IFRS

STAFF PAPER

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IASB

Project	**Rate-regulated Activities**		
Paper topic	Cover note and summary of the model		

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Purpose of this meeting

1. This session is an education session for the Board to update it on our progress in developing a new accounting model for rate-regulated activities. The objective of the model is to provide a more faithful representation in IFRS financial statements of the financial effects of rate regulation. In line with the feedback from the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the DP) and subsequent outreach, we have been developing the model to lead to the recognition of at least some regulatory assets and regulatory liabilities.

2. The staff are not asking the Board to make decisions about the model in this meeting. We are providing an overview to help Board members understand the core features of the model to aid their consideration of more detailed proposals for the model that we will present in a meeting in early 2017. This education session also gives Board members an opportunity to identify any other issues raised in this overview for which further analysis is needed.

Questions for the Board
Do you have any questions or comments on the core features of the model presented in this overview? In particular, have you identified any further specific issues or questions that staff should address in the more detailed proposals to be considered in a future meeting?

Papers for this meeting

3. There are three papers for this meeting:

   (a) Agenda Paper 9 *Cover note and summary of the model*—that is this paper, which gives a brief introduction to the education session and summarises, at a high level, proposals for the new accounting model, together with the planned next steps.

   (b) Agenda Paper 9A *Overview of the core features of the model*—this paper expands on the high-level proposals summarised in Agenda Paper 9. It explains the core objective and principles of the model and provides numerical examples to show how the proposals would result in the recognition of regulatory assets and regulatory liabilities.

   (c) Agenda Paper 9B *Responding to issues raised by ASAF*—this paper summarises concerns expressed by ASAF members and outlines how those concerns are addressed in the model. The content replicates much of the content of ASAF Agenda Paper 3 *Responding to issues raised by ASAF*, which will be discussed by ASAF on 8 December 2016.

Background

4. In responding to the DP, some stakeholders, particularly standard-setters, stressed the importance of the *Conceptual Framework* definitions and the need for any items recognised in the statement of financial position to meet them. In developing the model, we have taken into account the Board's discussions through the *Conceptual Framework* project, particularly the discussions about the definitions of assets and liabilities and executory contracts, which have recently been completed.

5. In addition, the Accounting Standards Advisory Forum (ASAF) has contributed to the staff's exploration of the issues through its meetings in December 2014, July 2015, October 2015, April 2016 and September 2016. We will be discussing issues further with ASAF on 8 December 2016 meeting, a few days before the Board's December 2016 meeting. We will update the Board on the ASAF discussion during the education session.

Next steps

6. Throughout Agenda Paper 9A, we have highlighted a number of areas for which we intend to bring a more detailed analysis to the Board in a meeting in early 2017. Staff are seeking comments now from the Board to help identify any other areas for which more detailed analysis is needed and to further develop the more detailed analysis. Staff will seek decisions from the Board in that future meeting about detailed proposals for the model on scope, recognition and dereocgnition, initial and subsequent measurement (including impairment), presentation and disclosure.

Summary of proposed model

Features of the basic model	Basis for proposals
Objective To inform users of financial statement about the effects of rate regulation arising from past transactions, events and other conditions on the entity's financial position, performance and cash flows.	The rate regulator, through the regulatory agreement, imposes obligations on the entity to transfer specified goods and services to the entity's customers, the rate regulator or other designated parties. The rate regulator determines the amount and timing of the compensation/funding the entity is entitled to in exchange for performance of these regulatory obligations, ie the rate regulator determines the payment schedule for the period(s) covered by the regulatory agreement. The rate regulator uses the customer-base as a vehicle for transferring the agreed compensation/funding to the entity.
Core principle The model supplements, but does not override, other IFRS Standards. Consequently, all other IFRS Standards are applied first to the entity's transactions, other events and conditions, including IFRS 15 *Revenue from Contracts with Customers*. The model focuses on the effects of the rate regulation by capturing, through the recognition of assets and liabilities in the statement of financial position, the rights and obligations created by the rate regulator's intervention in the setting of the rate chargeable to customers.	The regulatory agreement establishes the entity's right and obligation to exchange resources with the **customer-base**.[1] At the start of the regulatory agreement, both parties, the entity and the customer-base, have equally unperformed under the agreement and so the regulatory agreement is executory. The payment schedule established by the regulatory agreement often does not reflect the work performed at each payment date and so leads to some amounts being received by the entity, from the customer-base, in arrears and some being received in advance of the entity satisfying its related regulatory obligations. Consequently, as one party performs in a way that is disproportionate to the other, the agreement ceases to be executory and an asset or liability is recognised to reflect this difference in performance. Recognising these assets and liabilities gives rise to a corresponding entry in the income statement.

