IFRS® Foundation

Exposure Draft Regulatory Assets and Regulatory Liabilities

Capital Markets Advisory Committee

Agenda Paper [AP3]

March 2021

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

Purpose of this session

- To provide an overview of the proposals included in the Exposure Draft (ED) *Regulatory Assets and Regulatory Liabilities*. (slides 4–31)

- To gather preliminary feedback from CMAC members on the proposals and address any questions on the proposals. (slides 35–36)

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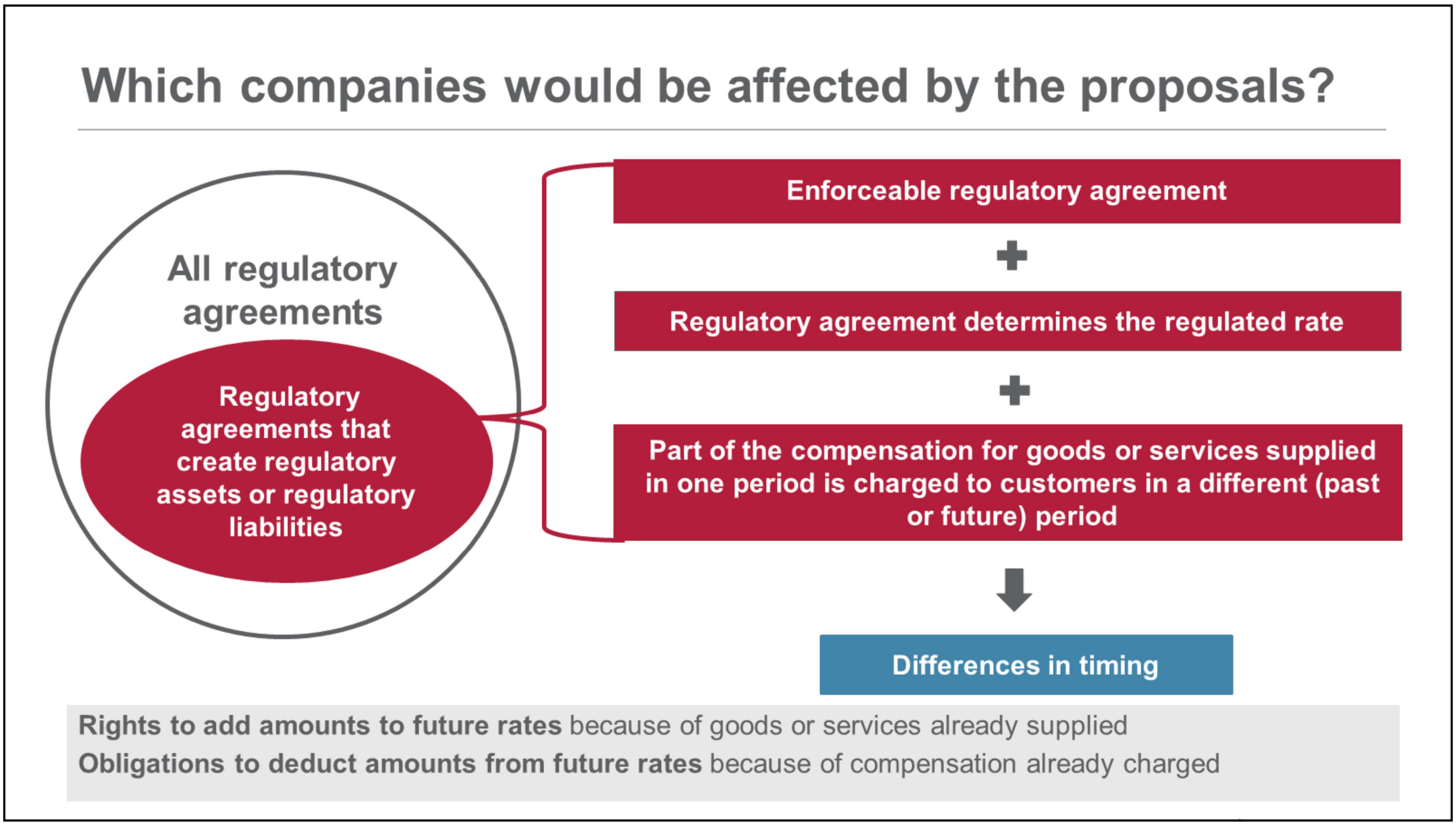
Introduction



Companies that would be affected by the proposals would be subject to a particular type of rate regulation.

These companies would be a party to an **enforceable regulatory agreement** that determines the **regulated rate** the companies can charge for goods or services supplied to customers in such a way that in some cases the compensation for goods or services supplied in one period is charged to customers through the regulated rate in a different period. In other words, the way in which the rate is set causes **differences in timing** to arise.

