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STAFF PAPER

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ASAF Meeting

Project	**Rate-regulated Activities: Research project**		
Paper topic	Preliminary analysis of asset and liability definitions		
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Background

Previous IASB project

1. The IASB's previous Rate-regulated Activities project resulted in the issue of the Exposure Draft *Rate-regulated Activities* (the 2009 ED). The 2009 ED proposed that regulatory balances derived from a specific type of rate regulation (cost-of-service regulation) should result in the recognition of assets and liabilities.

2. Virtually all respondents from the utilities industry supported the general proposal to recognise regulatory balances as assets and liabilities. However, many disagreed that such recognition should be restricted to regulatory balances that arise only in cost-of-service regulation and suggested instead that it should apply to a much wider range of rate regulation. The responses from non-utilities industry respondents were split almost evenly between those that agreed and those that disagreed with the general proposal for recognising regulatory balances as assets and liabilities.[1]

3. Some who agreed with the recognition of regulatory balances as assets and liabilities noted that the proposals were similar to the requirements for such balances in US GAAP. Some commentators argued that the conclusions reached by the IASB should be consistent with those of the US Financial Accounting

[1] See paragraphs 12-15 and Appendix E of IASB Agenda Paper 7 *Summary comment letter analysis*, February 2010.

Standards Board (FASB) because the definitions of assets and liabilities in the respective conceptual frameworks of both US GAAP and IFRS are similar, albeit not identical.

4. However, the mixed views expressed in the responses to the 2009 ED and the subsequent deliberations of those responses resulted in the IASB suspending the project in September 2010. The IASB decided that it was unable to form a timely conclusion as to whether, and if so what types of, rate regulation should lead to the recognition of regulatory balances as assets and liabilities. Subsequently, there has been a lot of confusion as to why 'regulatory assets' and 'regulatory liabilities' are recognised in accordance with US GAAP but not in accordance with IFRS.

Current IASB project

5. In September 2012, the IASB decided to restart the project with the development of a Discussion Paper. Developing a Discussion Paper will provide the opportunity for a broader debate on the circumstances in which rate-regulated activities may give rise to assets or liabilities.

6. As part of the research work for this project, the IASB published, in March 2013, a Request for Information *Rate Regulation*. The responses received highlighted that there is a wide variety of types of rate regulation. To help filter this information the IASB, with input from its Rate-regulated Activities Consultative Group, has decided to focus on a number of common features of rate regulation.[2] These features have been identified as being most likely to:

   (a) distinguish rate-regulated activities from general commercial activities; and

   (b) have the biggest impact on the amount, timing and certainty of cash flows and the stability of 'regulated earnings'.[3]

[2] The features are discussed later in this paper and are also described in more detail in the September 2013 IASB Agenda Papers 9B-9B(iii).

[3] We have heard from users that they value information about the amount, timing and certainty of cash flows and 'regulated earnings' (see IASB Agenda Paper 9A *Rate regulation: User needs*, September 2013).

7. These features will be the focus of the discussion as to whether some forms of rate regulation establish rights and obligations that could result in the recognition of assets and liabilities in IFRS financial statements. Not all forms of rate regulation will contain all of these features. Consequently, we envisage that the Discussion Paper will explore whether all of the features, or a combination of certain features, are needed to distinguish particular forms of rate regulation that should be captured within the scope of any accounting guidance that might subsequently be developed from this project.

8. The Discussion Paper will also explore, as a possible alternative, whether any particular feature is sufficient, in isolation, to distinguish any particular form of rate regulation from other commercial activities or from forms of rate regulation for which specific accounting guidance is not considered necessary.

9. An analysis of the distinguishing features, and the rights and obligations arising from them is presented in paragraphs 13-48 of this paper. The IASB considered this analysis in October 2013. As a result, the IASB tentatively decided that the next stage of the staff's analysis as to whether rate regulation might result in assets and liabilities being recognised in IFRS financial statements should focus on one particular feature. This feature is a regulatory 'true-up' adjustment, which arises in a 'dual-element adjustment' type of rate-setting mechanism. The staff's analysis of the true-up adjustment is set out in paragraphs 49-117.

Purpose of this paper

10. The purpose of this Agenda Paper 6 is to seek the views of the Accounting Standards Advisory Forum as to whether a rate-setting mechanism that incorporates a true-up adjustment could result in the existence of assets and liabilities, as defined in the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*).

11. However, the contents of the existing *Conceptual Framework* may be subject to revision, as proposed in the Discussion Paper: *A Review of the Conceptual Framework for Financial Reporting*, published in July 2013 (the *Conceptual Framework* DP). Consequently, any conclusions that are reached in this analysis of rate regulation may also be subject to revision. As a result, this analysis is

intended merely to provide a starting point for the discussion to be included in the Discussion Paper that is being developed as part of the IASB's Rate-regulated Activities research project.

Rights and obligations arising from the distinguishing features of rate regulation

12. The following section of this paper sets out the rights and obligations that might arise from the following features of rate regulation:

(a) the rate regulation gives the supplier an exclusive right or near-exclusive right to provide the rate-regulated goods or services;

(b) the rate-regulated goods or services are considered 'essential' or near-essential, resulting in relatively inelastic demand;

(c) the rate regulator imposes obligations on the supplier:

  (i) to control the prices charged; and

  (ii) to protect the quality and availability of the supply of the regulated goods or services;

(d) there must be a 'rate regulator', whose role and authority is established in legislation or other formal regulations;

(e) the rate regulator approves the pricing structure to ensure that any flexible pricing is consistent with criteria contained within the rate-setting mechanism; and

(f) the rate regulation requires that the mechanism for setting the future rate charged to customers reflects a 'true-up' adjustment to the rate if the revenue billed to customers is lower than, or in excess of, the amount permitted by the rate regulation.

Exclusive or near-exclusive right to supply

13. In the vast majority of responses to the Request for Information *Rate Regulation* (the Request for Information), the entities described as being subject to rate regulation have an exclusive or near-exclusive right to operate in a predetermined service territory (which is commonly delineated by geographical boundaries).

Competition is restricted and any potential competitor would usually need to apply to the rate regulator or other authoritative body to seek permission to compete.

