



STAFF PAPER

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Project	Rate-regulated Activities
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Objective

1. This paper analyses the feedback from comment letters and outreach events on the proposed measurement requirements in paragraphs 29–45 of the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Question 5 of the Invitation to Comment).¹

Key messages

2. Most respondents who commented agreed with the Board's proposal that:
 - (a) regulatory assets and regulatory liabilities should be measured on a modified historical cost basis by applying a cash-flow-based measurement technique.
 - (b) using a cash-flow-based measurement technique would involve estimating the cash flows that are within the boundary of a regulatory agreement and discounting those estimated future cash flows to their present value.
 - (c) an entity estimates uncertain cash flows applying the 'most likely amount' method or the 'expected value' method, whichever better predicts the cash flows. The entity should apply the chosen method consistently from initial recognition to recovery or fulfilment.

¹ <https://www.ifrs.org/content/dam/ifrs/project/rate-regulated-activities/published-documents/ed2021-rra.pdf>

3. A few respondents who agreed with the proposals suggested the Board:
 - (a) provide more guidance or illustrative examples on specified aspects of the proposals;
 - (b) simplify the proposals along the lines of the requirements in IAS 12 *Income Taxes*;
 - (c) require an entity to change the method used to estimate uncertain cash flows when circumstances change and the method selected at initial recognition does not better predict the cash flows; and
 - (d) impose a constraint similar to the constraint on variable consideration imposed by IFRS 15 *Revenue from Contracts with Customers*, especially on regulatory assets associated with performance incentives, so that an entity would only include cash flows to the extent it is highly probable that a significant reversal in the amount of cumulative cash flows will not occur when the uncertainty associated with performance incentives is subsequently resolved.
4. A few respondents, mainly European preparers with rate-regulated activities in the United States, disagreed with the cash-flow-based measurement technique mainly due to concerns about the cost of applying the proposals. They preferred the cost deferral model in US GAAP.
5. In relation to uncertain cash flows, a few respondents, mainly an accounting firm, a few national standard-setters and a few preparers, disagreed with using the expected value method mainly due to concerns about the complexity in applying the method. They suggested the Board require an entity to use the most likely amount method combined with the constraint described in paragraph 3(d).

Structure of the paper

6. This paper is structured as follows:
 - (a) Question 5(a)—Modified historical cost (paragraphs 7–14);
 - (b) Question 5(b)—Cash-flow-based measurement technique (paragraphs 15–30);

- (c) Question 5(c)—Outcome uncertainty and measurement uncertainty (paragraphs 31–37); and
- (d) other related matters (paragraph 38).

Question 5(a)—Modified historical cost

Summary of proposals in the Exposure Draft

- 7. Paragraph 29 of the Exposure Draft specifies the measurement basis for regulatory assets and regulatory liabilities as historical cost, modified for subsequent measurement by using updated estimates of the amount and timing of future cash flows. An entity would implement that measurement basis by applying a cash-flow-based measurement technique.
- 8. Paragraphs BC130–BC134 of the [Basis for Conclusions](#) on the Exposure Draft describe the reasoning behind the Board’s proposals.²
- 9. When developing the proposal, the Board observed that describing the measurement basis as modified historical cost has some analogies to the measurement, applying IFRS 15, of contract assets based on transaction price and contract liabilities based on consideration received in advance. The Board also observed that the measurement basis could also have been described as a current value measurement basis, modified to use a historical discount rate. However, the Board proposed to describe it as a modified historical cost because the proposed measurement basis:
 - (a) depends on cash flows that result from total allowed compensation for goods or services and from regulated rates for goods or services. Both total allowed compensation and regulated rates can be viewed as forms of price. The *Conceptual Framework for Financial Reporting (Conceptual Framework)* says that ‘historical cost uses information derived, at least in part, from the price of the transaction or other event that gave rise to the asset or liability’.

² <https://www.ifrs.org/content/dam/ifrs/project/rate-regulated-activities/published-documents/ed2021-rra-bc.pdf>

- (b) requires an entity not to update the discount rate unless the regulatory agreement changes the regulatory interest rate, resulting in a change in the cash flows from regulatory interest.