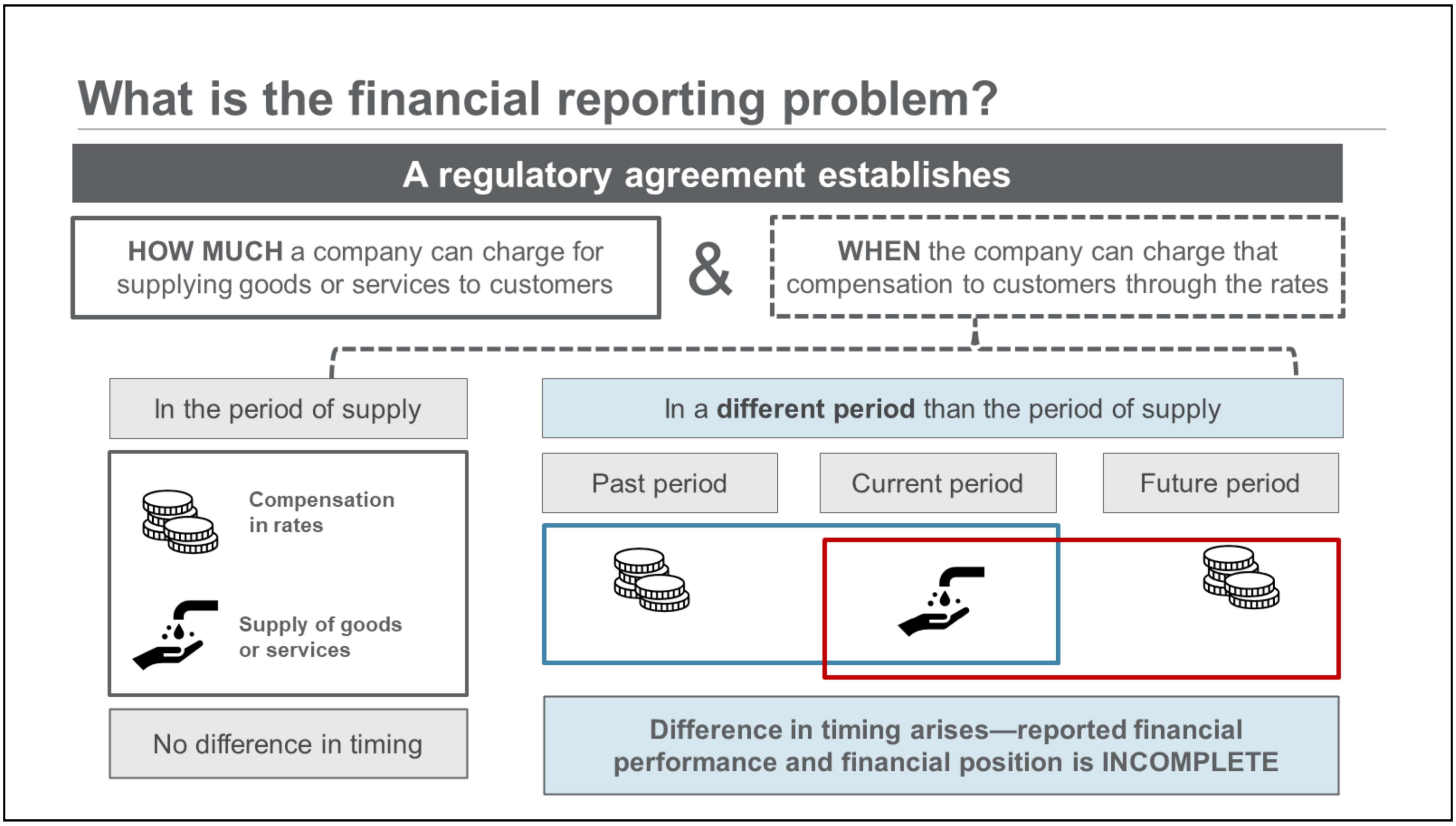
Consequently, the ED deals with a specific sub-set of rate regulation: regulation that sets the regulated rate in a way that causes **differences in timing** to arise. This type of rate regulation is common in some industries, including the utilities and public transport industries.

Those differences in timing will give a company:

- rights to add amounts to future rates because of goods or services already supplied; or
- obligations to deduct amounts from future rates because of compensation already charged.

The ED defines a regulatory agreement as 'a set of enforceable rights and obligations that determine a regulated rate to be applied in contracts with customers'. Only some regulatory agreements are capable of creating regulatory assets or regulatory liabilities. For example, some regulatory agreements place a cap on the price that companies can charge customers for their goods or services. Such agreements do not create regulatory assets or regulatory liabilities if they do not give rise to:

- rights to increase future rates because of goods or services already supplied; or
- obligations to decrease future rates because of amounts already charged to customers.



Background

Entities within the scope of the ED will be subject to regulatory agreements that establish:
(a) the **amount** that the company is entitled to charge to customers for the goods or services supplied; and

(b) **when** (ie in which periods) that amount can be included in the rate(s) charged to customers.

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

Typically, regulatory agreements will allow a company to charge customers compensation for goods or services supplied during the **same period** in which the company supplies those goods or services.

Timing does not coincide—differences in timing
In some cases, the regulatory agreement will require the company to include in the **regulated rate** for one period compensation for goods or services supplied in a **different period**.

This intervention of the regulation in the rates **causes differences in timing between the period when a company supplies the goods or services and the period when the related compensation is included in the rates charged to customers.**

When such **differences in timing** occur, the amount of revenue recognised in one period:
(a) includes compensation for goods or services that were supplied in a different period (past or future period); or
(b) does not include all the compensation that the company is entitled for the goods or services it supplied in the period, because part of this compensation was already included in revenue in the past, or will be included in revenue in the future.

When differences in timing arise, a company has a right to increase or obligation to decrease the regulated rates in the future. Existing IFRS Standards do not require a company to:
- recognise those rights or obligations in its balance sheet; or
- report how those rights or obligations affected its financial performance.

As a result, the information provided by applying IFRS 15 in the income statement is **incomplete**. This makes it **difficult for users to understand the relationship between revenue and expenses**. Differences in timing represent rights to increase or obligations to decrease the regulated rates in the future. Because those **rights and obligations are currently not recognised**, the information in the balance sheet is also **incomplete**.

Differences in timing—an illustration

- Company A charges a regulated rate for goods supplied in Year 1 that has been set based on estimated input costs of CU100. Actual input costs for Year 1 were CU120. Estimated and actual input costs for Year 2 were CU100.
- Company A has a right given by the regulatory agreement to add the under-recovery of CU20 of input costs incurred in Year 1 in the regulated rate for goods to be supplied in Year 2.

