



# STAFF PAPER

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Project	Rate-regulated Activities		
Paper topic	Overview of the core features of the model		
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This paper has been prepared for discussion at a public meeting of the International Accounting Standards Board (the Board) and does not represent the views of the Board or any individual member of the Board. Comments on the application of IFRS® Standards do not purport to set out acceptable or unacceptable application of IFRS Standards. Technical decisions are made in public and reported in IASB® Update.

## Purpose of the paper

1. This paper gives an overview of the core principles and features of the staff’s proposals for a new accounting model intended to provide a more faithful representation in IFRS financial statements of the financial effects of rate regulation. The paper is presented as part of an education session, updating the Board on the staff’s development of the proposals.
2. The paper is not intended to be a comprehensive analysis of the model. Consequently, the staff are not asking the Board to make decisions about the proposals in this meeting. The overview is intended to help Board members understand the core features of the model to aid their consideration of more detailed proposals for the model. Staff will ask the Board to make decisions on more detailed proposals at a meeting in early 2017. Throughout the paper, we have highlighted a number of areas for which we intend to bring a more detailed analysis. We ask Board members if there are 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?

## Structure of the paper

3. The paper contains the following information:
- (a) Background (paragraphs 4-6);
  - (b) Core objective and principles of the proposed model (paragraphs 7-17);
  - (c) Scope (paragraphs 18-22);
  - (d) Recognition—a revenue ‘supplementary’ approach (paragraphs 23-37);
  - (e) Derecognition (paragraphs 37-38);
  - (f) Measurement basis, including initial measurement, subsequent measurement and impairment, (paragraphs 39-46);
  - (g) Presentation and disclosure (paragraphs 47-56);
  - (h) Regulatory obligations related to the entity’s own assets (paragraphs 57-74);
  - (i) Appendix A—Overview of defined rate regulation
  - (j) Appendix B—Entity W background information.

## Background

4. Since the publication of the Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the DP) in September 2014, the Board has heard that the combination of rights and obligations created by the type of ‘defined rate regulation’ described in the DP may not always be faithfully represented by the existing predominant IFRS practice.<sup>1,2</sup> In line with the feedback from the DP and subsequent outreach, the staff have been developing proposals for a new accounting model that would result in the recognition of at least some regulatory assets and regulatory liabilities.

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<sup>1</sup> The overview of the features of ‘defined rate regulation’ contained in paragraphs 4.4-4.7 of the DP is reproduced in Appendix B.

<sup>2</sup> The existing predominant IFRS practice applies existing IFRS Standards without modification. As a result, few entities recognise regulatory assets or regulatory liabilities.

5. The DP noted that defined rate regulation balances the needs of customers to purchase essential goods or services at a reasonable price with the needs of the entity to attract capital and remain financially viable. Consequently, defined rate regulation involves a regulatory pricing (ie rate-setting) framework that:
- (a) applies in situations in which customers have little or no choice but to purchase the goods or services from the rate-regulated entity;
  - (b) establishes parameters to maintain the availability and quality of the supply of the rate-regulated goods;
  - (c) establishes parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections both for the entity and its customers; and
  - (d) creates rights and obligations that are enforceable on the rate-regulated entity and on the rate regulator.
6. Feedback suggested that the focus of the model should be on the enforceable rights and obligations created by the regulatory framework, with the scope limited to specified rate adjustments that relate to past transactions and events. Staff consider that the other features described in the DP support the enforceability of the rate regulation but are not essential criteria to determine the scope of the model.