Comment letter and outreach feedback

10. The Board asked stakeholders whether they agree with the proposed measurement basis.
11. Most respondents who commented agreed with the Board's proposal for the reasons explained in the Basis for Conclusions.
12. A few respondents who agreed with the Board's proposal said paragraph 29 of the Exposure Draft as drafted might lead an entity to conclude that the proposal distinguishes between historical cost measurement at initial recognition and a cash-flow-based measurement for subsequent measurement. Those respondents understand that the Board's intention is not to make that distinction and asked the Board to modify the wording to remove any potential confusion.
13. A few respondents who agreed with the Board's proposal said defining the measurement basis as a modified historical cost or a modified current value was not important, so long as regulatory assets and regulatory liabilities are measured using a cash-flow-based measurement technique. Some of them preferred calling the proposed measurement basis a modified current value. A national standard-setter added that the term 'historical cost' might confuse users of financial statements because a historical cost measurement does not involve updating estimates of the amount and timing of future cash flows.
14. Very few respondents asked the Board to consider a full current value measurement basis. A national standard-setter said the proposal is inconsistent with the fair value measurement basis required by the Board in other recent projects and asked the Board to provide sufficient justification for the inconsistency.

Question 5(b)—Cash-flow-based measurement technique***Summary of proposals in the Exposure Draft***

15. Paragraph 30 of the Exposure Draft proposes that measuring regulatory assets and regulatory liabilities using a cash-flow-based measurement technique would involve:
 - (a) estimating future cash flows that are within the boundary of a regulatory agreement—including future cash flows arising from regulatory interest—and updating those estimates at the end of each reporting period to reflect conditions existing at that date; and
 - (b) discounting those estimated future cash flows to their present value.
16. Paragraphs 31–38 of the Exposure Draft contain the proposed requirements on estimating future cash flows.
17. Paragraphs B28–B40 of the Exposure Draft provide guidance on determining the boundary of a regulatory agreement. Paragraph B28 of the Exposure Draft specifies that the boundary of a regulatory agreement is the latest future date at which an entity has:
 - (a) an enforceable present right to recover a regulatory asset by increasing the regulated rate to be charged to customers; or
 - (b) an enforceable present obligation to fulfil a regulatory liability by decreasing the regulated rate to be charged to customers.
18. Paragraphs BC135–BC158 of the Basis for Conclusions describe the reasoning behind the Board’s proposals.
19. Agenda Paper 9F *Feedback summary—Discount rate* contains an analysis of the feedback on the Board’s proposal of discounting the cash flows.

Comment letter and outreach feedback

20. The Board asked stakeholders whether they agree with the proposed cash-flow-based measurement technique.

21. Most respondents who commented agreed with the Board's proposals for the reasons explained in the Basis for Conclusions.
22. A few respondents, mainly European preparers with rate-regulated activities in the United States, disagreed with the cash-flow-based measurement technique and preferred the cost deferral model in US GAAP for the following reasons:
 - (a) financial assets and financial liabilities are typically measured using cash-flow-based measurement techniques. However, the Board concluded that regulatory assets and regulatory liabilities are not financial assets and financial liabilities.
 - (b) if the proposals are meant to provide information that supplements information provided by applying IFRS 15, the measurement of regulatory assets and regulatory liabilities should be based on the transaction price model in IFRS 15.
 - (c) performing the calculations required in applying the cash-flow-based measurement technique could be operationally challenging. Some regulatory assets and regulatory liabilities, especially those associated with differences between the regulatory capital base and the carrying amount of property, plant and equipment, have a long life. Changing regulatory interest rates over the life make the calculations more difficult to track and manage.
 - (d) applying the minimum interest rate for a regulatory asset associated with an allowable expense would result in an entity accounting for a partial disallowance of the expense. That outcome does not reflect the intentions of a regulator and an entity.
23. Respondents provided comments on the following aspects of the proposals:
 - (a) estimating cash flows (paragraphs 24–25); and
 - (b) boundary of a regulatory agreement (paragraphs 26–30).

Estimating cash flows

24. A few respondents who agreed with the proposals suggested the Board:

- (a) clarify whether substantively enacted changes to a regulatory agreement or legislation at the reporting date should be considered in estimating the cash flows. These respondents said that a regulator typically consults on proposed changes to a regulatory agreement or legislation. Such consultations are open for a specified duration before any changes are formalised. At a reporting date, the regulator may have made decisions but not formally notified changes to the regulatory agreement.
- (b) clarify that the cash flows should be estimated using a reasonable and supportable basis. These respondents said that cash flows arising from regulatory assets and regulatory liabilities cannot always be separately identified. For example, in setting regulated rates a regulatory agreement may not distinguish assets not yet available for use from other assets. An entity cannot apply the measurement proposals for a regulatory liability associated with assets not yet available for use unless it allocates cash flows from the broader asset base to that regulatory liability.
- (c) provide more guidance and illustrative examples on the application of the measurement model to a regulatory liability associated with assets not yet available for use.
- (d) expand Illustrative Example 2B *Recovery period longer than an asset's useful life* and Illustrative Example 2C *Recovery period shorter than an asset's useful life* to illustrate a scenario of change of regulatory interest rate during the life of the asset.
- (e) provide more guidance on determining the period and pattern of recovery of a regulatory asset or fulfilment of a regulatory liability. These respondents said that estimating the timing and pattern of recovery or fulfilment may involve the use of significant judgement leading to subjective outcomes.
- (f) provide a practical expedient that allows an entity to assume that cash flows will arise evenly over a specified number of years (for example, a block of years for which regulated rates are set). Such an expedient would reduce the cost of applying the proposals.