Company A's Statement of profit or loss would include the following amounts:

	Year 1 CU	Year 2 CU
Revenue	100	120
Input costs	(120)	(100)
Profit (loss)	**(20)**	**20**

In the absence of information about the difference in timing of CU20, investors would not understand:

– revenue in Year 1 does not include compensation of CU20 that relates to goods supplied in that year; and

– revenue in Year 2 includes compensation of CU20 that relates to goods supplied in Year 1.

This not only makes it difficult for investors to analyse a company's financial performance, but also precludes them from having information about the company's rights/obligations to increase/decrease rates in the future.

* Monetary amounts are denominated in 'currency units' (CU).

Differences in timing—Board's proposals

Problem	Without information about **differences in timing**, investors have an **insufficient basis** for understanding their effects on a company's **financial performance, financial position and prospects for future cash flows**.
Proposals	A company should report **regulatory income** and **regulatory expense** in its income statement, and **regulatory assets** and **regulatory liabilities** in its balance sheet. That information would supplement the information that companies already provide by applying IFRS Standards, including IFRS 15 *Revenue from Contracts with Customers*.
Principle	A company should **reflect compensation* for goods or services supplied** as part of its reported financial performance **for the period in which it supplies those goods or services**.

*The ED calls this compensation 'total allowed compensation' and defines it as:
The full amount of compensation for goods or services supplied that a regulatory agreement entitles an entity to charge customers through the regulated rates, in either the period when the entity supplies those goods or services or a different period.

How would the proposals solve the problem?

Statement of profit or loss	Year 1 CU	Year 2 CU
Revenue	100	120
Regulatory income minus regulatory expense (slide 26)	**20**	**(20)**
Input costs	(120)	(100)
Profit (loss)	**-**	**-**

- **Regulatory income of CU20 in Year 1** to reflect compensation for goods supplied in Year 1.
- **Regulatory expense of CU20 in Year 2** to reflect amounts in regulated rates charged, and hence in revenue, in Year 2, that relates to compensation for goods supplied in Year 1.

Balance sheet	Year 1 CU	Year 2 CU
Regulatory asset	**20**	**-**

- **Regulatory asset of CU20 in Year 1** to reflect Company A's right to increase regulated rates in Year 2.
- **Derecognise regulatory asset in Year 2** when it increases the regulated rates to recover the input costs under-recovered in Year 1.

The information about regulatory income and regulatory expense would – in this case – provide investors with a basis for understanding that Company A's financial performance did not change from Year 1 to Year 2.

By applying the proposals, companies would be required to recognise regulatory assets, regulatory liabilities, regulatory income and regulatory expense. This would enable them to reflect the total compensation to which they are entitled for the goods or services supplied in a period as part of their reported financial performance for that period.

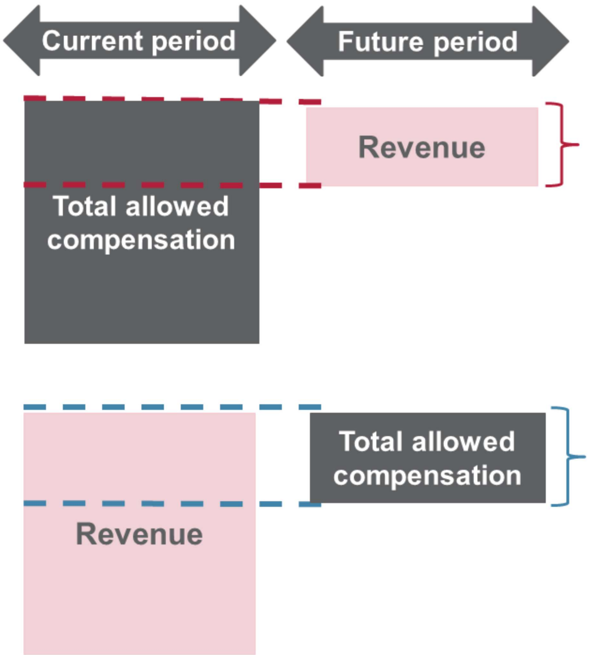
Objectives of the project

To give investors a more complete picture of the financial performance and financial position of rate-regulated companies

- Enhance comparability
- Improve understanding of financial performance
- Improve understanding of risks and uncertainties
- Improve understanding of future cash flows

Regulatory assets, regulatory liabilities and total allowed compensation

Regulatory assets and regulatory liabilities—overview



Regulatory asset

an enforceable present right, created by a regulatory agreement, **to add an amount** in determining a regulated rate to be charged to customers in future periods because part of the **total allowed compensation** for goods or services already supplied will be included in ***revenue in the future***

Regulatory liability

an enforceable present obligation, created by a regulatory agreement, **to deduct an amount** in determining a regulated rate to be charged to customers in future periods because the revenue already recognised includes an amount that will provide part of **the total allowed compensation** for goods or services to be supplied in the ***future***