14. The exclusive or near-exclusive right may be defined by an exclusive licence agreement with the rate regulator or other licensing body, or through a service concession arrangement (which may or may not be within the scope of IFRIC 12 *Service Concession Arrangements*), or through legislation/regulation.

Staff analysis

15. Licences or similar agreements that restrict competition and that grant an entity an exclusive right to sell particular goods or services in a defined service territory are common. Similar types of rights are commonly found in licensing agreements for items such as motion picture films, video recordings, plays, manuscripts, patents and copyrights.[4]

16. Consequently, we do not think that the exclusive licence, concession or other regulatory agreement is sufficient on its own to distinguish rate-regulated activities from other commercial activities. However, we think that this right is still an important feature of rate regulation. This is because, in our view, it supports the rate-setting mechanisms commonly used by rate regulators to affect the amount and timing of cash flows (see the section titled "The rate-setting mechanism" later in this paper).

Essential or near-essential goods or services

17. The responses to the Request for Information highlighted that a wide variety of goods and services are subject to some form of rate regulation.[5] In most cases, the goods or services are considered to be 'essential' (sometimes termed 'public') or near-essential in some jurisdictions. Whether a particular good or service is described as 'essential' depends on a number of factors. These factors include: the

[4] Such licensing agreements are accounted for within the scope of IAS 38 *Intangible Assets* (see paragraph 7 of IAS 38).

[5] See paragraph 11 of Agenda Paper 9B(i), September 2013. The broad categories identified are: energy; water; transport; telecommunications; postal services; insurance; and other (including fertilisers, health services, cemeteries).

level of availability compared to demand, the level of industrial development and the culture of the local environment.

Staff analysis

18. The 'essential' nature of the goods or services supplied does not, in itself, create any specific rights or obligations. As noted in paragraphs 13-15 of Agenda Paper 9B(i), September 2013, not all 'essential' goods or services are rate regulated in every jurisdiction. This is because, in some jurisdictions, there may be a plentiful supply of the essential goods or services, together with competition among suppliers. In such cases, rate regulation would be unnecessary.

19. Consequently, we do not think that the essential nature of the goods or services is sufficient on its own to distinguish rate-regulated activities from other commercial activities. However, we think that this feature is still important because, in our view, it supports the rate-setting mechanisms commonly used by rate regulators to affect the amount and timing of cash flows.[6]

Obligations imposed by rate regulation

20. In the vast majority of the responses to the Request for Information, the rate regulation described imposes significant obligations on the rate-regulated entity that would not usually be present in an efficiently competitive market. This reflects, in particular, the two common objectives of rate regulation, which are:

    (a) to control the prices charged; and

    (b) to maintain the quality and availability of the supply of the rate-regulated goods or services.

21. In general, the rate-regulated entity cannot choose to stop delivering the rate-regulated goods or services, and is obliged to provide them to consumers on a non-discriminatory basis. This usually means that network access cannot be refused or that services must be provided to certain classes of consumers at the regulated rate, irrespective of the cost of providing services to that particular class of consumer, for example, those in remote or rural areas.

[6] See the section titled "The rate-setting mechanism" later in this paper.

Staff analysis

Control of prices charged

22. Rate regulation that is designed to control prices charged in a market in which competition is inefficient is commonplace. Examples of such regulation include the capping of prices that:

    (a) banks in some jurisdictions can charge for processing credit card transactions; and

    (b) European Union (EU)-based telecommunications providers can charge for mobile telephone 'roaming' services such as text messaging and telephone calls made in other EU countries.

23. Such price caps restrict the prices that an entity can charge and, as a result, may affect the total amount of revenue that the entity can earn. However, it does not oblige the entity to continue to operate in the market and does not directly fix the price in order to restrict the amount of profit that the entity can earn. For example, a bank could charge a lower price than the maximum 'price cap' in order to encourage higher demand and, consequently, earn more revenue and profit (assuming that demand was price-elastic).

24. Consequently, we do not think that the capping or similar restriction of prices that is applicable to all suppliers or to a specific group of suppliers in a market is sufficient on its own to distinguish such rate-regulated activities from other commercial activities.

Maintaining the quality and availability of the supply

25. However, we do think that the obligations imposed by rate regulation that relate to the maintenance of the quality and availability of the supply of the rate-regulated goods or services are an important distinguishing feature from general commercial activities. An entity that has a strong or monopoly market share can usually choose whether or not to continue in that market, or can choose whether or not to sell goods or services to individual customers or groups of customers, or can choose to provide different levels of service or quality of goods to individual customers or groups of customers. This choice is denied to an entity that is

subject to rate regulation that obliges the entity to supply the rate-regulated goods or services to consumers on a non-discriminatory basis.

26. We think that the obligation to supply to all customers for the regulated price and without discrimination is an important feature of rate regulation. This feature often supports the rate-setting mechanisms commonly used by rate regulators to affect the amount and timing of cash flows.[7]

An 'authorised' rate regulator

27. The existence of a rate regulator whose role and authority is established in legislation or other formal regulations was identified, by some members of the IASB's Rate-regulated Activities Consultative Group, as an essential distinguishing feature. This view was shared by a few respondents to the 2009 ED, and to the Exposure Draft *Regulatory Deferral Accounts*, issued in April 2013 (the interim ED), who raised concerns that the scope of each of those EDs might inappropriately, in their view, capture self-regulated entities.

Staff analysis

28. The existence of a rate regulator whose role and authority is established in legislation or other formal regulations does not, in our view, of itself create any specific rights or obligations for an entity subject to rate regulation. However, we think that this is an important feature to consider when analysing what rights and obligations established by the rate regulation are enforceable. This is because we think that in order for there to be a right or obligation, there has to be an enforcement mechanism external to the entity. For example, a management decision to commit to a particular course of action can, without any external interaction, be changed or reversed by the entity. Consequently, we do not think that an internal decision without an external interaction is sufficient to create an obligation.

[7] See the section titles "The rate-setting mechanism" later in this paper.

Pricing flexibility

29. The ability of the entity to have some flexibility for charging different prices is not a distinguishing feature of rate regulation. Such flexibility is commonly used by entities engaged in general commercial activities that are not subject to rate regulation. This flexibility enables entities to influence demand for the goods or services and to influence whether customers buy from the entity or would instead buy from a competitor.

