged to customers, or fulfils part or all of a regulatory liability by deducting the related amounts from the rate(s) charged to customers, the entity derecognises that (part of the) regulatory asset or regulatory liability, and recognises regulatory expense or regulatory income accordingly.
26. The model measures regulatory assets and regulatory liabilities recognised using a cash-flow-based measurement technique. That technique requires that estimated cash flows arising from the regulatory asset or regulatory liability are updated at each

reporting date (see paragraph 28 of Agenda Paper 9C). If a change in estimate were to have the result that the estimated cash flows are now zero, the regulatory asset or regulatory liability would, in effect be derecognised. The staff see no reason to treat a change in estimate that results in derecognition differently from other changes in estimate. The Board has tentatively decided to require entities to disclose changes in carrying amounts of regulatory assets and regulatory liabilities due to changes in estimates, together with qualitative and quantitative information about the reasons for those changes.⁴

27. Consequently, staff conclude that the description of the model contains sufficient proposals to explain when and how to derecognise regulatory assets and regulatory liabilities and, as a result, recommend that no further requirements need be developed.

Questions for the Board

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1. Does the Board agree with the following staff recommendations that:

- (a) the Board update its previous tentative decisions about the scope criteria and the definitions of regulatory assets and regulatory liabilities to reflect the following refined descriptions (paragraph 14);

Scope: the accounting model should apply to defined rate regulation established through a formal regulatory framework that:

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⁴ See Agenda Paper 9G *Summary of tentative decisions to date*.

compensation for specified goods or services supplied is included in the rate(s) charged to customers (paragraph 4).

Regulatory asset—the present right to add an amount to the rate(s) to be charged to customers in future periods because the total allowed compensation for the goods or services already supplied exceeds the amount already charged to customers (paragraph 11).

Regulatory liability—the present obligation to deduct an amount from the rate(s) to be charged to customers in future periods because the total allowed compensation for the goods or services already supplied is lower than the amount already charged to customers (paragraph 11).

- (b) explanatory guidance about the meaning of total allowed compensation for goods or services supplied should include a reference to fines payable through the rate(s), but there is no need to develop separate requirements for these fines (paragraph 21);
- (c) the Board retain its previous tentative decisions about recognition (paragraph 24); and
- (d) no further requirements need be developed for derecognition of regulatory assets and regulatory liabilities (paragraph 27).