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Regulatory assets

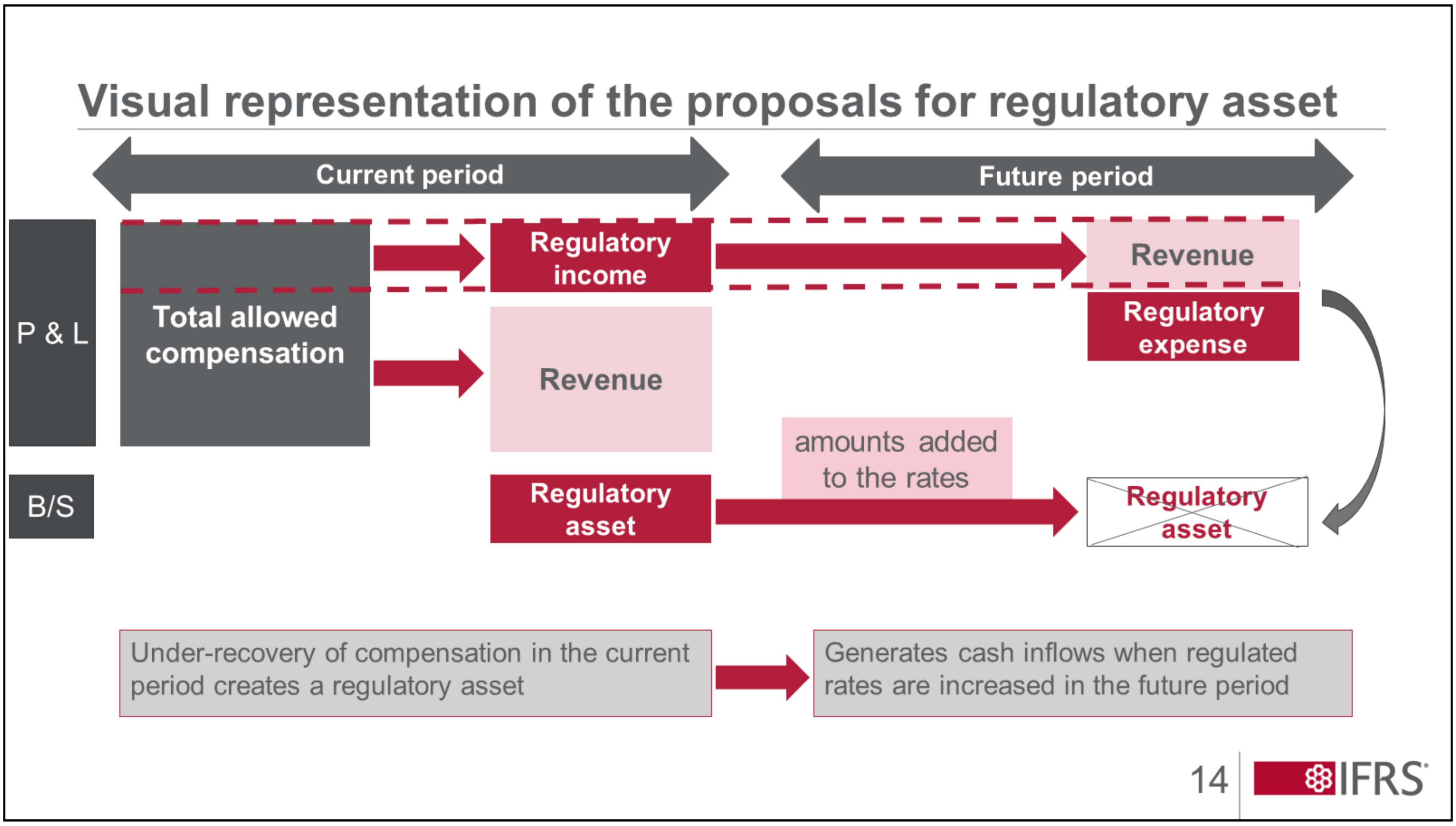
Example RA1	Example RA2	Example RA3
The rate a company charges customers during the current period includes an estimated amount of input costs. Actual input costs incurred in that period exceeded this estimate. The regulatory agreement gives the company the right to add that under-recovery of input costs in the rates to be charged to customers in the future.	A company incurs an obligation for environmental clean-up costs during the current period. The rates charged to customers during the current period did not include the environmental costs incurred. The regulatory agreement gives the company the right to recover those costs by adding them in the rates only when it pays the related cash in the future.	A regulatory agreement entitles a company to a bonus because it met specified performance criteria in the current period. The rates charged to customers during the current period did not include the bonus. The regulatory agreement gives the company the right to recover the bonus by adding it in the rates to be charged to customers in the future.

Under-recovery of compensation in the current period creates a regulatory asset → Generates cash inflows when regulated rates are increased in the future period

In the current period, recognition of:
- Regulatory asset
- Regulatory income

→

In the future period:
- Recognition of revenue and regulatory expense
- Stop recognising regulatory asset



The ED defines a regulatory asset as an **enforceable present right**, created by a **regulatory agreement**, to **add an amount** in determining a regulated rate to be charged to customers in future periods because part of the **total allowed compensation for goods or services already supplied** will be included in **revenue in the future** (slide 12).

A regulatory asset is **not** a financial asset—it does not entitle a company to require customers or any other party to pay the company cash: the company ultimately receives cash when customers pay the increased regulated rate.

What will the recognition of a regulatory asset tell investors?
By applying the proposals, a company would recognise all its **regulatory assets** (and the related regulatory income). This would tell investors that:

- the company has **a right to add an amount** to the rates it will charge customers when it supplies goods or services in the future.
- that right exists only because that amount is part of the **total allowed compensation for goods or services** the company has **already supplied**.
- the company has not yet charged that amount to customers.
- that amount will be **revenue in the future**.

Regulatory liabilities

Example RL1	Example RL2	Example RL3
The rate a company charges customers during the current period includes an estimated amount of input costs. Actual input costs incurred in that period were lower than this estimate. The regulatory agreement obliges the company to deduct that over-recovery of input costs in the rates to be charged to customers in the future.	A regulatory agreement entitles a company to recover part of the construction cost of an asset through the rates charged to customers ('pre-funding') in the current period. The asset was not yet available for use in the current period. The regulatory agreement obliges the company to deduct the amount of the pre-funding in the rates to be charged to customers in the future.	A regulatory agreement imposes a penalty on a company because it failed to meet specified performance criteria in the current period. The rates charged in the current period did not reflect the penalty. The regulatory agreement obliges the company to deduct the amount of the penalty in the rates to be charged to customers in the future.

