Staff paper

Agenda reference: 9A

IASB® meeting

Date	**May 2023**
Project	**Rate-regulated Activities**
Topic	**Timing of initial recognition**
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Objective

1. This paper sets out staff analysis and recommendations on the proposals relating to initial recognition of regulatory assets and regulatory liabilities in the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft).

Staff recommendations

2. We recommend the final Accounting Standard:

   (a) retain the proposal to require recognition of all regulatory assets and all regulatory liabilities existing at the end of the reporting period;

   (b) clarify that initial recognition of a regulatory asset or a regulatory liability occurs at the end of a reporting period; and

   (c) retain the proposal to treat any regulatory assets or regulatory liabilities arising from regulated rates denominated in a foreign currency as monetary items when applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

Structure of the paper

3. This paper is structured as follows:

   (a) proposals in the Exposure Draft (paragraphs 5–6);

   (b) feedback received (paragraphs 7–8); and

(c) staff analysis (paragraphs 9–35).

4. Appendix A contains extracts from IAS 21. Appendix B discusses the classification of regulatory assets and regulatory liabilities as monetary or non-monetary items.

Proposals in the Exposure Draft

5. Paragraphs 25–28 of the Exposure Draft deal with recognition. Paragraph 25 states:

> **25 An entity shall recognise:**
>
> **(a) all regulatory assets and all regulatory liabilities existing at the end of the reporting period; and**
>
> **(b) all regulatory income and all regulatory expense arising during the reporting period.**

6. A few respondents commenting on recognition also commented on paragraph 45 of the Exposure Draft.

> **Foreign currency amounts**
>
> 45 If regulated rates are denominated in a foreign currency, an entity shall treat any related regulatory assets or regulatory liabilities as monetary items when applying IAS 21 *The Effects of Changes in Foreign Exchange Rates*.

Feedback received

7. Some respondents—mainly a few preparers and a few European national standard-setters—asked the IASB to clarify when a regulatory asset or a regulatory liability is initially recognised. They sought clarity on whether a regulatory asset or a regulatory liability can be recognised before the end of the reporting period.

8. A few accounting firms and a few European national standard-setters also commented on the application of IAS 21 to regulatory assets and regulatory liabilities. Their comments were:

(a) the timing of initial recognition has implications for the application of IAS 21.

(b) the regulatory assets and regulatory liabilities to which paragraph 45 of the Exposure Draft refers might not always be monetary items.

(c) the IASB should explain the rationale for the proposal in paragraph 45 of the Exposure Draft.

Staff analysis

9. The analysis is structured as follows:

(a) timing of initial recognition (paragraphs 10–25); and

(b) application of IAS 21 (paragraphs 26–35).

Timing of initial recognition

10. Some respondents asked the IASB to clarify when a regulatory asset or a regulatory liability is initially recognised (paragraph 7). In their view, paragraph 25 of the Exposure Draft (which states that an entity recognises all regulatory assets and all regulatory liabilities existing at the end of the reporting period) is unclear as to whether a regulatory asset or a regulatory liability can be recognised before the end of the reporting period. At a minimum, entities applying the model will be required to assess the existence of regulatory assets and regulatory liabilities at the end of the reporting period. The question raised by respondents is whether they will also need to assess existence for initial recognition throughout the reporting period. In this paper we use the term 'reporting period' to mean both an interim reporting period and an annual reporting period.

11. As some of these respondents noted, the timing of initial recognition has implications for the application of IAS 21.[1] Assuming that regulatory assets or regulatory

[1] Appendix A contains extracts from IAS 21.

liabilities arising from regulated rates denominated in a foreign currency are treated as monetary items (as per paragraph 45 of the Exposure Draft), IAS 21 would require:

(a) translation into the functional currency on initial recognition using the spot exchange rate at the date of the transaction;

(b) translation into the functional currency at the end of the reporting period using the closing rate; and

(c) recognition of exchange gains and losses arising between initial recognition and the end of the reporting period in the statement of financial performance.

12. The timing of initial recognition also has implications for when and how often entities need to gather information and make judgements about the existence of regulatory assets and regulatory liabilities. Respondents have stated that making such judgements can be difficult and costly, particularly when regulatory periods and financial reporting periods do not coincide. If entities are required to assess existence for initial recognition throughout the reporting period they will need to gather information more frequently.

