

CMAC meeting, 10 October 2019
Agenda Paper 2

Rate-regulated Activities

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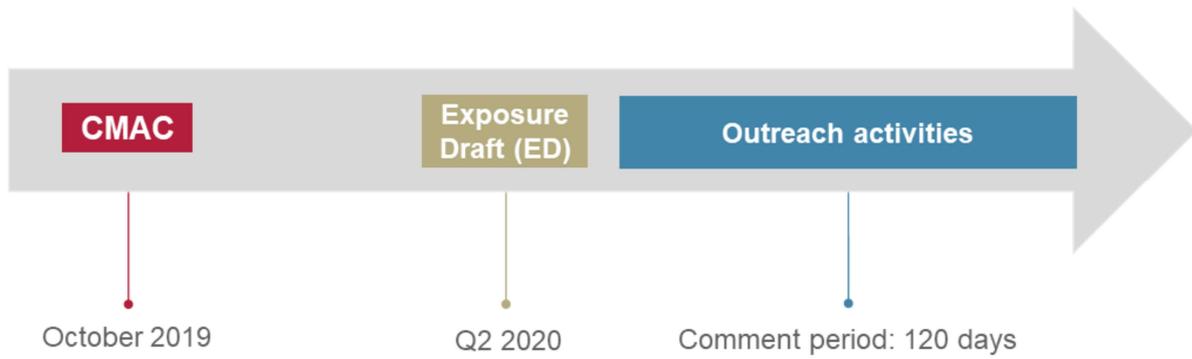
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Objective of the meeting

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- Provide you with information about the key aspects of the proposed accounting model for regulatory assets and regulatory liabilities (model).
- Ask you for advice on how best to reach out to users during the comment period of the forthcoming exposure draft.

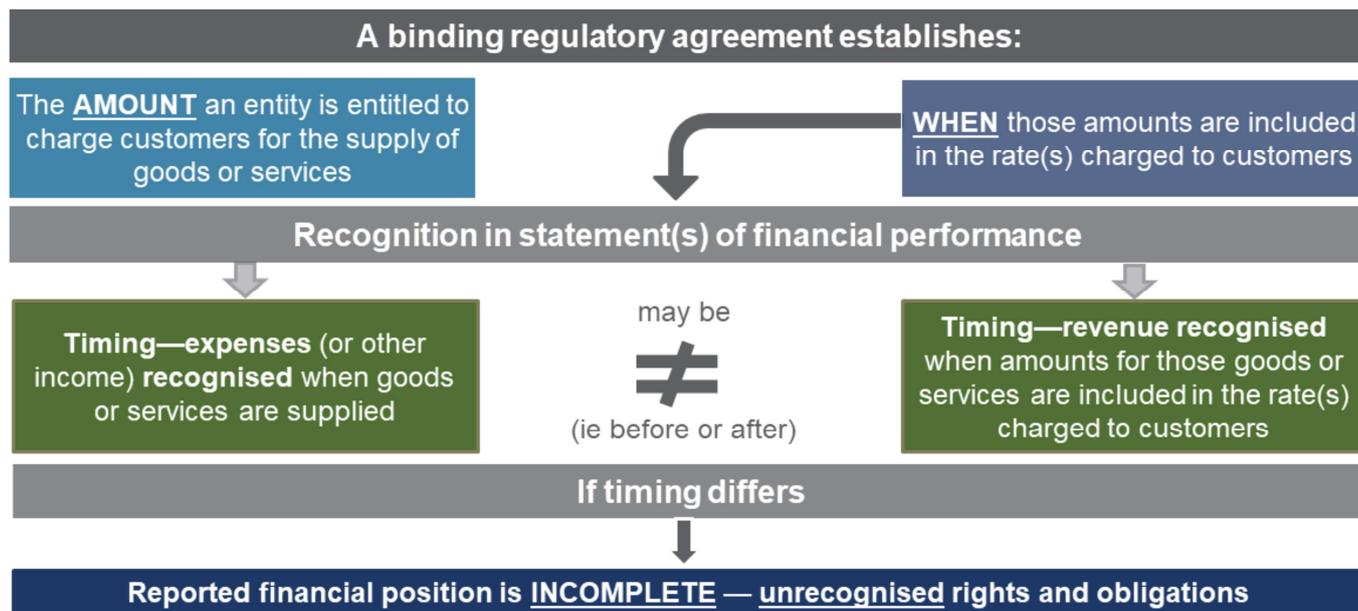
Timeline



Financial reporting problem and purpose of the rate-regulated activities model

Problem: Reported financial performance and financial position is incomplete

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Background

In defined rate regulation, both the regulated entity (entity) and rate regulator (regulator) are **bound** by a **regulatory agreement** that establishes:

- the amount** that the entity is entitled to charge to customers for the goods or services **supplied during the period; and**
- when** (ie in which periods) that amount is included in the rate(s) charged to customers.

Timing of compensation for goods or services supplied coincides with the amounts charged to customers

Typically, the regulatory agreement aims to charge customers compensation for goods or services supplied during the **same** period in which the entity supplies those goods or services. In this case, IFRS 15 *Revenue from Contracts with Customers* provides users of financial statements with relevant information that faithfully represents an entity's right to charge customers for the goods or services supplied during the same period.