Over-recovery of compensation in the current period creates a regulatory liability

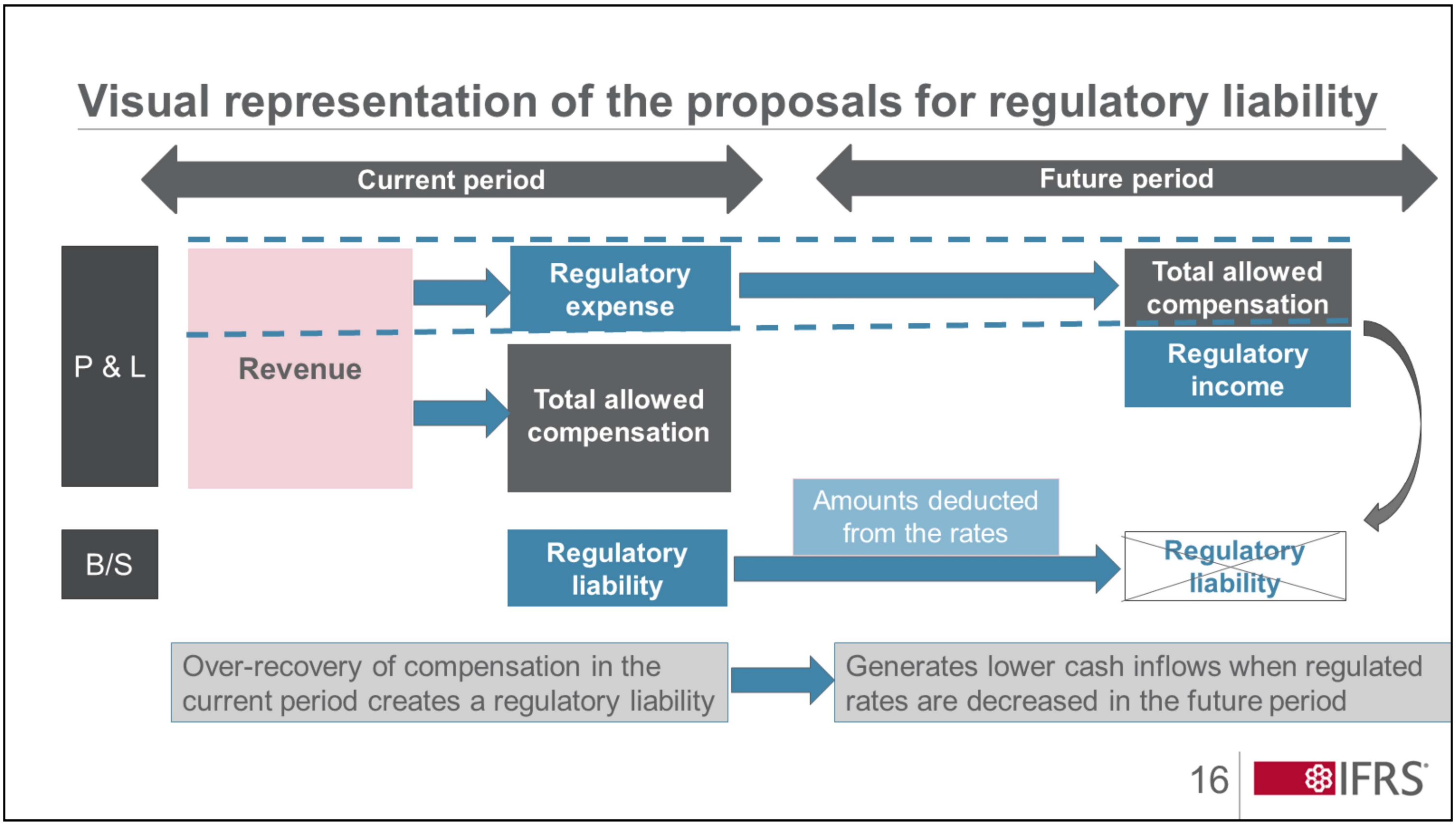
→ Generates lower cash inflows when regulated rates are decreased in the future period

In the current period, recognition of:

- Regulatory liability
- Regulatory expense

→ In the future period:

- Recognition of lower amount of revenue and regulatory income
- Stop recognising regulatory liability