### **Core objective and principles of the proposed model**

7. The core objective of the model is to inform users of IFRS financial statements about the effects of rate regulation arising from past transactions, events and conditions on the entity's financial position, performance and cash flows. To achieve that objective, the model:
- (a) supplements, but does not override, the requirements of existing IFRS Standards; ie, an entity applies all other IFRS Standards before applying the model;
  - (b) focuses on the effects of the rate regulation by capturing, through the recognition of regulatory assets and regulatory 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 **the customer-base**,<sup>3</sup>

- (c) restricts the scope of the proposed accounting to those regulatory adjustments that link, through the rate-setting mechanism:
  - (i) the entity's right to charge a determinable amount in exchange for satisfying specified regulatory obligations; and
  - (ii) the entity's satisfaction of those obligations.
- (d) addresses the satisfaction of the entity's regulatory obligations to the customer-base separately from the satisfaction of the entity's performance obligations to individual customers (which are addressed through IFRS 15 *Revenue from Contracts with Customers*).

### ***The entity's regulatory obligations and the customer-base***

8. 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 satisfying these regulatory obligations, ie the rate regulator determines the payment schedule for the period(s) covered by the regulatory agreement. In some cases, the rate regulator or other designated party may pay the entity, for example, by providing a government grant. More commonly, the rate regulator imposes the obligation to pay on the entity's customers collectively, ie the customer-base.
9. When setting the regulated rate that the entity charges its individual customers for the delivery of goods and services to them, the rate regulator does not look at the individual customers. Instead, the rate regulator views the entity's customer-base as a vehicle for transferring the agreed compensation/funding to the entity. This means that the rate regulator views the entity's customers as a group, without distinguishing between old and new customers. This distinction between individual customers and the customer-base is a unique feature of defined rate

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<sup>3</sup> 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 8-15).

regulation and underpins the core principles of the both the regulatory framework and the accounting model.

10. The regulatory agreement establishes the entity's right and obligation to exchange resources with the customer-base. 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. At this time, the entity does not record a gross asset and gross liability for its interdependent rights and obligations under the regulatory agreement. Instead, the entity records the regulatory agreement as a net zero position, consistently with the existing IFRS treatment for executory contracts.
11. 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. 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.
12. 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 satisfaction, or partial satisfaction, 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.

### ***The customer-base***

13. The rate regulator has the power to impose a rate on the customer-base that includes compensation/funding for the entity's past or future satisfaction of its regulatory obligations. The rate regulator also uses this power, through the rate-setting mechanism, to smooth rate changes and fluctuations, and consequently cash flows, for individual customers. The regulator does this by imposing rate

adjustments prospectively on customers as a group (ie as a single ‘customer-base’), without distinguishing between old and new customers.

14. Commonly, the regulated rate shown on bills to customers does not distinguish between the different aspects of the rate calculation. From an individual customer perspective, the regulated rate is the contractual consideration payable in exchange for the goods or services received in the period. Consequently, the composition of the rate is not relevant to the terms of the contracts with customers.
15. Because the regulated rate may include adjustments that relate to goods or services transferred to the customer-base in past periods, or to be transferred to the customer-base in future periods, the customer-base collectively may, at any point in time, have either ‘underpaid’ or ‘overpaid’ for the goods or services it has consumed in a period. If the customer-base has underpaid, the entity is not entitled, based on the terms of the contracts with individual customers, to bill individual customers retrospectively for the amount underpaid. Instead, this underpayment is included in the regulated rate chargeable to all individuals within the customer-base in the future. Similarly, if the customer-base has overpaid, the individual customers within the customer-base are not entitled to a refund or credit for a proportion of the amount overpaid. Instead, this overpayment is included in the regulated rate chargeable to all individuals within the customer-base in the future.

### ***A ‘supplementary’ approach—general***

16. The model is designed to ‘supplement’ the requirements of existing IFRS Standards. This means that a rate-regulated entity will recognise income, expenses, assets and liabilities in accordance with other IFRS Standards before applying the model.
17. The model informs users of the effects of the rate regulation on the entity’s financial position, performance and cash flows arising from past transactions, events and conditions by presenting separately:

- (a) revenue recognised as (or when) the entity satisfies performance obligations contained in contracts with individual customers, using the regulated rate (ie recognised using IFRS 15); and
- (b) regulatory assets and regulatory liabilities resulting from regulatory adjustments that are included, or expected to be included, in the regulated rate to be charged to the customer-base in future periods.