Timing does not coincide

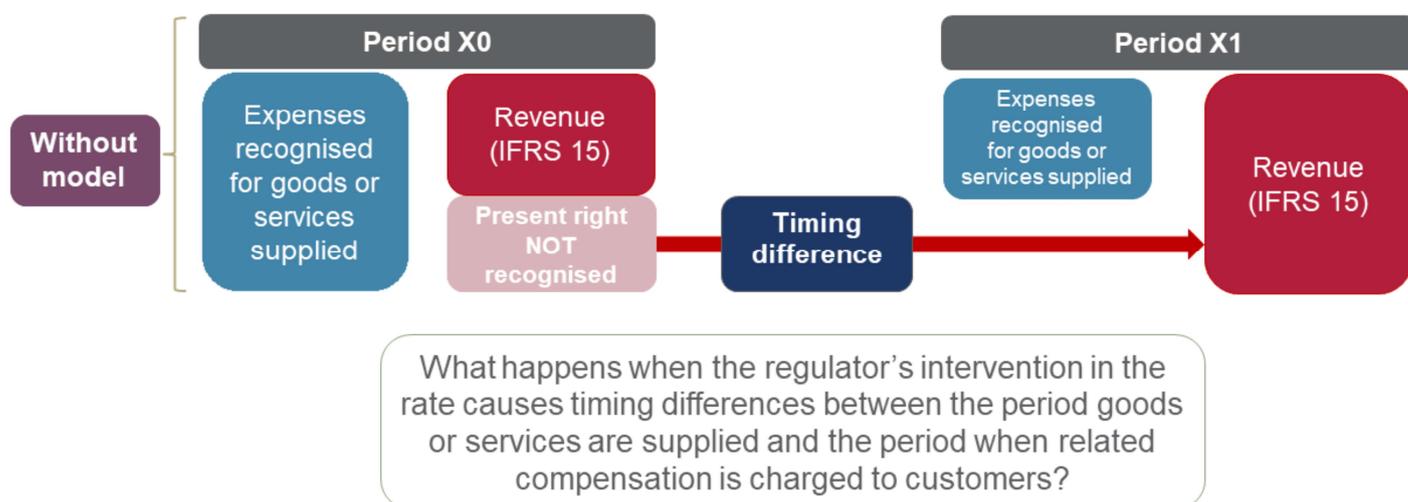
However, in some other cases, the regulatory agreement requires or allows the entity to include compensation for goods or services in the rate(s) charged to customers in a **different** period than the period in which the entity supplied those goods or services, causing timing differences that will be **'trued-up'** in future rate(s). When this happens, an entity has present rights and present obligations for which current IFRS Standards do not provide information about:

- a **present right to add an amount** to the rate(s) to be charged to customers in future periods because of goods or services already supplied; and
- a **present obligation to deduct an amount** from the rate(s) to be charged to customers in future periods because of compensation already charged.

These rights and obligations arise through the regulatory agreement, rather than through the contracts with customers, and so are **incremental** to those reported using IFRS 15. Not recognising these incremental rights as assets and incremental obligations as liabilities gives users of financial statements **incomplete information** about an entity's financial position and financial performance.

Financial reporting problem and purpose of the model—regulatory asset (1/2)

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Example to demonstrate the financial reporting problem

This example deals with regulatory assets.

Assume the regulator allows the entity to recover all expenses incurred when supplying goods or services in X0 through the rate(s) charged to customers on a 1 to 1 basis (that is, without any margins or returns).

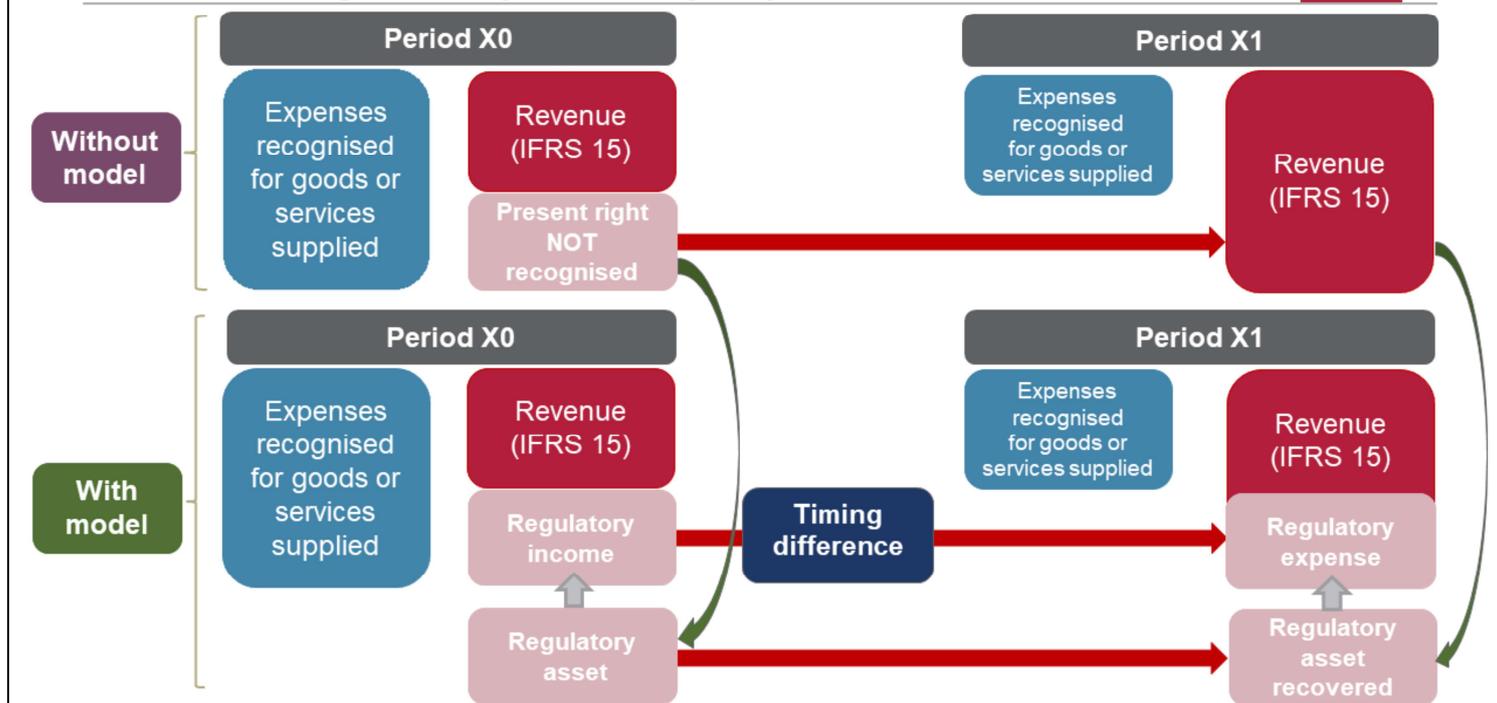
In X0, the entity is only allowed to include in the rate(s) a portion of the compensation that the entity is entitled to for the goods or services supplied during this period. That portion, ie the amounts charged to customers, is recognised as revenue in accordance with IFRS 15.