[1] The 'customer-base' is a notion that underpins the effectiveness of defined rate regulation and is used by the rate regulator when establishing the rate to be charged by the entity (see paragraphs 7-14 of Agenda Paper 9A *Overview of the core feature of the model* for more details).

Features of the basic model	Basis for proposals
	The accumulation of these corresponding income statement items reflects the net timing difference between the entity's performance of its regulatory obligations and the funding of that performance by the customer-base. An asset represents the entity's right to be compensated for past performance of regulatory obligations. A liability represents the entity's obligation to satisfy specified regulatory obligations for which no further compensation, or reduced compensation, is receivable from the customer-base because some compensation has already been received.
Scope The model is applied only to the regulatory adjustments that: • are identified through the rate-setting mechanism; and • result in regulatory balances that are included, or expected to be included, by the rate regulator in establishing the rate(s) that can be charged to customers.	The revenue recognised in accordance with IFRS 15 is recognised and measured at P x Q, where: - P is the regulated rate per unit agreed by the rate regulator; and - Q is the quantity of goods/service delivered by the entity to individual customers during the period. Any differences between the quantity delivered and the quantity billed to customers will be recognised in accordance with IFRS 15 as a contract asset/ receivable, or as a contract liability/ payable, as applicable. This model recognises a regulatory asset or regulatory liability if the rate-setting mechanism is sufficiently clear that the regulated rate for a future period will be adjusted to reflect amounts that: • are included in the regulated rate (P) for the current period but do not relate to the goods/services delivered by the entity to individual customers in the period; and/or • are excluded from the regulated rate (P) for the current period but relate to the goods/services delivered by the entity to individual customers in the period.

Features of the basic model	Basis for proposals
	There are three main types of regulatory adjustment: • Estimation adjustments; • Bonus/ penalty adjustments; and • Performance timing difference adjustments.[2]
Recognition The entity recognises a regulatory asset for: • regulatory estimation adjustments that arise from variances between actual amounts and estimated amounts used in the rate-setting mechanism and for which a rate increase is included, or expected to be included, in a future period; and • regulatory bonus adjustments and performance timing differences that originate from the performance of a regulatory obligation in a period before the entity is entitled to charge the customer for that performance. The entity recognises a regulatory liability for: • regulatory estimation adjustments that arise from variances between actual amounts and estimated amounts used in the rate-setting mechanism and for which a rate decrease is included, or expected to be included, in a future period; and • regulatory penalty adjustments and performance timing differences that originate from the entitlement of the entity to charge the customer for the performance of a regulatory	The model recognises, as a regulatory asset or regulatory liability, amounts included in the revenue recognised using IFRS 15 that relate to: (a) variances between estimated and actual amounts (estimation adjustments); (b) the application of regulatory bonuses/ penalties; and/ or (c) the satisfaction, or partial satisfaction, of the entity's obligations in another period (performance timing difference adjustments). The model does not intend to capture the adjustments to the future regulated rate that relate to future transactions, events or conditions. Such adjustments reflect the future operations of the business and affect the fair value of the business, including its goodwill. Although the fair value of the business may be relevant to users of the IFRS financial statements, valuing the business is not the objective of the model.

[2] See paragraphs 26-37 of Agenda Paper 9A for a description and example of each type of adjustment.