13. This section assesses the need for further clarification in the final Standard by considering:

(a) recognition in the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) and other IFRS Accounting Standards (Standards)—(paragraphs 14–15);

(b) the earliest recognition point for regulatory assets and regulatory liabilities (paragraphs 16–20); and

(c) options for determining timing of initial recognition in the final Standard (paragraphs 21–25).

Recognition in the Conceptual Framework *and other Standards*

14. The *Conceptual Framework* describes recognition as the process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements of financial statements.[2] It states that items are recognised only if they meet the definition of that item and recognition provides users of financial statements with useful information. However, the *Conceptual Framework* does not discuss when initial recognition of assets and liabilities occurs—this is addressed in individual Standards.

15. Individual Standards generally require that items are recognised at the earliest point at which they meet the relevant definitions and the recognition criteria in those Standards. For example, IFRS 9 *Financial Instruments* requires that an entity recognise a financial asset or a financial liability when, and only when, the entity becomes party to the contractual provisions of the instrument.[3]

Earliest recognition point for regulatory assets and regulatory liabilities

16. The earliest point at which an entity could be required to recognise regulatory assets and regulatory liabilities would be when the entity has enforceable present rights and enforceable present obligations that meet the definitions of regulatory assets and regulatory liabilities and, if their existence is uncertain, are more likely than not to exist.

17. In some cases, requiring recognition at the earliest recognition point is straightforward. For example, an entity with an enforceable present right to recover expenses it incurs in year 1 by adding these expenses in regulated rates charged in future reporting periods could be required to recognise a regulatory asset when it incurs the expense. In this case:

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[2] Paragraph 5.1 of the *Conceptual Framework*.

[3] Paragraph 3.1.1 of IFRS 9.

(a) a difference in timing arises in year 1 because the entity has incurred an expense whose related compensation was not included in regulated rates charged in that period; and

(b) the difference in timing fulfils the definition of a regulatory asset and that asset is more likely than not to exist (that is, the difference in timing fulfils the recognition criteria).

18. We think this approach to recognition has conceptual merit because initial recognition of regulatory assets and regulatory liabilities would coincide with the point in time when a difference in timing arises—that is, it faithfully represents when the entity has an enforceable present right or enforceable present obligation.

19. However, we think that entities could find this approach difficult and costly to apply. Comments raised by respondents—mainly preparers and a European national standard-setter—about the likely effects of the proposals suggest:

(a) some of the inputs affecting the recognition and measurement of regulatory assets and regulatory liabilities are available only on an annual basis. This is because some regulatory agreements are negotiated based on annual data. As a result, some entities do not have processes to collect data during the reporting period.

(b) monitoring changes in individual regulatory assets and regulatory liabilities and tracking the corresponding information involves high administrative costs.

20. Some of the comments in paragraph 19 were raised in the context of preparing interim financial statements and may be unavoidable in that context. We will discuss issues associated with the application of IAS 34 *Interim Financial Reports* at a future meeting.

Options for determining timing of initial recognition

21. Some respondents asked the IASB to clarify whether the proposed recognition requirements could be applied before the end of the reporting period. As mentioned

in paragraph 15, Standards generally require recognition at the earliest point that an item meets the relevant definitions and recognition criteria.

22. We have identified three ways in which the recognition requirements in the final Standard could be clarified. The final Standard could:

(a) require that the recognition criteria be applied during the reporting period and that regulatory assets and regulatory liabilities be recognised at the earliest point that the recognition criteria are satisfied (that is, when the difference in timing arises) (Option A);

(b) require that the recognition criteria be applied at the end of each reporting period, but permit earlier recognition (Option B);[4] or

(c) require that the recognition criteria be applied only at the end of each reporting period (Option C).

23. Table 1 sets out these options, identifies some pros and cons, and explains the application of IAS 21.

[4] If a Standard permits an accounting policy choice it usually requires that an entity apply that policy consistently and specifies whether the policy choice is irrevocable or can be changed (subject to satisfying the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*).