The regulator allows the shortfall in compensation to be included in the rate(s) charged to customers during X1. This implies that a portion of the compensation for the goods or services supplied in X0 will be recognised in revenue in X1.

The timing difference created by the intervention of the regulator gives the entity a **present right** to add an amount in the rate(s) to be charged to customers in X1 because compensation for the goods or services it supplied in X0 will be **trued-up** in X1. Without the model, this present right is **not** recognised in the financial statements in X0.

Financial reporting problem and purpose of the model—regulatory asset (2/2)

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The purpose of the model is to **supplement the information** provided by IFRS 15 and other IFRS Standards by reflecting, in the current period, the **incremental** rights and obligations identified in slide 5.

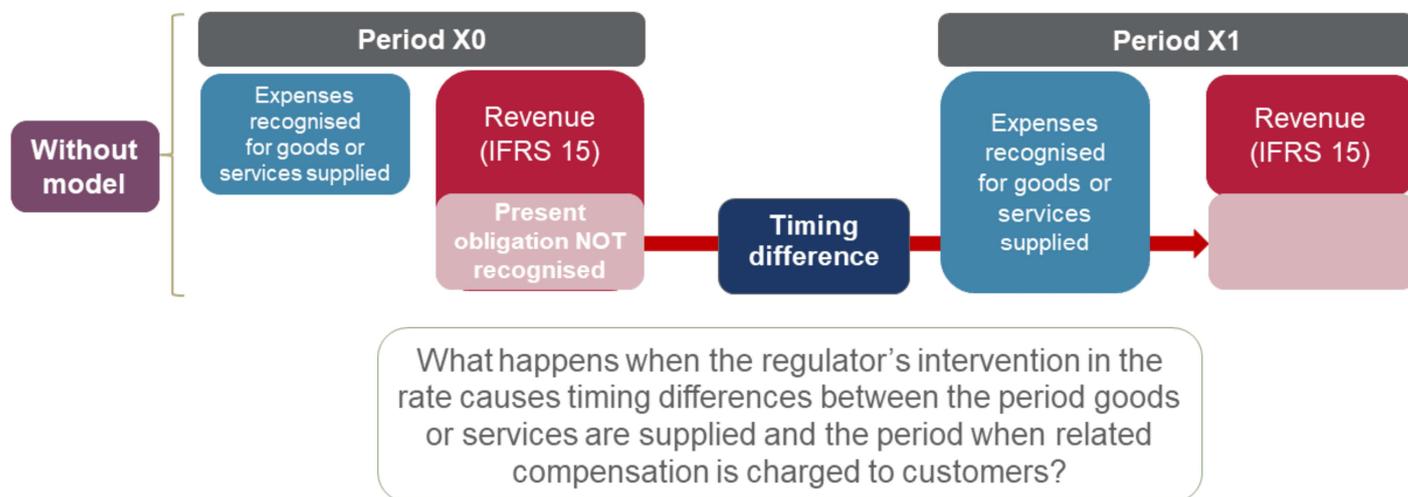
Depiction of how the model accounts for the unrecognised present right

In X0, an entity applying the model would recognise the **present right** as a **regulatory asset** thereby addressing the problem created by the timing difference. The recognition of the regulatory asset in X0 causes the recognition of regulatory income in profit or loss.

As allowed by the regulator, the entity adds the shortfall in compensation for the goods or services supplied in X0 to the rate(s) charged to customers during X1. When it does so in X1, the entity recovers the regulatory asset and thus recognises regulatory expense in profit or loss.