30. Within the context of features that we think distinguish rate-regulated activities from general commercial activities, the entity's ability to change the price of the rate-regulated goods or services is limited. If the rate regulator approves the pricing structure to ensure that the flexible pricing is consistent with criteria contained within the rate-setting mechanism, then pricing flexibility should not preclude the activities from being considered to be rate-regulated. This is because any price flexibility permitted is intended to supplement the rate-setting mechanism, but does not negate the control imposed by that mechanism.

Staff analysis

31. We do not think that pricing flexibility is either necessary or sufficient to support rate regulation, and neither is its presence relevant to the assessment as to whether such rate-regulated activities are distinguishable from other commercial activities.

The rate-setting mechanism

32. In a competitive market, the 'value' of the goods or services provided is most easily identified as the market price, which reflects the interaction between supply and demand and the market participants' willingness to buy or sell at that price. However, within the context of this analysis, rate regulation applies in circumstances in which there is no competitive market. Consequently, the rate regulation is designed to try to establish a 'fair and reasonable' price to reflect the value of the goods or services supplied.

33. The responses to the Request for Information identified a wide variety of rate-setting mechanisms that used a wide variety of formulas to calculate the rate to be charged to customers for the rate-regulated goods or services. Often, the

price to be charged is initially determined by using estimated costs and volumes. The entity will typically provide budgets and forecasts to the rate regulator, setting out what costs are expected to be incurred to provide the estimated volume of goods or services in the future 'regulatory period'.[8] This period has historically been set as one year but, increasingly, is being set for longer periods, typically three to five years.[9]

Single element adjustment

34. In some forms of rate regulation, there is no mechanism to 'true-up' for differences between estimated and actual amounts for previous periods. Consequently, the entity is subject to both demand risk and cost risk and is able to earn higher or lower levels of profit than was intended by the rate regulation.

35. If, for example, the entity's costs are higher than anticipated during the regulatory period (Period 1), it will not be able to recover the higher costs already incurred in Period 1 during the next regulatory period (Period 2). Instead, if the higher cost level is expected to continue, then this will be reflected in the budget for expected costs in Period 2.

36. Alternatively, the entity's costs may be lower than expected or the demand for the goods or services may be higher, resulting in a greater contribution to fixed costs. In both cases, the entity would earn a higher level of profit than originally expected.

37. If the differences between the estimated and actual amounts are expected to continue, this will be reflected in the budgets and forecasts used to set the price for the next regulatory period. This type of adjustment might be termed 'forward-looking', because it is based on expectations about future costs and volumes.

[8] In some cases, the rate regulator may influence these budgets and forecasts because the entity may be obliged, through the rate regulation, to incur additional capital investment costs in order to expand or improve the supply capacity.

[9] The lengthening of the regulatory period is common in more stable and mature regulatory environments where costs and volumes for demand can often be more reliably predicted. This enables detailed 'rate reviews' to be performed less frequently. This helps to improve the efficiency of the regulatory process, which provides cost savings that can be passed on to customers.

Dual element adjustment

38. In other forms of rate regulation, there is a mechanism to adjust for differences between estimated and actual amounts for previous periods. This mechanism is usually designed to balance the common objectives of the rate regulator, which are:

    (a) to protect the interests of consumers by:

        (i) controlling the price charged to customers (a 'fair and reasonable rate'); and

        (ii) providing rate stability; and

    (b) to maintain the quality and availability of the supply of the rate-regulated goods or services.

39. An important factor in maintaining the quality and availability of the supply is ensuring the financial viability of the supplier. Consequently, it is common to find rate-setting mechanisms that include an adjustment for differences between the estimated and actual results of earlier regulatory periods.

40. If the differences between the estimated and actual amounts are expected to continue, this will be reflected in the budgets and forecasts used to set the price for the next regulatory period. This is consistent with the forward-looking adjustment in the 'single element adjustment' type of regulation noted in paragraphs 34-37 above.

41. However, in a dual adjustment type of rate-setting mechanism, there will be a separate adjustment (or adjustments) to 'true-up' the experience differences that arose in the previous period. In some cases, the adjustment is linked to differences in the cost of a specific item or items, for example, the cost of fuel or staff costs. In other cases, the differences that are captured by the adjustment need not be based solely on identifiable cost differences. Instead, the adjustment may relate to a group of costs, or to a profit amount or to an incentive target. For example, the rate-setting mechanism might include a bonus or penalty adjustment based on whether the entity has achieved a target level of customer satisfaction or reliability of service.

42. In rare cases, the true-up adjustment will be paid to or received from the rate regulator or individual customers who have purchased the rate-regulated goods or services during the past regulatory period. However, in the vast majority of cases, the rate regulation will usually use a price adjustment for future sales as a pragmatic and practical mechanism for collecting/delivering the cash flows associated with this adjustment. The rate-setting mechanism will usually determine a target period over which this 'true-up' adjustment will apply, which may vary from a few months to several years, depending on the nature and amount of the difference.

Staff analysis

43. We do not think that the forward-looking adjustment in a single element or dual element adjustment rate-setting mechanism is a distinguishing feature of rate regulation. Entities commonly set selling prices that use estimates of costs and volumes as a starting point, which may then be adjusted to reflect market conditions. In our view, the component of the price that reflects estimated costs and volumes represents the best estimate of the 'fair and reasonable' price for the goods that are sold during the period.

44. Without rate regulation, most entities can make 'real-time' adjustments to the selling price in reaction to changes in their estimates for costs or volumes. Such real-time price adjustments are rarely available to rate-regulated entities, for whom the selling price is fixed until the end of the regulatory period. In a dual element adjustment rate-setting mechanism, the permitted true-up adjustment, which is related to past performance and events, is then accumulated until the selling price can be adjusted at the start of the next regulatory period.