Table 1—Options for initial recognition			
	Option A—Apply recognition criteria during the reporting period	*Option B—Permit application of recognition criteria during the reporting period*	*Option C—Apply recognition criteria only at the end of the reporting period*
Description	During the reporting period an entity would apply the initial measurement requirements to regulatory assets and regulatory liabilities originated at different points in time during that period. At the end of the reporting period an entity would apply the subsequent measurement requirements—which would generally only consist of updating the estimates of future cash flows.	See Option A or Option C, depending upon the entity's accounting policy choice.	At the end of the reporting period, an entity would apply the initial measurement requirements to the regulatory assets and regulatory liabilities originated during that period.
Pros	Conceptual merit—A regulatory asset or a regulatory liability would be recognised when a difference in timing arises and the recognition requirements are met (that is, it is more likely than not that an enforceable present right or enforceable present obligation exists). This option aligns with the recognition requirements in other Standards. This option could result in the provision of information relating to the exchange gains or losses during the reporting period through disclosures (see example below).	Entities that are able to recognise regulatory assets and regulatory liabilities during the reporting period would be able to do so—see Option A. The accounting policy choice would not affect the amounts at which the regulatory assets and regulatory liabilities would be measured at the end of the reporting period (that is, this option has the same measurement outcome as Option A), but it would allow an entity to minimise compliance costs.	This option has the same measurement outcome as Option A, but lower compliance costs than Option A (see Option A 'Cons').

<table>
<tr><th colspan="4">Table 1—Options for initial recognition</th></tr>
<tr><td></td><td>Option A—Apply recognition criteria during the reporting period</td><td>Option B—Permit application of recognition criteria during the reporting period</td><td>Option C—Apply recognition criteria only at the end of the reporting period</td></tr>
<tr><td>Cons</td><td>This option has higher compliance costs than Option C. An entity would have to track differences in timing (paragraph 12) and make regular recognition assessments.

In cases where application of the recognition criteria is challenging, repeated application of judgement could be costly.</td><td>This option does not align with the recognition requirements in other Standards—Standards do not normally provide recognition options.</td><td>This option does not align with the recognition requirements in other Standards—there could be a delay between when a difference in timing arises and when it is recognised as a regulatory asset or regulatory liability. That delay would not affect the measurement of a regulatory asset or a regulatory liability but would affect the provision of information relating to the exchange gains and losses during the reporting period (see example below).</td></tr>
<tr><td rowspan="2">Application of IAS 21 to a regulatory asset</td><td colspan="3">Assume the following example:
(a) Year end is 31 December.
(b) A difference in timing arises on 1 July 2020 of foreign currency units (CU) 100.
(c) The spot rate on 1 July 2020 is 1.
(d) The spot rate on 31 December is 0.95.
(e) There are no other changes in the regulatory asset during the reporting period.
(f) The entity treats any regulatory assets or regulatory liabilities related to regulated rates denominated in a foreign currency as monetary items (as per paragraph 45 of the Exposure Draft).</td></tr>
<tr><td>Roll-forward of regulatory asset
(in functional CU)</td><td>See Option A or Option C, depending upon the entity's accounting policy choice.</td><td>Roll-forward of regulatory asset
(in functional CU)</td></tr>
</table>

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<tr><th colspan="4">Table 1—Options for initial recognition</th></tr>
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<tr><td></td><td>Opening carrying amount 0
Amount recognised (1/07/20) 100
Exchange loss (31/12/20) (5)
Closing carrying amount 95

During the reporting period, the entity would reflect an amount of functional CU95 in profit or loss.

Applying the proposals in the Exposure Draft we would expect an entity:(*)
(a) to present the functional CU95 in the regulatory income minus regulatory expense separate line item (paragraph 67 of the Exposure Draft); and
(b) to disclose:
(i) the origination of the regulatory asset as regulatory income amounting to functional CU100 (paragraph 78(a) of the Exposure Draft).
(ii) the exchange loss as part of a (negative) remeasurement amounting to functional CU5</td><td>This option would give rise to lack of comparability in the disclosures an entity would provide about the exchange gains or losses arising during the reporting period in which the difference in timing arose.</td><td>Opening carrying amount 0
Amount recognised (31/12/20) 95
Closing carrying amount 95

During the reporting period, the entity would reflect an amount of functional CU95 in profit or loss.

Applying the proposals in the Exposure Draft we would expect an entity:(*)
(a) to present the functional CU95 in the regulatory income minus regulatory expense separate line item (paragraph 67 of the Exposure Draft); and
(b) to disclose the origination of the regulatory asset as regulatory income amounting to functional CU95 (paragraph 78(a) of the Exposure Draft).</td></tr>
</table>

Table 1—Options for initial recognition			
	Option A—Apply recognition criteria during the reporting period	*Option B—Permit application of recognition criteria during the reporting period*	*Option C—Apply recognition criteria only at the end of the reporting period*
	(paragraph 78(g) of the Exposure Draft).		
	(*): We will discuss presentation and disclosure at a future meeting.		
Conclusion (paragraph 24)	Do not recommend Option A.	Do not recommend Option B.	Recommend Option C.