## Scope

18. For adjustments to be within the scope of the model, the rate regulator must have the power to bind both the entity and the customer-base to a rate and the rate regulation must establish:
  - (a) the obligations that the entity must satisfy; and
  - (b) the entity's right to charge the customer-base a determinable amount in exchange for satisfying those obligations.
19. To link the right to charge the customer-base a determinable amount to the obligations to be satisfied in exchange for that amount, the regulatory agreement must include a rate-setting mechanism that:
  - (a) establishes how the regulated rate is calculated, which identifies the basis of the rate calculation in terms of the entity's regulatory obligations; and
  - (b) adjusts the future regulated rate for the effects of past transactions, events or conditions.
20. 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. Instead, the model uses a historical cost approach to recognise only those regulatory adjustments that:
  - (a) relate to specified past transactions and events;
  - (b) reflect the rate regulator's intervention in establishing the rate(s) to be charged to the customer-base; and

- (c) are enforceable by either or both the entity or the rate regulator.
21. For the rights and obligations contained in the regulatory agreement to exist, it is necessary for them to be enforceable. Enforceability also influences the probability that reversal of a regulatory balance (whether an asset or a liability) will be achieved fully through the regulated rate, ie will be reflected in the entity's future cash flows receivable from the customer-base. Users of financial statements consider such probability when assessing the entity's operating risks and the timing and certainty of the entity's cash flows. The model proposes disclosure in the notes that will give users information relevant to making that assessment.<sup>4</sup>
22. The concept of the 'customer-base' transfers demand risk from the entity to the customer-base, increasing the probability that reversal of a regulatory balance will be achieved fully through the regulated rate. This is because, if individual customers cease, reduce, or increase their consumption of the regulated goods or services, the rate-setting mechanism adjusts the regulated rate such that any remaining regulatory balance is reflected in the regulated rate to be charged to the other members of the customer-base. Although a change in demand may affect the timing of reversal through rates of the regulatory balance, the amount receivable from the customer-base is unaffected.

### **Recognition—a revenue 'supplementary' approach**

23. The model supplements the requirements of other IFRS Standards. As a result, the entity applies IFRS 15, without modification, to recognise revenue from contracts with customers, before applying the model. This means that the entity will recognise revenue when (or as) the entity satisfies a performance obligation to customers using the contractual rate, ie the regulated rate. This means that the amount of revenue recognised ( $P \times Q$ ) is based on the regulated rate ( $P$ ) and the quantity ( $Q$ ) of goods or services transferred to individual customers during the period.

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<sup>4</sup> IFRS 14 *Regulatory Deferral Accounts* contains requirements for disclosures that staff propose to carry forward into the new model.



24. The entity then recognises regulatory assets and regulatory liabilities resulting from regulatory adjustments that arise due to:
- (a) specified variances between actual amounts and the estimated amounts used in the calculation of the regulated rate (estimation adjustments);
  - (b) the application of bonuses or penalties for exceeding or failing to meet specified targets (bonus/penalty adjustments); and
  - (c) performance timing differences between:
    - (i) the entity's performance (by satisfying its regulatory obligations); and
    - (ii) the performance of the entity's the customer-base (making payments).
25. The following paragraphs outline how the adjustments arise and give examples of each type of adjustment. All examples are based on a water utility, Entity W. Background information about Entity W and its rate-regulatory environment are contained in Appendix B. The examples assume that the regulatory adjustments are within the scope of the model, are material to Entity W and are expected to be included within the future regulated rate. For simplicity, the time value of money is assumed to be immaterial.