Features of the basic model	Basis for proposals
obligation in a period before the entity has performed that regulatory obligation.	
Derecognition The entity derecognises a regulatory asset or regulatory liability as the originating regulatory adjustment reverses through the rate charged to the customer-base. • The entity derecognises a regulatory asset as it becomes entitled to charge the customers for the regulatory obligations to which the asset relates. • The entity derecognises a regulatory liability as it fulfils the regulatory obligation to which it relates or refunds the amounts previously charged to the customer-base.	The model requires derecognition of regulatory assets and regulatory liabilities as the originating differences reverse through amounts charged to the customer-base. Amounts that are no longer expected to be reversed through the rate charged to the customer-base will be adjusted through subsequent measurement or impairment of the related regulatory asset or regulatory liability.
Initial measurement The model uses an allocated transaction price approach to measure regulatory assets, regulatory liabilities and the corresponding income statement adjustments. If the regulated rate includes a financing component, the model adjusts the carrying amounts of recognised regulatory assets/ liabilities to reflect the time value of money. A regulatory asset is initially measured at the amount agreed, or expected to be agreed, by the rate regulator that can be charged to the customer-base in future periods in respect of that regulatory adjustment. A regulatory liability is initially measured at the amount already charged to the customer-base which the regulator has agreed, or is	To be within scope of the model, the regulatory agreement must include a rate-setting mechanism that identifies the basis of the rate calculation in terms of the entity's regulatory obligations. This mechanism facilitates the allocation of the amounts to be charged to the customer-base to the different regulatory obligations established by the regulatory agreement. The regulatory asset reflects the entity's right to recover the compensation/ funding that it is entitled to in exchange for having already satisfied, or partially satisfied, its regulatory obligations. The regulatory liability reflects the entity's obligation to either deliver goods or services without consideration being received in exchange (because the consideration has already been received), or to return to the customer-base amounts already received.

Features of the basic model	Basis for proposals
expected to agree, should reduce the rate to be charged to the customer-base in future periods in respect of that regulatory adjustment.	
Subsequent measurement and impairment The entity will adjust the measurement of a recognised regulatory asset for changes in the rate agreed by, or expected to be agreed by, the rate regulator. The entity will adjust the measurement of a recognised regulatory liability for changes in the expected cost of fulfilling the respective regulatory obligations, except to the extent that the regulator has agreed a corresponding adjustment to a future rate.	The recovery of a regulatory asset is dependent on continued sales of the regulated goods or services. The risk that a regulatory asset will not be recovered because of a fall in demand is usually transferred away from the entity to the customer-base. This means that, if demand falls, the entity is still entitled to recover its regulatory assets and the regulated rate is increased to enable it to do so. In rare circumstances, significant or persistent falls in the level of demand or changes in the regulatory environment could result in the rate regulator taking action to reduce the recoverable amount of a regulatory asset. In such circumstances, the entity applies judgement to assess whether the carrying amount of a recognised regulatory asset is expected to be recovered through amounts to be charged to the customer-base. If not, the regulatory asset is written down to its recoverable amount and an impairment loss is recognised. The entity assesses whether the pre-funding for which a regulatory liability has been recognised is sufficient to cover the expected costs to fulfil the related regulatory obligations. If not, the entity increases the carrying amount of the regulatory liability to reflect the excess costs expected to be incurred.
Presentation The entity presents the regulatory assets recognised separately in the Statement of Financial Position from the other assets recognised in accordance with other IFRS Standards. The entity presents the regulatory liabilities recognised separately in	The model applies a 'supplementary' approach to presentation similar to that used in IFRS 14. This allows a user to better understand the effects of rate regulation on the timing of the entity's cash flows.

Features of the basic model	Basis for proposals
the Statement of Financial Position from the other liabilities recognised in accordance with other IFRS Standards. The entity presents in profit or loss [or other comprehensive income] the net movement recognised in the period on its regulatory assets and regulatory liabilities. This net movement is presented separately from the IFRS 15 revenue line item.	
Disclosure objective An entity discloses information that enables users to assess: (a) the nature of, and the risks associated with, the rate regulation that establishes the price(s) that the entity can charge customers for the goods or services it provides; and (b) the effects of that rate regulation on its financial position, financial performance and cash flows. The entity provides sufficient disaggregation of the increases or decreases in the entity's regulatory assets and regulatory liabilities to enable a user to understand the principal sources of the regulatory assets and regulatory liabilities and to distinguish origination of timing differences from their reversal. The disclosure objective could be met by providing a reconciliation of opening to closing regulatory assets and regulatory liabilities recognised.	Users of financial statements need information about the entity's operating risks and the risk that changes in the rate-regulatory environment could change the timing and certainty of the entity's cash flows. An understanding of each class of regulatory asset and regulatory liability is considered important because that can provide information about the nature of the rate regulation and the potential timing of related cash flows.

Features of the basic model	Basis for proposals
Definitions The model includes definitions of: - customer-base - regulator - regulatory adjustment - regulatory asset - regulatory liability - regulatory obligation	Terms that are specific to the model will need to be defined. The list included here may not be complete. The accompanying Agenda Paper 9A contains brief descriptions of what is intended by these terms but the staff will ask the Board to consider more precise terminology in a future meeting.