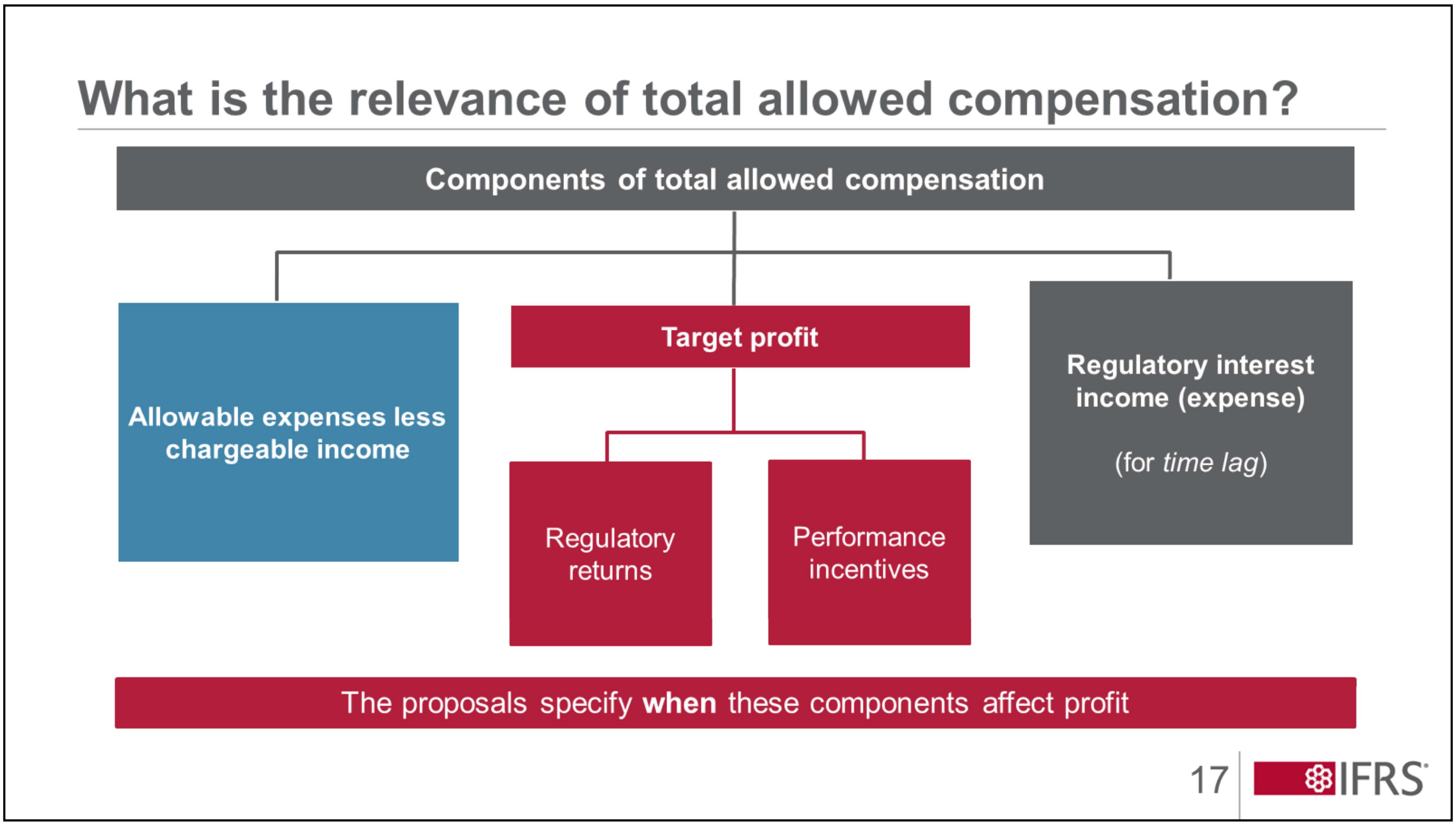
The ED defines a regulatory liability as an **enforceable present obligation**, created by a **regulatory agreement**, to **deduct an amount** in determining a regulated rate to be charged to customers in future periods because the **revenue already recognised** includes an amount that will provide part of the **total allowed compensation for goods or services to be supplied in the future** (slide 12).

A regulatory liability is **not** a financial liability—it does not oblige a company to pay cash to customers or to any other party: the company, in effect, ultimately pays cash by receiving less cash when customers pay the decreased regulated rate.

What will the recognition of a regulatory liability tell investors?

By applying the proposals, a company would recognise all its **regulatory liabilities** (and the related regulatory expense). This would tell investors that:

- the company has **an obligation to deduct an amount** from the rates that it will charge customers when it supplies goods or services in the future.
- that obligation exists only because the company has already charged customers that amount and hence a**lready recognised that amount in revenue**.
- that amount will be part of the **total allowed compensation for goods or services** that the company **will supply in the future**.
- that amount will **decrease revenue in the future**.



As a reminder, the Exposure Draft uses the term total allowed compensation for the full amount of compensation for goods or services supplied that a regulatory agreement entitles a company to charge customers through the regulated rates— in either the period when the company supplies those goods or services or a different period.

Measurement

Cash-flow-based measurement technique

	Future cash flows	Discount rate
Initial measurement	**Estimate all future cash flows (including cash flows from regulatory interest)** Using 'most likely amount' method or 'expected value' method	**Discount the estimated future cash flows** Using the **regulatory interest rate** **unless** this rate for a regulatory asset is **insufficient***
Subsequent measurement	**Update estimates of future cash flows** • to reflect recovery of the regulatory asset or fulfilment of the regulatory liability • for changes in estimates	**Continue to use the discount rate** determined at initial recognition, **unless** the regulatory agreement **changes** the regulatory interest rate

* For a regulatory asset only, if the regulatory interest rate compensates the company insufficiently for the time value of money and uncertainty, the discount rate would instead be the **(minimum) rate** that would be sufficient to provide that compensation.