45. The purpose of the true-up adjustment is to ensure that the entity is able to earn the amount of revenue permitted by the rate regulation during the regulatory period; that is, the period for which the rate calculation established by the rate regulation applies. The items that are captured by the true-up adjustment will be specified in the rate regulation. The amount of this true-up adjustment is calculated based on past performance and/or events that have arisen during the regulatory period and before the financial reporting date. The common types of items captured include:

(a) volume and price variances from expected costs;

(b) volume variances from permitted revenues;

(c) costs (or revenues) triggered by specified events (for example, costs incurred to repair storm damage or a gain/loss incurred on disposal of property, plant and equipment);

(d) financial bonuses awarded or penalties imposed for meeting or failing to meet a performance target; and

(e) timing differences between amounts recognised for financial reporting purposes and those recognised for regulatory purposes. For example, a timing difference can arise when pension costs are recognised for regulatory purposes only when paid, but for financial reporting purposes the entity's defined benefit pension costs are attributed to periods of service in accordance with the plan's benefit formula, or in some cases on a straight–line basis.

46. We think that the true-up adjustment used in the dual element adjustment rate-setting mechanism is a distinctive feature of rate regulation. In our view, the true-up adjustment distinguishes the rate-regulated activities subject to this type of rate regulation from other commercial activities and from other forms of rate regulation.

Conclusion on the distinguishing features of rate regulation

47. We think that the combination of all of the features described above contributes in some way to distinguishing rate-regulated activities from other commercial activities. However, for the purpose of our analysis as to whether the rights and obligations arising from the distinguishing features of rate regulation could result in the existence of assets or liabilities, we focus on the following:

(a) a primary feature, which is the true-up adjustment in the dual element rate-setting mechanism; and

(b) a group of supporting features, which collectively support the use of the future selling price of the regulated goods or services as an efficient and

reliable mechanism to collect/deliver the cash flows related to the true-up adjustment.

48. We think that the supporting features are:

(a) the obligations to maintain the quality and supply of goods or services to customers on a non-discriminatory basis (see paragraphs 20-26 above);

(b) the exclusive or near-exclusive right to supply the rate-regulated goods or services (see paragraphs 13-16 above);

(c) the existence of an authorised rate regulator(see paragraphs 27-28 above); and

(d) the essential or near-essential nature of the goods or services that are subject to rate regulation(see paragraphs 17-19 above).

Does the true-up adjustment result in the existence of an asset or a liability?

49. The remainder of this paper sets out the staff's analysis of whether the true-up adjustment mechanism could result in the existence of an asset or a liability, as defined in the *Conceptual Framework for Financial Reporting* (the *Conceptual Framework*). As noted in paragraph 11, this analysis is intended merely to provide a starting point for the discussion.

50. The staff's preliminary view is that the true-up adjustment, which is required by the rate-setting mechanism and that results from past performance, does represent a right or an obligation of the entity that is capable of resulting in the transfer of economic benefits to or from the entity. Consequently, we think that:

(a) when the regulatory adjustment is positive, an asset exists; and

(b) when the regulatory adjustment is negative, a liability exists.

51. This preliminary view is based on our understanding of the existing definitions of assets and liabilities, on conclusions reached in existing IFRSs and in other ongoing projects, as well as on the proposed definitions of assets and liabilities

and other supporting material in the *Conceptual Framework* DP. For convenience, the existing and proposed definitions[10] are reproduced below:

	Existing definitions	**Proposed definition**
Asset (of an entity)	a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.	a present economic resource controlled by the entity as a result of past events.
Liability (of an entity)	a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	a present obligation of the entity to transfer an economic resource as a result of past events.
Economic resource	[no existing definition]	a right, or other source of value, that is capable of producing economic benefits.
Control	[no existing definition]	An entity controls an economic resource if it has the present ability to direct the use of the economic resource so as to obtain the economic benefits that flow from it.

52. At this stage, we are asking the Accounting Standards Advisory Forum (ASAF) to comment on whether this initial analysis is a reasonable basis on which to progress the work on this project.[11] We have not reached a conclusion as to what type of asset or liability exists, and nor have we discussed recognition criteria or the measurement basis that might be appropriate to use. The analysis of those issues will be influenced by the IASB's tentative conclusions at its November 2013 meeting and by the ASAF's advice at this meeting.

Definitions of asset and liability

53. Previously, many opponents of recognising 'regulatory assets' and 'regulatory liabilities' have argued that the right to increase or the obligation to reduce the rate chargeable for future sales does not create a present resource/right or a present obligation. They argue that, in the vast majority of rate-regulatory

[10] The table of definitions is contained in paragraph 2.11 of the *Conceptual Framework* DP (except for 'control', which is defined in DP paragraph 3.23).

[11] The IASB will consider the same analysis at its meeting in November 2013.

frameworks, the recovery or reversal of the amounts recorded in regulatory deferral accounts[12] is conditional on future sales being made.

54. In addition, they argue that the ability to increase rates in the future is not a resource 'controlled' by the entity, because the related inflow of economic benefits is conditional on making future sales to customers whom the entity cannot compel to make future purchases from the entity.

55. Alternatively, those that support the recognition of regulatory deferral account balances as 'regulatory assets' and 'regulatory liabilities' argue that certain types of rate-regulatory frameworks grant the entity a right to earn a specified amount of revenue. Such frameworks also oblige the entity to restrict the amount of revenue earned to the specified or 'allowed' amount. Consequently, they argue that any regulatory deferral account balance has arisen because of past sales to customers, with the balance on the account reflecting the change to the estimated amount already billed.

56. In addition, they argue that the rate regulation uses the adjustment to future rates as a practical mechanism to recover or refund the regulatory deferral account balances, but that the mechanism does not change the substance of the right or obligation.

The focus of the analysis

57. For the purpose of the analysis in this paper, we focus on the regulatory true-up adjustment described earlier in this paper as the primary distinguishing feature of rate regulation. We think that this provides a more specific focus for the analysis than has been used previously. In the past, analyses of the issue have usually been based on a more general view of regulatory deferral account balances, which have not made a distinction between the specific true-up adjustment feature and other common features that are related to the rate-setting mechanism.

[12] The term "regulatory deferral account balances" is defined in the Exposure Draft *Regulatory Deferral Accounts* as: "The "balance of any expense (income) deferral or variance account this is included in the setting of future rate(s) by the rate regulator and that would not otherwise be recognised as an asset or liability in accordance with other Standards.". For the purpose of the analysis in this paper, the term 'true-up adjustment' is used to more precisely depict the adjustment arising from the rate-setting mechanism described in paragraphs 38-46 of this paper.