### ***Estimation adjustments***

26. The rate regulator uses estimates of input costs for a given quantity of goods or services expected to be transferred to the customer-base to determine the regulated rate to be charged to the customer-base during the regulatory period. Estimation adjustments can arise due to variances between actual and estimated costs or actual and estimated quantities or both. Estimation adjustments are commonly included in the regulated rate a year or two after the period in which they arise.
27. If the rate-setting mechanism adjusts the regulated rate to be charged to the customer-base in future periods to 'correct' for specified variances between these estimates and actuals, this transfers the variance risk from the entity to the customer-base. Consequently, the regulatory agreement operates in a similar way to a cost-plus contract. From the perspective of the entity, the original regulated rate is a preliminary transaction price, which is adjusted to reflect the actual costs

that are specified in the regulatory agreement as being reimbursable from the customer-base.

*Example*

28. The rate regulator includes an amount of CU1.32 per unit in the regulated rate, intended to recover Entity W's fixed costs for the next regulatory period, being the four calendar years, 20X1-20X4.<sup>5</sup> That amount includes estimated fixed costs of CU987,500 per year and estimated delivery of 748,100 units per year. Any variances arising are adjusted through the rate for year n+2, ie variances arising in 20X1 are adjusted through the rate for 20X3, those arising in 20X2 are adjusted in 20X4, and so on.
29. During 20X1, Entity W incurred fixed costs of CU986,729 and transferred 746,473 units to customers. Consequently, Entity W included CU985,344 (746,473 x CU1.32) in revenue recognised using IFRS 15. Using the model, Entity W also recognises a regulatory asset and corresponding regulatory adjustment in profit or loss of CU1,385, being the under-recovery of fixed costs that will be adjusted through the rate in 20X3 (CU986,729 - CU985,344).
30. During 20X2, Entity W incurred fixed costs of CU990,257 and transferred 753,217 units to customers. Consequently, Entity W included CU994,246 (753,217 x CU1.32) in revenue recognised using IFRS 15. Using the model, Entity W also recognises a regulatory liability and corresponding regulatory adjustment in profit or loss of CU3,989, being the over-recovery of fixed costs that will be adjusted through the rate in 20X4 (CU994,246 - CU990,257).<sup>6</sup>

***Bonus/ penalty adjustments***

31. The rate-setting mechanism may include specified adjustments to be made to the future regulated rate to reflect the entity's achievement or failure in meeting specified performance targets established through the regulatory agreement. The model recognises the bonus or penalty in the period in which it is earned, rather

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<sup>5</sup> In this Staff Paper, currency amounts are denominated in 'currency units' (CU).

<sup>6</sup> Staff will ask the Board in a future meeting to consider whether regulatory assets and regulatory liabilities arising from the same source, as demonstrated in this example, can or should be presented gross or net in the statement of financial position.

than the period in which it is included in the regulated rate that is charged to the customer-base. The bonus or penalty is commonly included in the regulated rate a year or two after the period in which it is earned, eg year  $n+2$ .

*Example*

32. The regulatory agreement includes targets for both water quality and continuity of supply. The regulated rate set for the four-year period 20X1-20X4 does not anticipate any bonuses or penalties. The regulatory agreement specifies that the regulated rate will be adjusted in future periods (year  $n+2$ ) to provide Entity W with bonuses for exceeding targets or penalties for failing to meet targets in each year as follows:
- (a) Water quality: bonus of CU20,000 or penalty of CU24,000; and
  - (b) Continuity of supply: bonus of CU23,000 or penalty of CU30,000.
33. During 20X1, Entity W exceeded the continuity of supply target and earned a bonus of CU23,000, but failed to meet its water quality target and suffered a penalty of CU24,000. Consequently, Entity W has suffered a net penalty of CU1,000 which will reduce the regulated rate to be charged to the customer-base in 20X3. Using the model, Entity W recognises either a net regulatory liability or a gross regulatory asset for the bonus and gross regulatory liability for the penalty, together with a net regulatory debit adjustment in profit or loss of CU1,000.

***Performance timing difference adjustments***

34. 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 customer-base performs by making payments to the entity. The entity performs by satisfying its regulatory obligations, resulting in it transferring goods, services or other economic benefits to the customer-base, the rate regulator or other designated parties.