Financial reporting problem and purpose of the model—regulatory liability (1/2)

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IFRS

Example to demonstrate the financial reporting problem

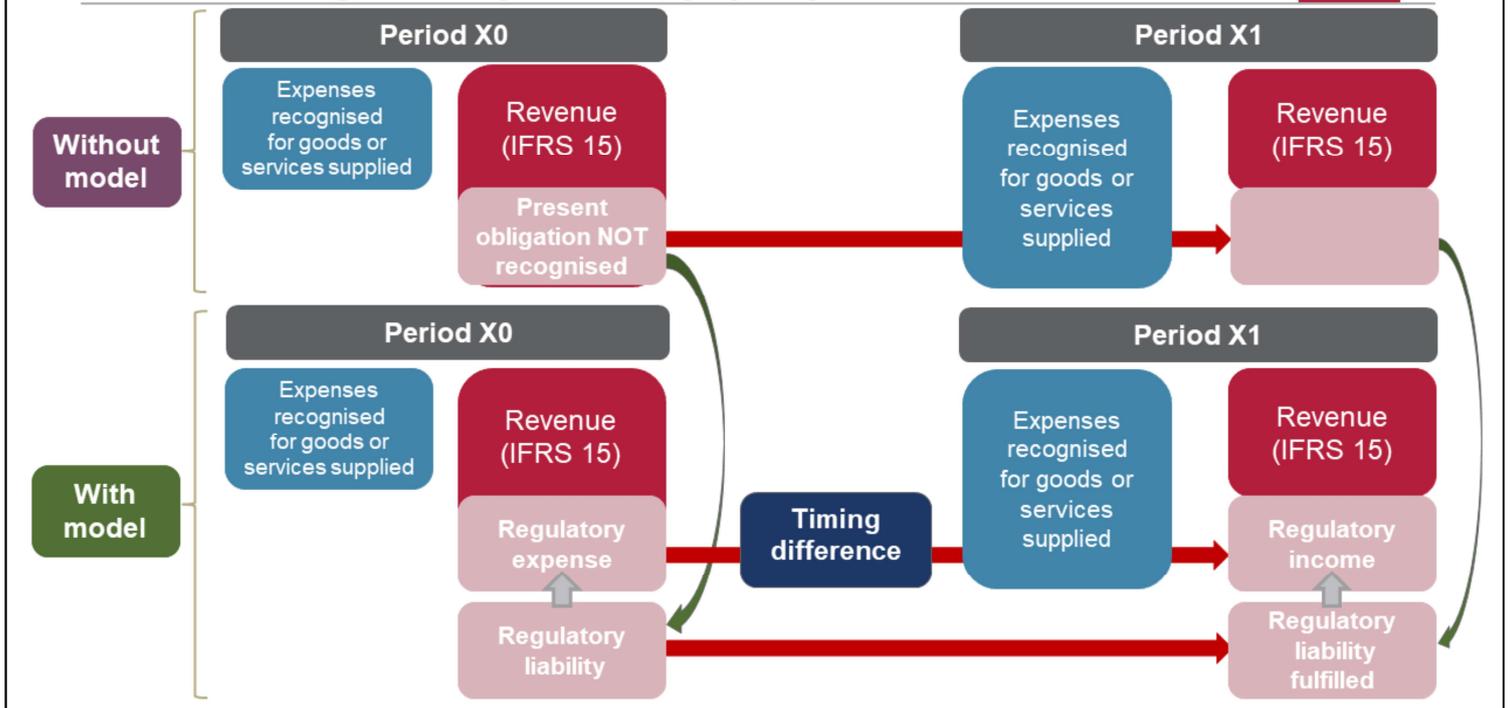
This example deals with regulatory liabilities.

Assume that, in X0, the regulator allows the entity to include in the rate(s) charged to customers an amount that pre-funds expenses to be incurred when supplying goods or services in X1. As a result, the amounts charged to customers in X0 are recognised as revenue in accordance with IFRS 15.

However, the entity will supply the related goods or services in X1 and in X1 it will not be able to include the related compensation in the rate(s) charged to customers.

The timing difference created by the intervention of the regulator in the timing when amounts for goods or services are included in the rate gives rise to a **present obligation** in X0 to deduct the amounts pre-funded in the rate(s) to be charged to customers in X1 because the consideration already charged in X0 will be **trued-up** in X1. Without the model, this present obligation is **not** recognised in the financial statements in X0.

Financial reporting problem and purpose of the model—regulatory liability (2/2)