58. The analysis presented in this paper uses various paragraphs in the *Conceptual Framework* DP, for which we provide cross-references and limited extracts. Consequently, those paragraphs may need to be referred to for a greater understanding of our analysis, which we break down into the following issues:

    (a) enforceability and control of the economic resource;

    (b) present right/obligation and past event; and

    (c) reduced inflow versus outflow.

Existing Conceptual Framework

59. The existing definition of an asset includes a requirement for the resource to be controlled by the entity. Although the IASB has defined 'control' in some individual projects,[13] the existing *Conceptual Framework* does not define the terms 'resource' or 'control'. Consequently, we think that the meaning of these terms is unclear when applied to so called 'regulatory assets' and 'regulatory liabilities' and has led to different interpretations within the context of rate regulation.

60. The existing definition of a liability contains the terms "present" and "as a result of past events". The existing definition of an asset also contains the term "as a result of past events". However, the existing *Conceptual Framework* contains little guidance on whether an entity can have a present obligation while any requirement to transfer an economic resource remains conditional on the entity's future actions, such as making future sales. Consequently, this aspect of the definition is unclear and the principles underlying its application in different Standards can appear inconsistent.[14]

61. In our view, the lack of clarity in the definitions of asset and liability has contributed to the confusion as to whether the existing *Conceptual Framework* supports the recognition of 'regulatory assets' and 'regulatory liabilities'. Consequently, the analysis in this paper draws on the additional guidance and explanatory material proposed in the *Conceptual Framework* DP.

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[13] For example, in the IASB's Exposure Draft *Revenue from Contracts with Customers*, published in November 2011, and in IFRS 10 *Consolidated Financial Statement*.

[14] This conclusion is based on paragraph 3.2 of the *Conceptual Framework* DP.

Conceptual Framework *DP*

62. Although the existing *Conceptual Framework* defines an asset as a resource and a liability as an obligation, the *Conceptual Framework* DP notes that "some readers have sometimes confused the resource (asset) or the obligation (liability) with the resulting inflow or outflow of economic benefits".[15] Consequently, the *Conceptual Framework* DP provides additional guidance to refocus the definitions of asset and liability onto the resource or obligation and away from the resulting inflow or outflow of economic benefits.[16]

63. The proposed definitions of assets and liabilities in the *Conceptual Framework* DP both contain the terms "present" and "as a result of past events". The addition of the term "present" to the definition of an asset makes explicit a notion that was already implicit in the existing definition. In addition, it emphasises the accounting for the past transaction or other event that brought the resource under the entity's control or imposed the obligation on the entity, and emphasises the parallel between the definitions of asset and liability.[17]

64. The *Conceptual Framework* DP provides additional guidance on the definitions of asset and liability, including guidance on "control",[18] "present obligation",[19] and the role of future actions or events that are outside the entity's control and those that depend on the entity's future actions.[20] The following paragraphs use the additional guidance in the *Conceptual Framework* DP to analyse whether the 'true-up' adjustment that is required by some rate-regulatory mechanisms could represent the existence of a 'regulatory asset' or 'regulatory liability'.

[15] See paragraph 2.13 of the *Conceptual Framework* DP.

[16] For example, see paragraph 2.14 and paragraph 3.4-3.15 of the *Conceptual Framework* DP.

[17] See paragraphs 2.13 and 2.16 of the *Conceptual Framework* DP.

[18] See paragraphs 3.16-3.32 of the *Conceptual Framework* DP.

[19] See paragraphs 3.63-3.69 of the *Conceptual Framework* DP.

[20] See paragraphs 3.70-3.97 of the *Conceptual Framework* DP.

Enforceability and control of the economic resource

65. An economic resource is not defined in the existing *Conceptual Framework* but is defined in paragraph 2.11 of the *Conceptual Framework* DP as "a right, or other source of value, that is capable of producing economic benefits".

66. The following paragraphs try to distinguish between the right (or obligation) related to the true-up adjustment and the mechanism used to collect or deliver the economic benefits associated with the true-up adjustment.

A right or other source of value

67. The rate-setting mechanism is formally established by the rate regulation, which is binding on the authorised rate regulator as well as on the rate-regulated entity. In the type of rate-setting mechanism being analysed, the amount of the true-up adjustment relates directly to past transactions and events.[21] The rate regulation will also establish the method to be used to recover from or 'refund' to customers the amount of the true-up adjustment.

68. In some, albeit rare, cases, the adjustment will be settled with the rate regulator. This means that the entity will pay cash to, or receive cash from, the rate regulator or other designated body, depending on whether the true-up adjustment is positive or negative. In other, again rare, cases, the entity will raise additional bills or credit notes to specific customers or groups of customers that had purchased the rate-regulated goods or services from the entity in the past. The amounts billed or credited will equal the value of the true-up adjustment and will be allocated to the customers in proportion to their past purchases during the regulatory period. Within this context, the regulatory period is the period over which the true-up adjustment is accumulated.

69. However, the methods of recovering or refunding the amount of the adjustment described in the paragraph above are, as noted, rarely used in practice. The most common method used is to adjust the price for future sales in order to recover or refund the amount of the true-up adjustment over a suitable period of time. The length of time usually depends on a number of factors, including the size of the adjustment and the ability of customers to absorb a price increase.

[21] See paragraph 45 of this paper.

70. The rate regulator is usually able to use future sales as a practical, low-cost and reliable mechanism for ensuring that the entity can recover the amount of any positive true-up adjustment or refund the amount of any negative true-up adjustment. This is because other distinguishing features of rate regulation support this mechanism; in particular, the exclusive or near-exclusive right to supply the rate-regulated goods or services and the essential or near-essential nature of those goods or services. These two features contribute to relatively inelastic demand and a high level of predictability of the timing and probability of reversal through future sales.