*Example*

35. Entity W owns and operates a water treatment facility close to the coast. An outlet pipe from the facility is located close to a popular beach and recreational area, which is owned and operated by the local government body. During 2016,

the beach and recreational area were damaged by a severe storm. Following negotiations between the rate regulator and Entity W, the regulatory agreement requires Entity W to repair the damage to the beach and recreational area to specified standards in exchange for a fixed fee income of CU200,000. The rate regulator is not responsible for paying the fee to Entity W. Instead, the rate regulator determines that the customer-base will provide the funding over the next regulatory period. As a result, the regulated rate for the four-year period 20X1-20X4 includes an amount of CU0.067 per unit, which is intended to recover the fixed fee of CU200,000 over the four-year period, based on estimated delivery of 748,100 units per year. Any under- or over-recovery of the fixed fee at the end of the four-year period will be adjusted through the rate for the next four-year regulatory period.

36. During 20X1, Entity W completed the specified repairs at a cost of CU178,300 and transferred 746,473 units of service to customers. As a result, Entity W was entitled to charge the customer-base CU50,013 during 20X1, which is included within the revenue recognised using IFRS 15. Using the model, Entity W also records a regulatory asset of CU149,987 (CU200,000 - CU50,013) and a corresponding regulatory credit adjustment to profit or loss. Consequently, Entity W recognises a profit of CU21,700 (CU50,013 + CU 149,987 – CU178,300) for the satisfaction of its beach and recreational park repair obligation during 20X1. This is because Entity W has wholly satisfied its obligation to repair the damage to the beach and recreational area. However, the customer-base has, so far, paid only one quarter of the amount payable to the entity in exchange for the entity's satisfaction of the repair obligation. Consequently, the regulatory asset reflects the disproportionate performance of the entity compared to the customer-base.
37. During 20X2, Entity W transferred 753,217 units to customers and, therefore, recovered a further CU50,466 of its CU200,000 fee. The CU50,466 is included in the revenue recognised using IFRS 15. Entity W then reduces its regulatory asset and records a corresponding regulatory debit adjustment in profit or loss.

## **Derecognition**

38. The entity derecognises a regulatory asset or regulatory liability as the originating regulatory adjustment reverses through the rate charged to the customer-base. As a result, the entity derecognises:
- (a) a regulatory asset as it becomes entitled to charge the customers for the regulatory obligations to which the asset relates.
  - (b) a regulatory liability as it fulfils the regulatory obligation to which it relates or refunds the amounts previously charged to the customer-base.
39. Amounts that are no longer expected to be reversed through the rate charged to the customer-base will be adjusted through subsequent measurement for impairment of the related regulatory asset or regulatory liability.

## **Measurement basis**

40. 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 (see paragraph 19). 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 model uses this 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.<sup>7</sup>

## ***Initial measurement***

41. A regulatory liability is measured initially at the amount charged to the customer-base in advance of the entity fulfilling the related regulatory obligation or applying the agreed or expected rate reduction in future periods. A regulatory asset is measured initially at the amount included, or expected to be included, in

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<sup>7</sup> Staff will ask the Board in a future meeting to consider in more detail the time value of money, including the discount rate to be applied.

the rate that can be charged to the customer-base in future periods in respect of the regulatory obligation already satisfied, or partially satisfied.

42. The entity considers, when assessing whether a regulatory balance is expected to be included in establishing the future rate, facts and circumstances that affect the enforceability of the rate regulation (see paragraph 21). The assessment considers the period over which the balance is expected to be reversed through rates because the longer the expected period, the higher the risk that facts and circumstances could change.
43. If an entity considers that a regulatory balance is not expected to be included in establishing the future regulated rate, it is not recognised as a regulatory asset or regulatory liability until such time that there is sufficient evidence to indicate that it will be included in the rate.