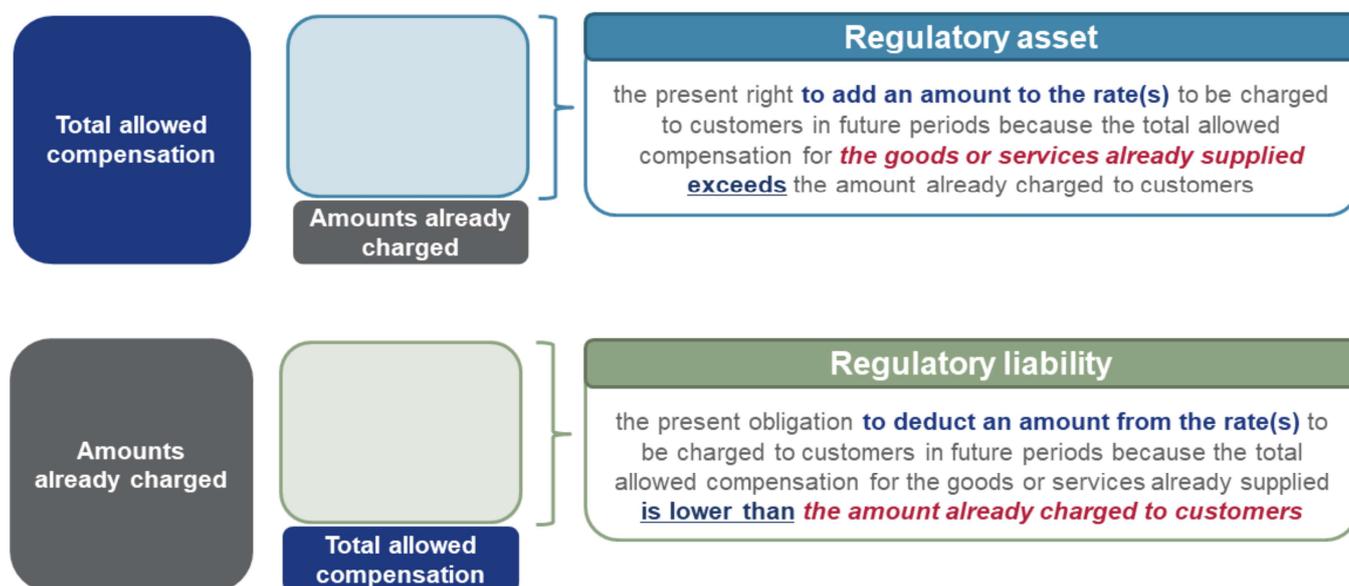


Depiction of how the model accounts for the unrecognised present obligation

In X0, an entity applying the model would recognise the **present obligation** as a **regulatory liability** thereby addressing the effect of the timing difference. The recognition of the regulatory liability in X0 causes the recognition of regulatory expense in profit or loss.

In X1, when supplying the goods or services, the entity deducts from the rate(s) the amount it already charged customers in X0. In doing so, the entity fulfils the regulatory liability and thus recognises regulatory income in profit or loss.

Total allowed compensation Regulatory assets and regulatory liabilities



Terminology used to discuss the model

The model uses the term **total allowed compensation** to refer to the amount an entity is entitled to charge customers for the goods or services supplied during the period.

This slide illustrates that an entity recognises:

- (a) as an asset (**regulatory asset**): the entity's present right to add an amount in determining the future rate(s) to be charged to customers because the total allowed compensation for the goods or services already supplied *exceeds* the amount already charged to customers; and
- (b) as a liability (**regulatory liability**): the entity's present obligation to deduct an amount in determining the future rate(s) to be charged to customers because the total allowed compensation for the goods or services already supplied *is lower than* the amount already charged to customers.

Under the model, an entity will recognise the movement between opening and closing carrying amounts of regulatory assets and regulatory liabilities as **regulatory income** or **regulatory expense**. The movement reflects the additions to and recovery/fulfilment of regulatory assets/regulatory liabilities during the period, plus other changes, for example, changes in estimated cash flows.

Example 1—Regulatory assets

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Entity A is bound by a regulatory agreement that includes a basis for setting the rate that allows it to include any variances between estimated and actual input costs incurred in the rate(s) charged to customers in the following year.

Entity A incurred actual input costs of CU1,400 during year X1, but was only compensated for estimated input costs of CU1,000 through the rate(s) charged to customers in X1.

In X1, Entity A has a present right to add the amount of the variance (CU400) to the rate(s) to be charged to customers in year X2, because the **total allowed compensation** of CU1,400 for **goods or services supplied** in X1 exceeds the amount already charged to customers (CU1,000).

The following table illustrates application of the model in X1 and X2.

In X1—Entity A recognises a present right to add an amount of CU400 to the rate(s) to be charged in X2	In X2—Entity A adds CU400 to the rate(s) charged to customers
<ul style="list-style-type: none">▪ Regulatory asset of CU400▪ Corresponding regulatory income of CU400	<ul style="list-style-type: none">▪ Recovery of regulatory asset of CU400▪ Corresponding regulatory expense of CU400

This example assumes that the effect of the time value of money is immaterial.



Conclusion

Applying the model to address the effects of the timing difference, results in recognising compensation in the period to which it relates (ie the period when related goods or services are supplied).

In this example, **with the model**:

- in X1, profit levels are CU400 higher than without the model; and
- in X2, profit levels are CU400 lower than without the model.

This is because compensation of CU400 will be recognised in X1, ie the period it relates to.

Example 2—Regulatory liabilities

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The regulator requires Entity A to upgrade a network of water pipelines during year X1 that will require an investment of CU1,000. The upgraded network will be used for the supply of services from the start of year X2 and will have a useful life of 10 years.

To support the cash flow requirements for the upgrade, the regulator allows Entity A to charge a higher rate to customers in year X1 which provides incremental cash flows of CU500. As a result, Entity A has an obligation to deduct CU500 from the rate(s) to be charged to customers over the next 10 years.

Entity A has a present obligation to deduct the amount charged during X1 (CU500) from the rate(s) to be charged to customers once the upgraded network is placed in use, because the **amount already charged to customers** (CU500) exceeds the **total allowed compensation** for the services supplied using the upgraded network during X1 (CU0). The following table illustrates application of the model in X1 and X2.

In X1—Entity A recognises a present obligation to deduct an amount of CU500 from the rate(s) to be charged in X2–X11	In X2—Entity A deducts CU50 (ie 500/10) from the rate(s) charged to customers
<ul style="list-style-type: none">▪ Regulatory liability of CU500▪ Corresponding regulatory expense of CU500	<ul style="list-style-type: none">▪ Fulfilment of regulatory liability of CU50▪ Corresponding regulatory income of CU50

This example assumes that the effect of the time value of money is immaterial.