71. We do not think that the mechanism used to reverse the true-up adjustment changes the entity's right or obligation to recover or refund the true-up adjustment. Instead, we think that the mechanism affects the timing of the resulting cash flows. Consequently, if future sales are used as the collection or delivery mechanism, and if demand for the goods or services were to change, increases would usually accelerate the cash flows, and decreases would delay them. The amount of the cash flows would, however, remain unchanged because the amount is fixed by the regulatory true-up adjustment calculation.[22]

Control

72. As noted in paragraph 59 above, the existing *Conceptual Framework* does not define "control" but the IASB has defined it in some individual projects. In the *Conceptual Framework* DP, the IASB proposes to build on these definitions to define the meaning of control within the context of the definition of an asset.[23]

73. In addition, the *Conceptual Framework* DP contains some additional guidance to support the proposed definition. In particular, paragraph 3.27 notes that: "For an entity to control an economic resource, the economic benefits arising from the resource must flow to the entity (either directly or indirectly) rather than to another party".

[22] The mechanism used will also affect the probability of recovering or delivering the cash flows related to the true-up adjustment. We plan to address this issue in the later analysis of recognition criteria and measurement/impairment.

[23] See paragraphs 3.16-3.25 of the *Conceptual Framework* DP.

74. Paragraph 3.27 goes on to confirm that: "This requirement does not imply that the entity can ensure that the resource will generate economic benefits in all circumstances. Instead it means that, if the resource generates economic benefits, the entity is the party that will receive them".

75. This concept that the entity does not need to control whether the resource will generate economic benefits is not new. The *Conceptual Framework* DP provides some explanatory material that clarifies what is already generally accepted in long-established practice and in existing IFRSs.[24] For example, IAS 2 *Inventories* has established that inventories are assets. This is so even when the entity holds inventories speculatively, hoping that there will be sufficient demand for those inventories that will result in future sales to customers, even if those customers have not been identified yet.

76. Similarly, other types of assets are commonly recognised that are capable of generating an inflow of economic benefits but that do not guarantee that the inflow will occur. This approach is supported in paragraph AG10 of the application guidance in IAS 32 *Financial Instruments: Presentation*, which states:

> AG10 Physical assets (such as inventories, property, plant and equipment), leased assets and intangible assets (such as patents and trademarks) are not financial assets. **Control of such physical and intangible assets creates an opportunity to generate an inflow** of cash or another financial asset, but it does not give rise to a present right to receive cash or another financial asset. [Emphasis added.]

77. When considering whether the true-up adjustment will reverse fully, we accept that this will usually rely on sufficient sales being made in the future. However, we think that this is an issue related to the recognition and measurement of the adjustment instead of the existence of a right/resource or obligation.[25]

[24] The IASB distinguishes, in Chapter 2 of the *Conceptual Framework* DP, between existence uncertainty (that is, does a right/resource or an obligation exist?) and outcome uncertainty. Paragraph 2.32 explains that outcome uncertainty refers to cases where the asset or liability exists, but the outcome (that is, the realisation of the resulting inflows or outflow) is uncertain. The same paragraph provides some examples, including inventory.

[25] We will consider recognition and measurement issues in the next stage of the analysis of the true-up adjustment.

Staff's tentative conclusion on enforceability and control

78. We think that the true-up adjustments that are required by the rate-setting mechanism, and that result from past performance, represent rights or obligations of the entity that are capable of resulting in the transfer of economic benefits to or from the entity.

79. We think that it is important to distinguish the right/resource (asset) or the obligation (liability) from the resulting inflow or outflow of economic benefits. Consequently, although the mechanism usually used for collecting or delivering the related cash flows is dependent upon future sales, we do not think that this changes the entity's right or obligation related to the regulatory true-up adjustment. Whether that right or obligation exists as a 'present' right or obligation at the reporting date is discussed in the paragraphs below.

Present right/obligation and past event

80. The proposed definitions of assets and liabilities in the *Conceptual Framework* DP both contain the terms 'present' and 'as a result of past events'. As noted in paragraphs 60 and 63 above, this is consistent with the definitions in the existing *Conceptual Framework*.

81. Paragraphs 3.63-3.66 of the *Conceptual Framework* DP discuss the term "present" and "as a result of past events" within the context of obligations. In particular, paragraph 3.66 notes that:

> A liability can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received, or activities conducted, by the entity before the end of the reporting period. Activities conducted by the entity could include, for example, making sales, earning profits or even operating on a particular date—the important fact is that the amount of the liability is determined by reference to that activity.

82. We think that those comments are equally applicable to determining whether an asset exists at the reporting date. This is because the proposed changes are

intended to emphasise that there is a parallel or symmetry between the definition of assets and the definition of liabilities.[26]

83. As noted in paragraph 57 above, we are analysing the regulatory true-up adjustment that is determined by reference to the past activities that have occurred before the end of the reporting period. When this adjustment is negative, we think that it represents an obligation to 'refund' an amount of revenue that has been billed to customers for past sales. This view is perhaps clearer in the rare cases in which the entity is required to make a direct payment to the rate regulator or other authorised body, or is required to provide credit notes or cash refunds to specific customers that have been 'over-billed' in the period during which the regulatory adjustment has arisen.[27]

84. However, in the vast majority of cases, the rate regulator uses future sales as a reliable mechanism for the entity to refund the amount of any negative true-up adjustment (or to recover the amount of any positive true-up adjustment).[28]

85. Consequently, having identified that the true-up adjustment is calculated on the basis of past transactions and events, we think that it would be helpful to consider whether this is sufficient to create a present obligation at the reporting date, when the mechanism to settle the obligation relies on future sales. This is because the IASB has acknowledged that, when trying to determine whether a liability exists, it has encountered difficulties in practice because

> "it is unclear whether those past events are **sufficient** to create a present obligation to transfer an economic resource if such a transfer remains conditional on future events that have not occurred, or on further actions that the entity has not taken, by the reporting date."[29]

86. Paragraphs 3.67-3.97 of the *Conceptual Framework* DP address this question. We use the discussion in those paragraphs in our analysis below (paragraphs 87-96).

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[26] See paragraphs 2.13(b) and 2.16(b) of the *Conceptual Framework* DP.

[27] See paragraph 68 of this paper.

[28] See paragraphs 69-70 of this paper.

[29] See paragraph 3.66 of the *Conceptual Framework* DP.