- (g) provide guidance or illustrative examples on how cash flows should be adjusted for credit risk and demand risk. These respondents said that an entity might not always have the historical information needed for adjusting the cash flows. Adjusting the cash flows for demand risk would not be required had the Board made the proposals applicable only to an entity whose customers have little or no choice to purchase its goods or services. In addition, the proposals are not clear if the credit risk assessment is different from the expected credit loss model in IFRS 9 *Financial Instruments*.
- (h) simplify the measurement proposals along the lines of the requirements in IAS 12. These respondents said that applying the measurement proposals could be operationally challenging. A history of frequent political interventions in rate-setting may not provide sufficient basis for an entity to make reliable estimates of the amount and timing of cash flows. A measurement model like the model in IAS 12 would:
- (i) allow an entity to measure regulatory assets and regulatory liabilities as the difference between the total allowed compensation for goods or services supplied in a period and the amount of revenue recognised; and
 - (ii) relieve an entity from estimating the timing of cash flows and from discounting the cash flows.
25. A European preparer who disagreed with the cash-flow-based measurement technique suggested the Board simplify the measurement proposals for some regulatory assets along the lines of the requirements in IAS 12. That respondent said that in relation to regulatory assets associated with corporate overheads that are not included in the carrying amount of property, plant and equipment but included in the regulatory capital base, a regulator may not provide regulatory interest on those regulatory assets until the item of property, plant and equipment becomes available for use. Applying the proposals, an entity would have to impute regulatory interest for the years for which the regulator did not provide any regulatory interest. Changing regulatory interest rates would complicate the calculations over the life of these regulatory assets. Furthermore, the cash-flow-based measurement of these regulatory assets is inconsistent with the historical cost measurement of property, plant and equipment. A

measurement model like the model in IAS 12 would allow an entity to measure these regulatory assets at the amount of corporate overheads included in the regulatory capital base and to derecognise these assets over the regulatory recovery period.

Boundary of a regulatory agreement

26. Some respondents said that the proposed guidance on boundary of a regulatory agreement (paragraphs B28–B40 of the Exposure Draft) could potentially lead entities to different conclusions as explained in paragraphs 27–29, and therefore, suggested the Board clarify the proposals.
27. A rate-regulated entity typically has an enforceable right (for example, a licence) to operate. In some jurisdictions, that right is renewable with a term of 10–25 years. In other jurisdictions, that right is perpetual. However, a regulator typically determines the basis for rate-setting, and approves regulated rates, for shorter durations of 2–6 years.
28. A few of those respondents, mainly preparers, said the definition of a regulatory agreement as drafted—a set of enforceable rights and obligations that determine a regulated rate to be applied in contracts with customers—could lead an entity to conclude that it has enforceable rights and obligations for the shorter duration of 2–6 years. Those respondents preferred the shorter duration because a longer duration would mean that an entity must predict the basis for rate-setting for the next block of years. An accounting firm thought that an entity’s licence to operate should not be confused with enforceable rights and obligations arising from a regulatory agreement.
29. However, the other respondents thought that the boundary of a regulatory agreement goes beyond the periods for which rates have been approved. A longer duration is consistent with the entity holding a right to operate for a long period, and consistent with the entity investing in assets that have a long life and expecting to recover its investment through the regulated rates. A regulator would not typically have the practical ability to exercise its right to cancel the regulatory agreement without compensating an entity.
30. A few respondents also suggested the Board:

- (a) remove what appears to be an inconsistency between the proposal to require an entity to include cash flows within the boundary of a regulatory agreement which arise from charging customers (see paragraphs 33–34 of the Exposure Draft) and the proposed guidance on the circumstances in which an entity includes in the cash flows compensation from a regulator or a third party;
- (b) provide illustrative examples on how to apply paragraphs B28–B34 of the Exposure Draft; and
- (c) require disclosure of how an entity determines the boundary of the regulatory agreement and of any unrecognised regulatory assets or regulatory liabilities that the entity expects to recover or fulfil beyond the boundary.