Conclusion

Applying the model to address the effects of the timing difference, results in recognising compensation in the period to which it relates (ie the period when related goods or services are supplied).

In this example, **with the model**:

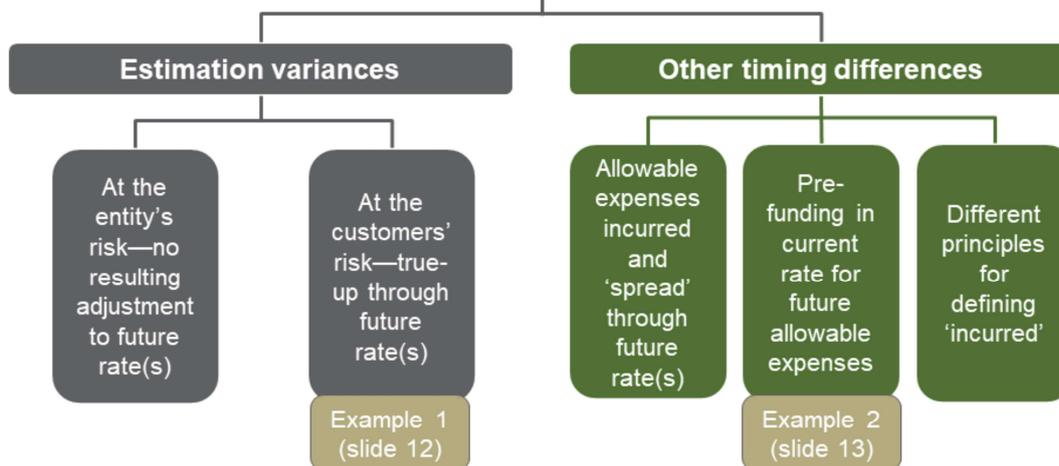
- in X1, profit levels are CU500 lower than without the model; and
- in X2, profit levels are CU50 higher than without the model.

This is because compensation of CU500 will be recognised over the years X2–X11, ie the periods it relates to.

Total allowed compensation—timing

Total allowed compensation—the amount an entity is entitled to charge customers for the goods or services supplied during the period

Typically, this compensation is included in the same period the goods or services are supplied but some **timing differences** may arise



The timing differences caused by the intervention of the regulatory agreement, as mentioned in slide 5, may occur either because:

- (a) the rate calculation uses estimated amounts; or
- (b) the regulatory agreement creates other timing differences.

(a) timing differences caused by estimation variances—The rate charged to customers reflects many estimated amounts. The regulatory agreement establishes which variances between estimated and actual amounts used in the rate calculation are at the risk of the entity and which are at the risk of customers.

For variances that are at the risk of customers, the total allowed compensation is subsequently **'trued-up'** by adding or deducting variances in future rate(s). Consequently, such variances create **rights** or **obligations** for the entity to adjust the future rate(s) charged to customers as a result of the goods or services already supplied (Example 1 in slide 12) or as a result of the amounts already charged (Example 2 in slide 13).

(b) other timing differences:

- i. allowable expenses incurred when supplying goods or services to customers, but for which the related total allowed compensation is spread through the rate(s) charged to customers over several periods;
- ii. the rate charged to customers includes an amount to pre-fund allowable expenses that have not yet been incurred and relate to the future supply of goods or services to customers (see Example 2 in slide 13); or
- iii. the regulatory agreement uses different principles than those used by IFRS Standards to define when allowable expenses are 'incurred' for the supply of goods or services to customers—typically this arises when the regulatory agreement provides for compensation on a cash basis for allowable expenses that the entity recognises in its IFRS financial statements on an accrual basis (for eg asset retirement obligations).

Presentation and disclosures

Present as **separate line items** in the primary financial statements:

- in the statement of financial position, as **regulatory assets** and **regulatory liabilities**;
- in the statement(s) of financial performance, the net movement between the opening and closing carrying amounts of regulatory assets and regulatory liabilities—**immediately below the revenue line item**. This line item will be labelled **regulatory income or regulatory expense**.

Revenue or expense line items in the statement(s) of financial performance are **not** adjusted.

Statement of financial position

The model requires **regulatory assets** and **regulatory liabilities** to be presented in the statement of financial position in **separate line items**.

Statement(s) of financial performance

Regulatory assets and regulatory liabilities arise when an entity supplies goods or services in one period but some amounts relating to those goods or services are charged to customers through the rate(s) and, are therefore, recognised and presented as revenue, in a different period.

Consequently, the model requires the net movement between opening and closing balances of regulatory assets and regulatory liabilities to be presented as a **regulatory income/(regulatory expense) line item immediately below the revenue line item**.

Presentation using Examples 1 and 2

In CU	X1
Revenue	7,500
Regulatory income (expense)	(100)
Subtotal	7,400
Expenses	(6,900)
Profit	500
Regulatory asset	400
Regulatory liability	(500)

Charged to customers this period for g/s supplied this period (IFRS 15)

- Does not include CU400 for g/s supplied in X1
- Includes CU500 for g/s to be supplied during X2-X11

- Includes:
- Add CU400 for g/s supplied in X1
 - Less CU500 charged this year for g/s to be supplied during X2-X11

Optional sub-total: all amounts chargeable to customers in this or other periods for g/s supplied this period

Includes all expenses incurred in this period for the g/s supplied this period

In CU	X2
Revenue	7,450
Regulatory income (expense)	(350)
Subtotal	7,100
Expenses	(6,600)
Profit	500
Regulatory asset	-
Regulatory liability	(450)