Transfer is conditional on future events or actions

87. The type of true-up adjustment being considered in this paper relates to past transactions or events that have arisen by the reporting date. When the amount of the adjustment is negative, the rate regulation obliges the entity to reduce the price it charges to customers for future sales of the regulated goods or services. Previously, some have argued that the reversal of a negative 'regulatory deferral account balance' is conditional on making sales in the future and so is not a 'present' obligation.

88. The following paragraphs consider this view within the context of the more specific regulatory true-up adjustment.

Future events outside the control of the entity

89. The nature of the rate regulation requires the entity to continue to provide the essential goods or services on demand at the reduced price. Some would argue that the obligation is conditional only on future events that are outside the entity's control and, consequently, that a liability should be recognised. This is because it is only conditional on customers demanding the goods or services. In other words, the entity has an unconditional 'stand-ready obligation'.[30] Consequently, although the entity does not know at the reporting date whether it will be required to transfer resources, it has an unconditional obligation to stand ready to transfer the resources if the specified future event occurs. Other examples[31] of such stand-ready obligations that are recognised as liabilities in IFRS financial statements include an insurer's obligation to compensate a policyholder on the occurrence of an insured event, a manufacturer's warranty obligation to make good manufacturing defects, and a guarantor's obligation to compensate a lender if a borrower defaults.

90. The IASB has concluded that these unconditional obligations are present obligations that meet the definition of a liability.[32]

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[30] A 'stand-ready obligation' is described in paragraphs 3.70-3.71 of the *Conceptual Framework* DP.

[31] See paragraph 3.70 of the *Conceptual Framework* DP.

[32] See paragraph 3.71 of the *Conceptual Framework* DP, which also notes that the requirements of several recent and proposed Standards—such as the draft Revenue Standard and the Exposure Draft *Insurance Contracts* that was published in June 2013—reflect this conclusion.

Future events that depend on the entity's future actions

91. An alternative argument against the recognition of a liability is that the entity does not have an unconditional obligation to refund a negative true-up adjustment. Instead, the entity has a conditional obligation that depends on its own future actions; that is, it depends on the entity making sales in the future.

92. The IASB has tentatively rejected the view (described as View 1 in the *Conceptual Framework* DP) that an obligation must be strictly unconditional. It does not think that an entity should omit from its financial statements liabilities that have arisen from past events and that the entity has no practical ability to avoid. Doing so would exclude relevant information about the inevitable future costs of the entity's past actions. [33]

93. The *Conceptual Framework* DP presents two further views (View 2 and View 3) as alternatives to View 1.[34] However, the IASB has not reached a preliminary view on whether the definition of a liability:

    (a) should include only those liabilities that the entity has no practical ability to avoid (View 2); or

    (b) should also include conditional obligations that the entity might be able to avoid through its future actions but that have nevertheless arisen as a result of past events (View 3).

94. As already noted, the rate regulation requires the entity to continue to provide the essential goods or services on demand at the reduced price. In addition, there is usually no competition and the goods or services are considered to be essential or near-essential. Consequently, customers have little choice except to purchase the rate-regulated goods or services from the entity. As a result, we think that it can be argued that the entity has no practical ability to avoid refunding the negative true-up adjustment balance (View 2).

95. In addition, the amount of the true-up adjustment required is based on past performance (including variances from expected costs and permitted revenues and/or bonuses/penalties for meeting or failing to meet incentive targets) and other

[33] See paragraph 3.96 of the *Conceptual Framework* DP.

[34] These alternative views are discussed in paragraphs 3.77-3.89 in the *Conceptual Framework* DP.

designated events (such as incurring costs for storm damage repairs). Consequently, even if the entity could avoid making future sales, the balance has nevertheless arisen as a result of past transactions and events (View 3).

96. Consequently, we think that the obligation to refund the negative true-up adjustment would be classified as a liability under both the alternative Views 2 and 3.

Identify of the party to whom the obligation is owed

97. Previously, some have argued that the identity of the future customers that will benefit from the reduced sales price might be different from the past customers that have, in effect, overpaid. However, we do not think that the fact that the individual customers buying the goods, and thereby claiming the refund, can change, precludes recognition of a liability. Indeed, paragraph 20 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* confirms that, although an obligation always involves another party to whom the obligation is owed, it is not necessary to know the identity of that party.

98. In the case of rate regulation, the adjustment to the price usually affects all customers or all customers within a certain group or groups. Each customer has a right to buy the regulated goods or services at the reduced price and, in that way, benefit from the refund. That right usually exists independently of whether the customer has bought goods or services from the entity in the past. Similarly, the entity's obligation to sell the regulated goods or services to each customer at the reduced price exists independently of the identity of the individual customers.

99. Consequently, we think that the fact that the refund may be given to different customers than those that have previously purchased the goods or services, and so were previously 'over-billed', does not affect the existence of the obligation.

Reduced inflow versus outflow

100. One of the arguments against the recognition of a liability for a negative regulatory deferral account balances is that a rate-regulated entity's obligation to reduce prices in the future does not meet the existing definition of a liability, because the obligation is settled by transferring future goods at a lower price.

Proponents of this view argue that this results in a reduced inflow of economic benefits but does not result in an actual outflow.

101. The aggregate amount of the true-up adjustment is determined independently of the period price component of the rate (that is, the estimated price for the period, reflecting the estimated costs and volumes for the period). Although rate regulators can use different mechanisms to settle the true-up adjustment, the most common method uses an adjustment to the price charged for future sales.

102. In some cases, the amount of the overall price that relates to the period price component, and the amount related to the true-up adjustment (or adjustments), are reported separately to customers. In other cases, the customer is not made aware of the two distinct components and may only see a combined price in bills from the entity. In either case, the customer is required to pay the net amount to the entity for the volume of goods or services delivered to them in the period.

103. We accept that when the true-up adjustment is settled through a price adjustment to future sales, the amount of the true-up adjustment is realised in conjunction with the period price component as part of a net receipt from the customer. However, as already stated,[35] we do not think that the mechanism used to settle the true-up adjustment changes the nature of the obligation (or right). Consequently, we think that the view that there is no liability because there is only a reduced inflow of economic benefits, but no outflow, confuses the distinction between the obligation (liability) and the method that is used to realise the resulting outflows.