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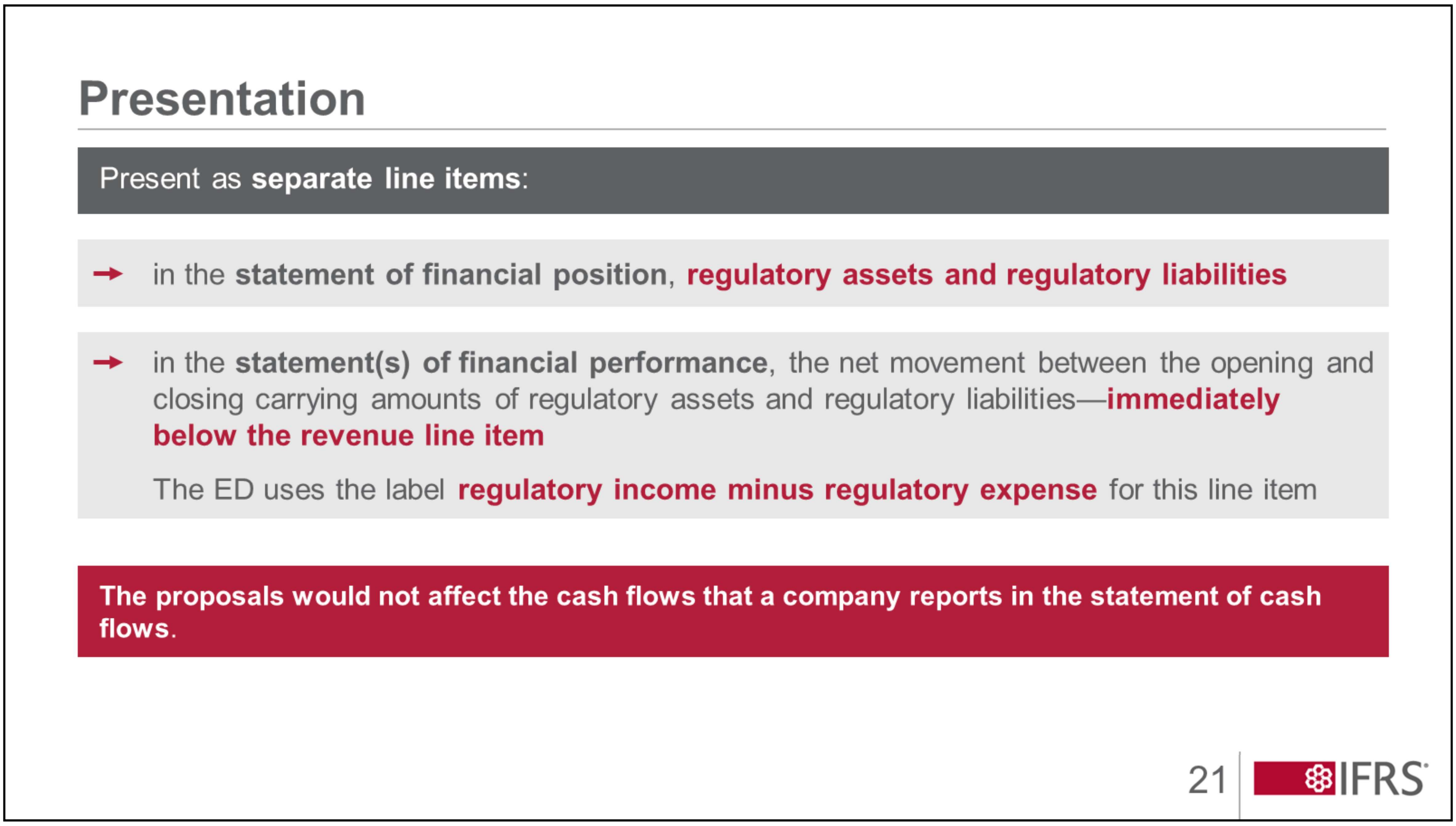
Presentation and disclosure



The proposals do **not** override the presentation requirements of other IFRS Standards.

Statement of financial position

The proposals require **regulatory assets** and **regulatory liabilities** to be presented in the balance sheet in **separate line items**. If a company presents a classified balance sheet, it would present current regulatory assets, non-current regulatory assets, current regulatory liabilities and non-current regulatory liabilities as separate line items in the balance sheet.

Statement(s) of financial performance

Regulatory assets and regulatory liabilities arise when a company supplies goods or services in one period but part of the compensation relating to those goods or services are charged to customers through the rates and, are therefore, recognised and presented as revenue, in a different period. The proposals require the **net movement between opening and closing balances of regulatory assets and regulatory liabilities** to be presented as a **regulatory income minus regulatory expense line item immediately below the revenue line item.**

Statement of cash flows

The proposals would not affect the cash flows companies report in the cash flow statement. If a company uses the indirect method for reporting cash flows from operating activities, the company would determine their amount by deducting regulatory income from, or adding regulatory expense to, profit or loss for the period.

Presentation—Statement of profit or loss

	Year 1 CU	Year 2 CU
Revenue	100	120
Regulatory income minus regulatory expense (note X, **slide 26**)	20	(20)
Expenses	(120)	(100)
Profit (loss)	-	-

This line item would be within the **operating category** under the proposals for Primary Financial Statements.

The proposed line item would include **regulatory interest income (expense) and changes** in the carrying amount of regulatory assets as a result of changes in the estimates of future cash flows.

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Applying IFRS 15, the Revenue line mostly includes compensation for goods supplied in the year, but:

- may not include part of compensation, for goods supplied in the year, that is charged in other years (past or future)—CU20 of Year 1 compensation charged in Year 2; or
- can also include compensation for goods supplied in other years (past or future)—CU20 of Year 1 compensation included in revenue for Year 2.

Applying the proposals, the 'Regulatory income minus regulatory expense' line item would reflect:

- compensation included in revenue of other years (past or future)—for goods supplied in the year; *less*
- compensation included in revenue for the year for goods supplied in other years (past or future).

Applying IFRS Standards, all 'Expenses' incurred are recognised in the year for goods supplied in this year.

Questions for CMAC members—Presentation

- Do you agree that a company should present all regulatory income minus all regulatory expense as a separate line item immediately below revenue? If not, what approach do you suggest and why?

- Do you agree with the proposed inclusion of regulatory interest income and regulatory interest expense within the line item immediately below revenue? If not, what approach do you suggest and why?

The questions for CMAC members have been included on this slide for convenience.

The staff will ask all questions for CMAC members at the end of the presentation.

Disclosure objective

Disclose information about regulatory income, regulatory expense, regulatory assets and regulatory liabilities

This information together with all other information provided in the company's financial statements will enable users of financial statements:

- to understand how regulatory assets and regulatory liabilities affected the company's financial performance and financial position; and
- to assess the amount, timing and uncertainty of the company's future cash flows.