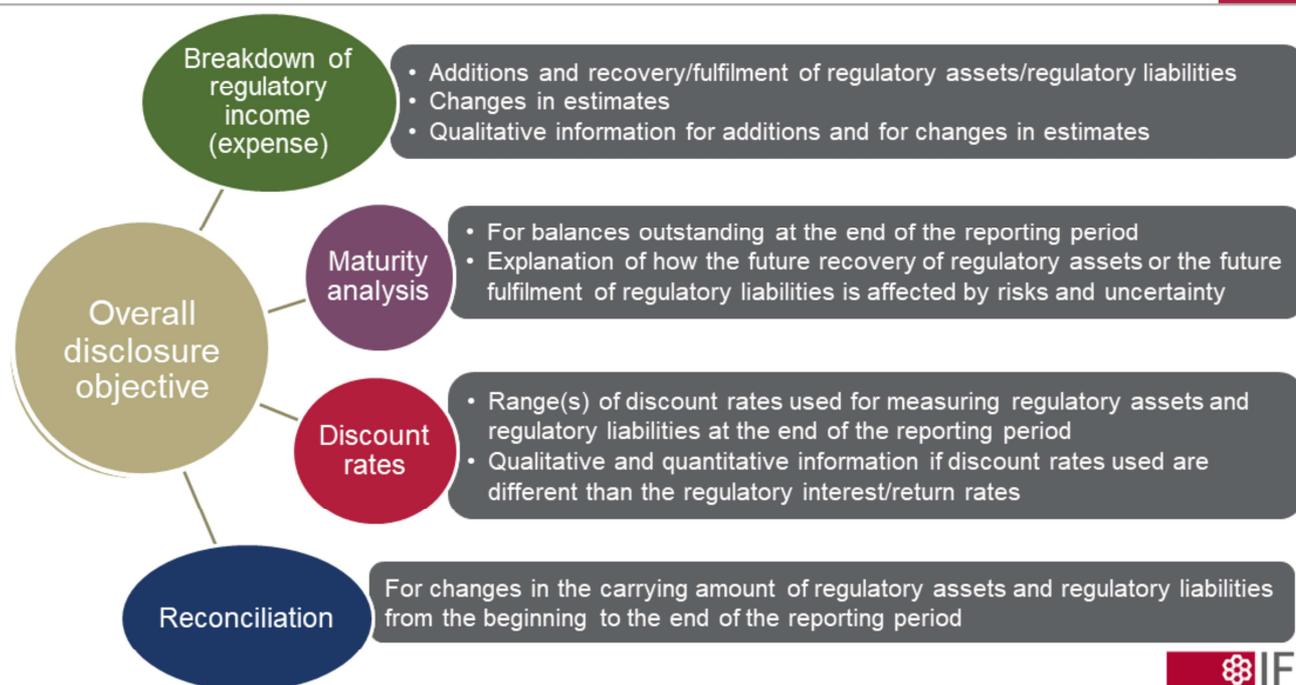
- Includes CU400 for g/s supplied in X1
- Does not include CU50 for g/s supplied in X2

- Includes:
- Less recovery of CU400 for g/s supplied in X1
 - Add CU50 (ie 500/10) charged in advance in X1 for g/s to be supplied during X2

Accounting in accordance with IFRS Standards.
Proposed model.

g/s: goods or services





The model identifies an **overall disclosure objective**, supported by more granular specific disclosure objectives and disclosure requirements supporting the specific disclosure objectives.

The **overall disclosure objective** is linked tightly with the purpose of the model, ie to recognise regulatory assets, regulatory liabilities and movements in those balances. The objective focuses on providing financial information about the effects that timing differences have on an entity's financial performance and financial position to help users understand and assess an entity's:

- (a) financial performance;
- (b) financial performance trends; and
- (c) amounts, timing and uncertainty of (prospects for) future cash flows.

The **specific disclosure objectives** focus on the following areas:

- (a) financial performance;
- (b) amount, timing and uncertainty of (prospects for) future cash flows from regulatory assets and regulatory liabilities; and
- (c) changes in the carrying amounts of regulatory assets and regulatory liabilities.

This slide summarises the specific disclosure requirements.

Note X—Breakdown of regulatory income (expense) using Examples 1 and 2

	X1	X2	
Amounts for goods or services supplied in the current year:			
- to be charged to customers in future year(s)	400	-	Addition to regulatory assets
- already charged to customers in prior year(s)	-	50	Fulfilment of regulatory liabilities
Amounts charged in the current year:			
- for supply of goods or services in future year(s)	(500)	-	Addition to regulatory liabilities
- for goods or services supplied in prior year(s)	-	(400)	Recovery of regulatory assets
Net regulatory interest on regulatory assets and regulatory liabilities	-	-	
Changes in estimates	-	-	
Regulatory income (expense)	(100)	(350)	

- Amounts charged to customers in other years—past or future—for goods or services supplied this year; *less*
- Amounts charged to customers this year for goods or services supplied in other years—past or future

Slide 17

Note X—Maturity analysis

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Maturity of regulatory assets and regulatory liabilities	Total	Within one year	Between one and five years	More than five years
Regulatory assets as at 31 December X1	700	100	200	400
Regulatory liabilities as at 31 December X1	300	70	100	130

Amounts to be added to future rate(s)

Amounts to be deducted from future rate(s)

The model also requires disclosure of information on risks and uncertainties associated with the regulatory assets and regulatory liabilities outstanding as of the reporting date.