### ***Subsequent measurement and impairment***

44. The carrying amount of the regulatory assets/liabilities recognised will be adjusted, if appropriate, to reflect any changes due to new or revised facts and circumstances.
45. If the entity has recognised a regulatory asset, the entity assesses whether that asset is recoverable through the inclusion of the amount recognised in the regulated rate chargeable to the customer-base in a future period. If facts and circumstances change such that the entity changes its expectation about future recoverability of the amount recognised, the entity may:
  - (a) reduce the carrying amount of the regulatory asset and recognise an impairment loss; or
  - (b) increase the carrying amount of the regulatory asset to reverse a previously recognised impairment loss.
46. If the entity has recognised a regulatory liability related to a regulatory obligation to be satisfied in a future period, the entity assesses whether the payment received in advance from the customer-base is sufficient to cover the cost of satisfying that obligation. If the expected cost is higher than the regulatory liability recognised, the entity recognises an increase in the regulatory liability, unless it expect the rate

regulator to approve a commensurate increase in the future regulated rate. As a result, the entity measures the regulatory liability at the higher of:

- (a) the amount received in advance from the customer-base; and
- (b) the expected cost of satisfying the obligation in a future period.

## **Presentation and disclosure**

47. The model recognises regulatory assets separately from regulatory liabilities and a net regulatory adjustment for the corresponding net movement in regulatory assets/liabilities. Using the model, an entity:
- (a) presents the net regulatory adjustment in profit or loss separately from the revenue recognised in accordance with IFRS 15; and
  - (b) discloses in the notes to the financial statements an analysis and description of the amounts included in the net adjustment.
48. The presentation and disclosure proposed is based on the requirements of IFRS 14 *Regulatory Deferral Accounts*, but with one significant difference. IFRS 14 requires that the regulatory balances are presented separately below sub-totals for ‘total assets’ and for ‘total liabilities’, and the net movement of regulatory balances is presented separately below a sub-total drawn for the net profit or loss recognised in accordance with other IFRS Standards. The model proposes that regulatory assets, regulatory liabilities and the net income statement movement are presented as separate line items within the relevant categories, instead of being isolated as distinct categories.
49. In a future meeting, staff will ask the Board to consider presentation and disclosure issues in more detail. This includes the level of offsetting of regulatory assets and regulatory liabilities and whether those items should be split between current and non-current amounts.

## ***Relationship between contract assets, receivables and regulatory assets***

50. In accordance with IFRS 15, when an entity performs first by satisfying a performance obligation in a contract with a customer before the customer

performs by paying consideration, the entity has a contract asset—a right to consideration from the customer in exchange for goods or services transferred to the customer.

51. Paragraph BC323 of the Basis for conclusions on IFRS 15 notes:

In many cases, that contract asset is an unconditional right to consideration—a receivable—because only the passage of time is required before payment of that consideration is due. However, in other cases, an entity satisfies a performance obligation but does not have an unconditional right to consideration, for example, because it first needs to satisfy another performance obligation in the contract. The boards decided that when an entity satisfies a performance obligation but does not have an unconditional right to consideration, an entity should recognise a contract asset in accordance with IFRS 15. The boards noted that making the distinction between a contract asset and a receivable is important because doing so provides users of financial statements with relevant information about the risks associated with the entity's rights in a contract. That is because although both would be subject to credit risk, a contract asset is also subject to other risks, for example, performance risk.

52. The model applies a similar principle to the relationship between the entity's satisfaction of its regulatory obligations and the performance of the customer-base. When an entity performs first by satisfying a regulatory obligation before the customer-base performs by making payments, the entity has a regulatory asset—a right to charge the customer-base in exchange for goods or services transferred to the customer-base or other designated parties. If the regulatory obligation has been satisfied by the transfer of goods or services to the customer-base, such that the entity's performance obligations in contracts with individual customers are satisfied, the entity's right to charge the customer-base will be a receivable and/or a contract asset, applying IFRS 15. However, if the entity's regulatory obligation is satisfied by the transfer of goods or services to other



parties, such as in the example in paragraph 35, the entity's right to charge the customer-base is recognised separately as a regulatory asset.