24. Option A is the most consistent with recognition requirements in other Standards and could result in disclosure of information about exchange gains or losses as part of remeasurements (paragraph 78(g) of the Exposure Draft). However, we do not recommend Option A because it would have the highest compliance costs. Nor do we recommend Option B because Standards do not normally provide entities with recognition options. We recommend Option C because it would have the same outcome as Option A (in both the statement of financial position and the statement of financial performance) but lower compliance costs. Option C would concentrate the need to gather data for differences in timing originating during the period at the end of reporting period and it would avoid an entity having to track changes between when the difference in timing arose and the end of the reporting period.

25. We recommend that the final Accounting Standard:

    (a) retain the proposal to require recognition of all regulatory assets and all regulatory liabilities existing at the end of a reporting period; and

    (b) clarify that initial recognition of a regulatory asset or a regulatory liability occurs at the end of a reporting period.

Question for the IASB
1. Does the IASB agree with the recommendations in paragraph 25?

Application of IAS 21

26. Paragraph 45 of the Exposure Draft proposes that 'If regulated rates are denominated in a foreign currency, an entity shall treat any related regulatory assets or regulatory liabilities as monetary items when applying IAS 21.'

27. Respondents commented on the application of IAS 21 to regulatory assets and regulatory liabilities (paragraph 8). This section considers their comments:

    (a) the timing of initial recognition has implications for the application of IAS 21 (paragraph 29).

    (b) the regulatory assets and regulatory liabilities referred to in paragraph 45 of the Exposure Draft might not always be monetary items (paragraphs 30–33).

    (c) the IASB should explain the rationale for the proposal in paragraph 45 of the Exposure Draft (paragraph 34).

28. Appendix A outlines the relevant requirements in IAS 21.

Timing of initial recognition and application of IAS 21

29. If the IASB agrees with our recommendation in paragraph 25, the initial recognition of a regulatory asset or a regulatory liability would occur at the end of a reporting period. The end of the reporting period would therefore also be the date of the transaction for the purpose of applying IAS 21.

Monetary or non-monetary

30. The Exposure Draft proposes that the regulatory assets and regulatory liabilities referred to in paragraph 45 of the proposals are to be treated as monetary items when applying IAS 21—respondents queried whether they would always be monetary items. The determination of an item as monetary or non-monetary has implications for the application of the subsequent measurement requirements in IAS 21, with different rates being used to translate monetary and non-monetary items (see Appendix A).[5]

[5] IAS 29 *Financial Reporting in Hyperinflationary Economies* also uses the concept of monetary and non-monetary items.

31. The proposal in paragraph 45 of the Exposure Draft does not say that regulatory assets and regulatory liabilities arising from regulated rates denominated in a foreign currency *are* monetary items—it says that entities are *to treat* such regulatory assets and regulatory liabilities as monetary items. This means that entities do not have to determine whether such regulatory assets and regulatory liabilities are monetary or non-monetary for the purpose of applying the subsequent measurement requirements in IAS 21.

32. We think the proposal in paragraph 45 of the Exposure Draft simplifies the application of the subsequent measurement requirements in IAS 21:

    (a) although IAS 21 contains examples of monetary and non-monetary items, determining whether items are monetary or non-monetary can require judgement. Paragraph BC17 of the Basis for Conclusions accompanying IFRIC 22 *Foreign Currency Transactions and Advance Consideration* acknowledges that an entity may need to apply judgement in determining whether an item is monetary or non-monetary. We think there could be differing views about whether regulatory assets and regulatory liabilities are monetary or non-monetary items; however, when considering their nature, we think regulatory assets and regulatory liabilities are closer to monetary items than to non-monetary items (see Appendix B). The proposal in paragraph 45 of the Exposure Draft avoids the potential for entities to make different determinations about similar items.

    (b) the rate used to translate foreign currency non-monetary items at the end of each reporting period in accordance with IAS 21 depends on whether the item is measured at historical cost or fair value. The Exposure Draft proposes a modified historical cost as the measurement basis (that is, historical cost modified by using updated estimates of future cash flows). However, paragraph BC133 of the Basis for Conclusions accompanying the Exposure Draft notes that the proposed measurement basis could also have been described as a current value measurement basis, modified to use a historical discount rate.[6] The proposal in paragraph 45 of the Exposure Draft to treat these items as monetary items means that there is no need to determine whether to treat the proposed measurement basis as historical cost or fair value when applying IAS 21, or to amend IAS 21 to clarify its application to regulatory assets and regulatory liabilities.