The numbers in this slide are for illustrative purposes only and are not related to any other examples in this presentation.

IASB Staff will prepare communications materials to accompany the Exposure Draft. To help us anticipate potential questions from users, we would like to discuss the following questions.

1. Do you have any questions on the model?
2. Are these slides helpful for communicating the purpose and principles of the model?

The ED will propose accounting requirements for regulatory assets and regulatory liabilities. Entities that are subject to the type of rate regulation that creates these assets and liabilities are found mainly in some sectors.

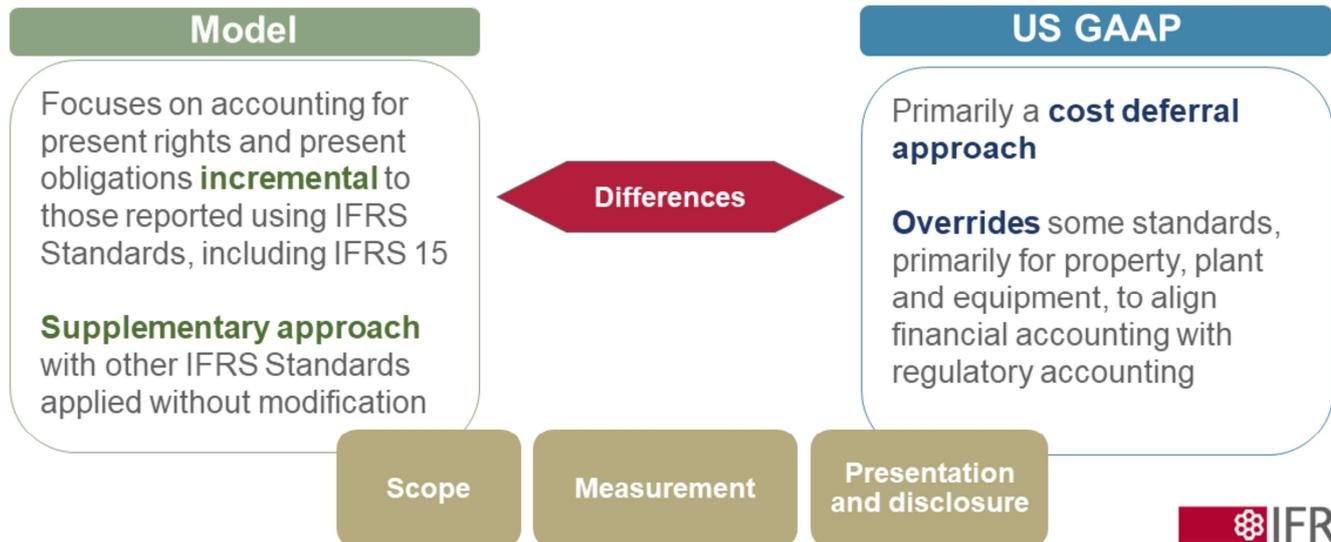
The input of specialist users will be key. However, during the comment period, we want to gather feedback from the users community as a whole.

3. What advice can you give us on how best to reach out to generalist users on a topic that is highly specific?

Appendix Comparison with US GAAP

Difference in approach

Many entities that currently recognise regulatory balances in their financial statements do so applying US GAAP or GAAP based on US GAAP.



Model

Defined rate regulation established through a formal regulatory framework that:

- is **binding** on both the entity and the rate regulator; and
- establishes a **basis for setting the rate that gives rights and obligations** to add amounts to/deduct amounts from future rate(s) charged to customers.

US GAAP

Requires **binding** regulatory framework.

- Rate(s) are designed to recover costs of service.
- Focus on an entity's **ability to recover costs** in order to apply the requirements.

The scope of US GAAP appears to be narrower than the model. The model focuses on **total allowed compensation** which includes both allowable expenses and a target profit.

However, the differences with the model are not likely to result in materially different outcomes because:

- (a) the model considers an entity's ability to recover costs in applying the recognition and measurement requirements rather than in the scope requirements.
- (b) development of rate regulation had led regulators to authorise some revenue programs, resulting in US GAAP permitting recognition of additional revenues if specified conditions are met.

Model

The model uses a **cash-flow-based measurement technique** to measure regulatory assets and regulatory liabilities by:

- estimating future cash flows (including the regulatory interest or return); and
- **discounting** those estimates of future cash flows using the **regulatory interest or return rate** as the discount rate unless that rate is not adequate.

US GAAP

Generally **prohibits** measurement of regulatory balances at **discounted present value**. The measurement is based on deferral or capitalisation of incurred costs as long as recovery is probable.

Discounting applies in some circumstances such as in case of abandonments or indirect disallowances.

In most cases, the regulatory interest or return rate would be adequate. As a result, the requirement for discounting in the model is not likely to result in materially different outcomes in most cases.

Model

The model requires regulatory items to be presented in **separate line items** in the primary financial statements.

The supplementary nature of the model means that the revenue or expense line items in the statement(s) of financial performance are **not** adjusted.

The model requires **disclosures** that help users to understand and assess the entity's financial performance, financial performance trends and assess the amounts, timing and uncertainty of (prospects for) its future cash flows.

US GAAP

Generally results in a '**net**' presentation in the statement(s) of financial performance (ie recoverable amounts of expenses are netted off against the respective expense line items; similarly, revenue line items are adjusted for advance billings).

Limited disclosure requirements.

Differences with the model are likely to result in different presentation and disclosure outcomes.

Get involved

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