104. We also think that further arguments can be made to support this conclusion:

    (a) the resulting cash flows from future sales can be allocated to the period price component and to the true-up adjustment component (see paragraphs 105-108 below); and

    (b) the future goods/services will be transferred in exchange for economic resources of lower value (see paragraphs 109-115 below).

[35] See paragraph 71 of this paper.

Allocation of cash flows

105. The rate regulation considered in this analysis distinguishes between the price charged to customers for 'current' goods and services (the period price component), and the amount that relates to goods and services delivered in previous periods (the true-up adjustment component). The components of the price are usually separately identifiable by the entity.

106. In order to apply the rate-setting mechanism, each price adjustment that relates to past activities can usually be identified and 'tracked' through the record-keeping system. In some cases, the bills provided to customers show the different components of the pricing structure, distinguishing between the 'current' price and the adjustments related to the past. Consequently, when the entity bills the customer for sales in the current period, it can allocate, based on sales made, the net receivables due from customers into distinct components, each reflecting different components of the net price:

(a) receivable related to goods and services delivered in the current period;

(b) receivable related to goods and services delivered in past period(s) (positive regulatory adjustments); and

(c) payable related to goods and services delivered in past period(s) (negative regulatory adjustments).

107. When the sales are made to customers, the amount of the price adjustment that relates to past periods becomes a financial asset[36] or financial liability[37], in the

[36] Paragraph 11 of IAS 32 *Financial Instruments: Presentation* defines a *financial asset* as "any asset that is:
(a) cash;
(b) an equity instrument of another entity;
(c) a contractual right:
  (i) to receive cash or another financial asset from another entity; or
  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or :: [. . .]".
(d) a contract that will or may be settled in the entity's own equity instruments and is:: [. . .]".

[37] Paragraph 11 of IAS 32 *Financial Instruments: Presentation* defines a *financial liability* as "any liability that is:
(a) a contractual obligation :
  (i) to deliver cash or another financial asset to another entity; or
  (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
(b) a contract that will or may be settled in the entity's own equity instruments and is: [. . .]".

same way as normal trade receivables/payables. However, we do not think that the fact that the settlement mechanism results in a net inflow of cash precludes recognition of separate assets and liabilities for the components that are netted at settlement.

108. Nor do we suggest that, prior to the relevant sales being made to customers, the amounts of the price adjustments that are not yet reflected in sales are financial assets or financial liabilities. The 'unbilled' balance of the true-up adjustment relates to the rate regulation, not the individual contracts with customers. However, we do not think that this precludes these regulatory amounts from being depicted as assets and liabilities in the financial statements.[38]

Exchange for resources of lower value

109. The existing *Conceptual Framework* definition of a liability uses the term "the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits". In our view, this does not require that the settlement must result in an outflow of cash, but could result in the outflow of a variety of resources, including the outflow of the goods or services being sold. We think that this interpretation is supported in the *Conceptual Framework* DP, which suggests that the entity could settle an obligation in a variety of ways, including transferring assets other than cash and rendering services.[39]

110. This approach is also reflected in existing IFRSs, and is highlighted in paragraph AG11 of the application guidance in IAS 32 *Financial Instruments: Presentation*, which states:

> AG11 Assets (such as prepaid expenses) for which the future economic benefit is the receipt of goods or services, rather than the right to receive cash or another financial asset, are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities **because the outflow of economic benefits associated with them is the delivery of goods**

[38] At this stage, we have not reached a conclusion as to what type of asset or liability exists. This analysis will be influenced by the IASB's tentative conclusions at the November 2013 meeting and by the ASAF's advice at this meeting.

[39] See paragraph 3.36 of the *Conceptual Framework* DP.

> **and services** rather than a contractual obligation to pay cash or another financial asset. [Emphasis added.]

111. We are not suggesting that all obligations to deliver goods or services should be recognised as liabilities. In some cases, the obligation may be part of an executory contract[40] by which the entity is obliged to deliver, but has not yet delivered, goods or services in exchange for consideration of equal value. We do not suggest that the entity should recognise a liability for this obligation, unless the contract is onerous.[41] This is because the obligation is matched with a right or resource of equal value within an executory arrangement.

112. We think that this view is consistent with paragraph 3.38 of the *Conceptual Framework* DP. This paragraph notes that a requirement to provide economic resources only if, at the same time or earlier, the entity expects to receive economic resources of equal or greater value does not give rise to a present obligation. We interpret this to mean that a requirement to provide economic resources in exchange for resources of lesser value can (or does) give rise to a present obligation.

113. There are two distinct components to the price charged to customers for the rate-regulated goods or services delivered to them in the period:

    (a) the estimated price for the period, reflecting the estimated costs and volumes for the period; and

    (b) an identifiable 'true-up' adjustment that is based on past performance and events.

114. The first component is, we think, designed to provide consideration that is of equal value to the goods or services being supplied in the period. However, when circumstances change from the estimates used and the rate regulation prevents the entity from reflecting that change in the selling price in the current regulatory period, the price set may cease to reflect consideration of equal value.

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[40] Executory contracts are contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent (paragraph 3 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*).

[41] See paragraph 66 of IAS 37.

115. Consequently, when the true-up adjustment is negative, we think that it can be argued that this results in the entity having to transfer the rate-regulated goods or render the rate-regulated services in exchange for consideration of a lesser value. As a result, we think that it can be argued that this gives rise to a present obligation.

Staff's tentative conclusion on the existence of a present right or obligation

116. Our analysis focuses on the regulatory true-up adjustment that is based on past performance and events (including variances from expected costs and permitted revenues, bonuses/penalties for meeting or failing to meet incentive targets and other designated events, such as incurring costs for storm damage repairs). In our view, although the mechanism used to collect or deliver the resulting cash flows is usually linked to future sales, the entity's right or obligation to settle the true-up adjustment exists independently of that mechanism.

117. Consequently, when the regulatory adjustment is positive, we think that this represents a right to bill customers for an amount of revenue that relates to past transactions and events. Similarly, when this adjustment is negative, we think that it represents an obligation to 'refund' an amount of revenue that has previously been billed to customers but that exceeds the amount of revenue that the entity is entitled to retain.