33. In addition, we think treating regulatory assets and regulatory liabilities as monetary items leads to reasonable outcomes. In common with current value measurement bases such as fair value, the proposed measurement basis requires an entity to update estimates of future cash flows. There is likely to be little difference between the amounts reported if an item is treated as a monetary item (translated at the closing rate) or as a non-monetary item measured at fair value (translated using the closing rate when fair value was measured). This is because an entity would always reflect the fair value measurement of the non-monetary item at the end of the reporting period. Consequently, we think that the proposal in paragraph 45 of the Exposure Draft to treat regulatory assets and regulatory liabilities arising from regulated rates denominated in a foreign currency as monetary items simplifies the application of IAS 21 and would result in reasonable outcomes.

Rationale for proposal

34. We agree with respondents that it would be helpful for the final Accounting Standard to explain the rationale for the proposal in paragraph 45 of the Exposure Draft—that is, that treating regulatory assets and regulatory liabilities denominated in a foreign currency as monetary items simplifies the application of IAS 21 (paragraph 32).

Recommendation—Application of IAS 21

35. We recommend that the final Accounting Standard retain the proposal to treat any regulatory assets or regulatory liabilities arising from regulated rates denominated in a foreign currency as monetary items when applying IAS 21.

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[6] Feedback received on the proposed measurement basis will be discussed at a future meeting.

Question for the IASB
2. Does the IASB agree with the recommendation in paragraph 35?

Appendix A

A1. This appendix outlines the initial and subsequent recognition requirements in IAS 21.

Table 2—Extracts from IAS 21	
Definition	***Monetary items* are units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency.**
Elaboration on the definition	16 The essential feature of a monetary item is a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: pensions and other employee benefits to be paid in cash; provisions that are to be settled in cash; lease liabilities; and cash dividends that are recognised as a liability. Similarly, a contract to receive (or deliver) a variable number of the entity's own equity instruments or a variable amount of assets in which the fair value to be received (or delivered) equals a fixed or determinable number of units of currency is a monetary item. Conversely, the essential feature of a non-monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency. Examples include: amounts prepaid for goods and services; goodwill; intangible assets; inventories; property, plant and equipment; right-of-use assets; and provisions that are to be settled by the delivery of a non-monetary asset.
Initial recognition	**21 A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction.** 22 The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with IFRSs. For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

Table 2—Extracts from IAS 21	
Reporting at the ends of subsequent reporting periods (emphasis added)	23 At the end of each reporting period: (a) foreign currency monetary items shall be translated using the closing rate; (b) non-monetary items that are measured in terms of historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction; and (c) non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was measured.
Recognition of exchange differences	28 Exchange differences arising on the settlement of monetary items or on translating monetary items at rates different from those at which they were translated on initial recognition during the period or in previous financial statements shall be recognised in profit or loss in the period in which they arise, except as described in paragraph 32.

Appendix B

B1. This appendix explains why determining whether regulatory assets and regulatory liabilities are monetary or non-monetary items could be difficult and why treating them as monetary items is appropriate.

B2. Assume the case of a bonus or penalty amount relating to performance in a period, but added to or deducted from the regulated rates charged in a future period. Considering the definition of monetary items in IAS 21 (see Appendix A), some may argue that the regulatory assets or regulatory liabilities related to bonuses or penalties would be monetary items because the amount of the bonus or penalty to be added to, or deducted from, future regulated rates is a fixed or determinable number of units of currency.

B3. However, paragraph 16 of IAS 21 states that ‘the essential feature of a monetary item is *a right to receive* (or *an obligation to deliver*) a fixed or determinable number of units of currency.’ Considering this, others might argue that a regulatory asset or a regulatory liability would not be monetary items. This is because:

(a) a regulatory asset is *a right to add an amount* to future regulated rates, not a right to receive a fixed or determinable number of units of currency; and

(b) a regulatory liability is *an obligation to deduct an amount* from future regulated rates, not an obligation to pay a fixed or determinable number of units of currency.

B4. When considering the nature of regulatory assets and regulatory liabilities, we think that the proposal in the Exposure Draft *to treat* regulatory assets and regulatory liabilities as monetary items is appropriate. This is because even though they are not a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency, they are closer in nature to monetary items such as accounts receivable or accounts payable than to non-monetary items such as goodwill or property, plant and equipment. For example, regulatory assets and accounts receivable bear similar risks (credit risk) and regulatory assets, regulatory liabilities and accounts receivable also form part of the same transaction cycle (see chart below).