Proposed disclosure requirements

Breakdown of regulatory income (expense)

- Additions
- Recovery/ fulfilment
- Regulatory interest income (expense)
- Changes in estimates

Maturity analysis and risks

- Maturity profile of recovery/ fulfilment
- How risks and uncertainty affect recovery/ fulfilment

Discount rates

- Discount rates (or range) used
- Regulatory interest rate IF minimum interest rate used

Reconciliation of regulatory asset (liability) balances

- Changes for reasons other than regulatory income (expense)

Disclosure—Note X Regulatory income minus regulatory expense

	Year 1 CU	Year 2 CU
Amounts for goods supplied in current year:		
- to be included in revenue in future years	20	-
- already included in revenue in previous years	-	-
Amounts included in revenue in current year:		
- for future goods	-	-
- for goods in previous years	-	(20)
Regulatory interest income on regulatory assets less regulatory interest expense on regulatory liabilities	-	-
Changes in estimates	-	-
Regulatory income minus regulatory expense (slide 22)	**20**	**(20)**

Addition to regulatory assets

Fulfilment of regulatory liabilities

Addition to regulatory liabilities

Recovery of regulatory assets

- Amounts included in revenue in other years—past or future—for goods supplied this year; **less**
- Amounts included in revenue this year for goods supplied in other years—past or future

The proposals would require a company to give investors information about:

- enforceable rights to increase future rates as a result of goods or services it has already supplied to customers;
- enforceable obligations to decrease future rates as a result of an amount it has already charged customers and hence included in revenue already recognised;
- amounts included in revenue in the current period for goods or services it supplied to customers in previous periods;
- amounts included in revenue in previous periods for goods or services it supplied to customers in the current period;
- regulatory interest income on regulatory assets and regulatory interest expense on regulatory liabilities; and
- other items affecting measurement of regulatory assets or regulatory liabilities such as changes in estimates of future cash flows.

Questions for CMAC members—Disclosures

- Do you agree that the overall disclosure objective should focus on information about an entity's regulatory income, regulatory expense, regulatory assets and regulatory liabilities? If not, what focus do you suggest and why?
- Do you have any comments on the proposals for specific disclosure objectives and disclosure requirements? Would requiring any other disclosures help a company better meet the proposed disclosure objective?

The questions for CMAC members have been included on this slide for convenience.

The staff will ask all questions for CMAC members at the end of the presentation.

Likely effects

Likely effects of the proposals

The proposals in the ED would affect some companies more than others.

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Likely effects on quality of financial reporting and benefits for investors

Better information for users—coherent, prominent and understandable presentation and disclosure of information about regulatory assets and regulatory liabilities

Understandability	Better insights into the relationship between a company's revenue and expenses by providing information about differences in timing
Usefulness	Information focused on the incremental future cash flows that result from regulatory assets and regulatory liabilities
Comparability	Improved comparability across companies using a single set of principles for reporting all regulatory assets and regulatory liabilities

The availability of better information about regulatory assets and regulatory liabilities in the financial statements would decrease investors' costs of gathering information from other sources.

Transition

The ED would require full retrospective application of the proposals.

	Comparative	Date of initial application: 1-Jan-20X3
Statement of profit or loss	20X2 CU	**20X3 CU**
Revenue	XX	XX
Regulatory income minus regulatory expense	**XX**	**XX**
Expenses	(XX)	(XX)
Profit (loss)	-	-

Full retrospective approach

The ED would require companies to apply the proposals **retrospectively** in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*—this would require **full restatement of comparative information**.

While restatements would affect **time series data** that is based on company's income statement and balance sheet, the **full retrospective approach** would result in data being comparable across all time periods and across companies.

EBITDA | ROI | EPS | P/E ratio

IFRS

Question for CMAC members—Transition

- Do you agree with the Board's proposals for the transition requirements? If not, why not?

The question for CMAC members has been included on this slide for convenience.

The staff will ask all questions for CMAC members at the end of the presentation.

Next steps and questions for CMAC members

Next steps

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Questions for CMAC members (1/2)

General

Q1. Do members have any questions regarding the Board's proposals?

Presentation

Q2. Do you agree that a company should present all regulatory income minus all regulatory expense as a separate line item immediately below revenue? If not, what approach do you suggest and why? (slides 21–22)

Q3. Do you agree with the proposed inclusion of regulatory interest income and regulatory interest expense within the line item immediately below revenue? If not, what approach do you suggest and why? (slide 22)

The questions about Presentation on this slide also appear on slide 23.

Questions for CMAC members (2/2)

Disclosure

Q4. Do you agree that the overall disclosure objective should focus on information about an entity's regulatory income, regulatory expense, regulatory assets and regulatory liabilities? If not, what focus do you suggest and why? (slide 24)

Q5. Do you have any comments on the proposals for specific disclosure objectives and disclosure requirements? Would requiring any other disclosures help a company better meet the proposed disclosure objective? (slide 25)

Transition

Q6. Do you agree with the Board's proposals for the transition requirements? If not, why not? (slide 31)

The questions about Presentation on this slide also appear on slide 27.

The question about Transition on this slide also appears on slide 32.

Useful resources

For more information, please refer to the following materials on the IFRS Foundation's website:

- Debrief: Video on Exposure Draft *Regulatory Assets and Regulatory Liabilities*
- Exposure Draft *Regulatory Assets and Regulatory Liabilities*
- Illustrative Examples: *Regulatory Assets and Regulatory Liabilities*: Illustrative Examples
- Snapshot: Exposure Draft *Regulatory Assets and Regulatory Liabilities*

Appendix—summary of previous CMAC meetings

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Summary of previous CMAC meetings

Meeting	Purpose of the meeting
October 2019, CMAC: AP2	The session aimed to provide an overview of the key aspects of the proposed accounting model for regulatory assets and regulatory liabilities, and to ask CMAC members for their advice on: • communication materials; and • how best to reach out to users during the comment period of the forthcoming ED, in particular reaching out to generalist users on a topic that is highly specific.
March 2018, CMAC: AP5	The session sought feedback of CMAC members' views on the usefulness of possible disclosure requirements for an accounting model being developed for rate-regulated activities.
March 2017, CMAC: AP3	The session sought feedback of CMAC members on the usefulness of recognising regulatory assets and regulatory liabilities for understanding the financial position, performance and expected cash flows of a company.

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