Question 5(c)—Outcome uncertainty and measurement uncertainty

Summary of proposals in the Exposure Draft

31. If cash flows arising from a regulatory asset or regulatory liability are uncertain, the Exposure Draft proposes that an entity estimate those cash flows applying whichever of two methods—the ‘most likely amount’ method or ‘expected value’ method—better predicts the cash flows. The entity should apply the chosen method consistently from initial recognition to recovery or fulfilment.
32. Paragraphs BC136–BC139 of the Basis for Conclusions describe the reasoning behind the Board’s proposal.

Comment letter and outreach feedback

33. The Board asked stakeholders whether they agree with the proposal.
34. Most respondents who commented agreed with the Board’s proposal.
35. A few respondents who agreed with the proposal suggested the Board:
 - (a) provide more guidance on factors to consider in assessing which method better predicts the cash flows. Incorporating some of the guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* on determining a best

estimate could help an entity that newly becomes party to a regulatory agreement.

- (b) reconsider its proposal that an entity should apply the chosen method consistently from initial recognition to recovery or fulfilment. These respondents said that it is possible that the method selected at initial recognition may not better predict the cash flows when circumstances change. For example, when initially measuring a regulatory asset associated with performance incentives an entity may conclude that the expected value method better predicts the cash flows. However, as an entity gains more clarity on its entitlement, the most likely amount method may better predict the cash flows.
- (c) clarify whether and how any existence uncertainty should be reflected in measuring a regulatory asset or regulatory liability that meets the ‘more likely than not’ recognition threshold. These respondents said that if a regulatory asset or regulatory liability meets the recognition threshold and an entity concludes that the most likely amount method better predicts the cash flows, an entity would ignore the possible outcomes in which the regulatory asset or regulatory liability is less likely to exist. However, when using the expected value method, it is not clear if the entity should also include possible outcomes in which the regulatory asset or regulatory liability is less likely to exist.
- (d) provide guidance on specified sources of outcome uncertainty and measurement uncertainty. These respondents said that unexpected intervention by governments is a common feature of rate regulation, which could lead to partial recovery of regulatory assets. It is not clear whether and how a government’s discretion should be considered in measuring regulatory assets.
- (e) provide guidance or illustrative examples on how subsequent events could affect the measurement of regulatory assets and regulatory liabilities. An entity routinely has negotiations with a regulator. Not all negotiations affecting a regulatory asset or regulatory liability that exists at a reporting date are settled by that date.

- (f) clarify that uncertainties reflected in cash flows should not be reflected again in the discount rate.
- (g) impose a constraint similar to the constraint on variable consideration imposed by IFRS 15, especially on the cash flows that can be included in measuring regulatory assets associated with performance incentives. The effect of imposing the constraint would be that an entity will only include cash flows to the extent it is highly probable that a significant reversal in the amount of cumulative cash flows will not occur when the uncertainty associated with performance incentives is subsequently resolved. These respondents said that regulatory assets associated with performance incentives are typically subject to significant outcome uncertainty and measurement uncertainty. Applying the proposals to these regulatory assets could be operationally challenging. See paragraphs 16–17 of Agenda Paper 9D *Feedback summary—Recognition*. Recognising the financial effects of these regulatory assets based on management’s judgement and expectations may lead to volatility in earnings and adversely affect the quality and reliability of the resulting financial information. Furthermore, a regulator’s knowledge of the possible outcomes considered in measuring these regulatory assets using the expected value method could adversely affect an entity’s negotiations with the regulator.
36. A few respondents disagreed with the proposal for the same concerns explained in paragraph 35(g) about regulatory assets associated with performance incentives. A preparer in North America suggested the Board require a ‘highly probable’ recognition threshold combined with the ‘most likely amount’ method. An accounting firm suggested the Board require the ‘most likely amount’ method combined with the constraint described in paragraph 35(g).
37. A few respondents suggested the Board require the use of the expected value method for all regulatory assets and regulatory liabilities. A national standard-setter said that financial information across entities would be comparable if all entities use the same method. A securities regulator said that the expected value method should be the preferred method when there is uncertainty.

Other related matters

38. A national standard-setter said that the Board should require an entity to test regulatory assets for impairment, especially when there is a change in customer base.

Question for the Board

Does the Board have any questions or comments on the feedback discussed in this paper? Specifically:

- a. Is there any feedback that is unclear?
- b. Are there any points you think the Board did not consider in developing the Exposure Draft but should consider in the re-deliberations?
- c. Are there any points you would like staff to research further for the re-deliberations?