### ***Relationship between contract liabilities, payables and regulatory liabilities***

53. Paragraph BC325 of the Basis for conclusions on IFRS 15 notes that the act of invoicing the customer for payment does not indicate whether the entity has an unconditional right to consideration. The paragraph provides an example of when an entity can have an unconditional right to consideration before it has satisfied a performance obligation.

For example, an entity may enter into a non-cancellable contract that requires the customer to pay the consideration a month before the entity provides goods or services. In those cases, on the date when payment is due, the entity has an unconditional right to consideration. (However, in those cases, the entity should recognise revenue only after it transfers the goods or services.)

54. In some cases, the entity may have an unconditional right to consideration from the customer-base that includes amounts related to the future satisfaction of a regulatory obligation. Although the entity would recognise a receivable for the amount due, it would recognise:

- (a) a contract liability for any amount related to goods or services not yet transferred to the customer-base (by applying IFRS 15); and
- (b) a regulatory liability for any further amount related to regulatory obligations to be satisfied in a future period,

55. Paragraph BC326 of the Basis for conclusions on IFRS 15 goes on to note:

The boards observed that in some cases, an entity will have an unconditional right to consideration, even though the entity may be required to refund some or all of that consideration in the future. In those cases, the possible obligation to refund consideration in the future will not affect the entity's present right to be entitled to the gross amount of consideration. In those cases, the boards

observed that an entity may recognise a receivable and a refund liability (for example, when a right of return exists).

56. In some cases, the entity may have an unconditional right to consideration from the customer-base that includes amounts that will reduce, or are expected to reduce, the regulated rate in a future period (for example, when a penalty has been incurred or an estimation variance has arisen). In such cases, the entity would recognise, by applying IFRS 15, a receivable for the amount due. The entity has no obligation to give individual customers a credit note or to refund cash for the regulatory penalty adjustment or variance adjustment. Instead, the entity recognises a regulatory liability to reflect its obligation to return the regulatory adjustment amount to the customer-base through the rate reduction in a future period.

### **Regulatory obligations related to the entity's own assets**

57. A significant aspect of the entity's regulatory obligation is to be able to deliver specified goods or services to customers *on demand*. This means that the entity needs to ensure that it has the assets and infrastructure in place to ensure that it is able to transfer rate-regulated goods or services to customers without disruption to supply. This typically requires significant investment in the maintenance, replacement and enhancement of assets required to produce and/or deliver the regulated goods or services.
58. When establishing the regulated rate, the rate regulator typically considers the programme of maintenance, replacement and enhancement of assets needed to ensure the continuity of supply. The rate regulator ensures that the entity is provided with sufficient funding for such investment activities by using the regulated rate and/or other funding sources, such as government grants. This funding might be in advance or in arrears of the investment occurring.
59. The model proposes that, whatever method is used by the rate regulator to fund allowable maintenance, replacement and enhancement activities, the principles to be applied to the accounting treatment of the related costs and funding are the same. The following paragraphs outline the model's proposed requirements for

recognising assets and liabilities arising from such activities and the related funding received/receivable.

***Recognising assets from activities that generate or enhance the entity's own assets***

60. Activities that result in the entity incurring maintenance, replacement or enhancement costs do not directly transfer goods or services to customers or other parties. Instead, they maintain, generate or enhance resources of the entity (ie its own assets) that will be used in satisfying (or in continuing to satisfy) its obligations to transfer economic benefits to customers, the rate regulator or other parties in the future, ie satisfying its regulatory obligations. The model proposes that such costs be identified as 'costs incurred to fulfil a regulatory agreement'.<sup>8</sup>
61. If the costs incurred in fulfilling the entity's regulatory obligations are capitalised as an asset within the scope of another IFRS Standard (for example IAS 2 *Inventories*, IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* or IFRS 15), the entity accounts for those costs in accordance with those other Standards.
62. If, instead, the entity carries out activities that lead to it incurring costs in fulfilling a regulatory obligation that are not capitalised as an asset within the scope of another IFRS Standard, the model proposes that the entity recognises an asset from those costs if the costs:
- (a) relate directly to the regulatory agreement;
  - (b) generate or enhance resources of the entity that will be used in satisfying (or in continuing to satisfy) regulatory obligations in the future; and
  - (c) are expected to be recovered through the regulated rate mechanism.
63. The criteria are intended to preclude an entity from deferring costs merely to normalise profit margins. However, we acknowledge that this is an area in which significant judgement may be required. This may be particularly so in situations

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<sup>8</sup> Paragraphs 95-104 of IFRS 15 provide requirements to account for 'costs to fulfil a contract'. The staff's proposals for the treatment of costs to fulfil a regulatory agreement apply similar principles to those IFRS 15 requirements.

in which the regulatory agreement specifically allows for the recovery of costs that would normally be expensed in accordance with other IFRS Standards, such as indirect overheads incurred during the construction of an asset. Consequently, staff will ask the Board to consider this issue in more detail in a future meeting.

64. Any asset recognised from the generation and enhancement costs incurred in fulfilling a regulatory obligation is amortised on a systematic basis that is consistent with the transfer to customers of the goods or services to which the asset relates.<sup>9</sup>
65. For any costs capitalised in accordance with the model or other IFRS Standards, such as IAS 16, an entity assesses the recoverability of the carrying amount. If all or part of the carrying amount is no longer considered to be recoverable, the entity recognises an impairment loss. For assets recognised using other IFRS Standards, the entity applies IAS 36 *Impairment of Assets* or any specific impairment requirements in the relevant Standard. For regulatory assets, the entity applies impairment requirements specified in the model.<sup>10</sup>

***Recognising liabilities from funding received/receivable for activities that generate or enhance the entity's own assets***

66. The rate regulator determines when an entity receives the funding required to carry out the investment activities that maintain, repair or enhance the entity's own assets. This funding might be in advance or in arrears of the investment occurring. The model proposes that the entity recognises a regulatory liability or regulatory asset for timing differences between the entity's performance (by satisfying its regulatory obligations) and the performance of the customer-base and the rate regulator (by making payments).
67. If the customer-base pays in advance of the entity generating or enhancing its own assets, it seems clear that the customer-base has performed before the entity. Consequently, the entity recognises a regulatory liability for the pre-funded amount already charged to the customer-base. Because the model focuses on the performance of the entity by transferring goods, services or other economic

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<sup>9</sup> Staff will ask the Board to consider the amortisation basis in more detail at a future meeting.

<sup>10</sup> Staff will ask the Board to consider the impairment requirements in more detail at a future meeting.

benefits to its customers, the rate-regulator or other designated bodies (see paragraphs 8 and 34), activities that generate or enhance the entity's own assets are not considered to be activities that satisfy a regulatory obligation. Instead, the asset is used to satisfy the entity's regulatory obligations by it is used to create or deliver the goods or services that the entity is obliged to transfer to the customer-base or other parties. In this case, the entity subsequently reduces the carrying amount of the regulated liability by recognising the amount pre-funded by the customer-base in profit or loss on a systematic basis. This systematic basis is consistent with the transfer to customers of the goods or services to which the asset relates. This is usually on the same basis as the depreciation of the asset to which it relates.

68. The model is consistent with the gross presentation approach used in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* for the treatment of grants related to assets. IAS 20 requires that, when an entity receives a government grant intended to fund capital expenditure and uses the gross presentation approach in IAS 20, the grant is initially recognised in the balance sheet and then is recognised in profit or loss on a systematic basis, usually on the same basis as the depreciation of the asset to which it relates.<sup>11</sup> The requirements reflect that the government has performed, by making a payment, earlier than the entity has performed.

#### *Example*

69. As a result of recent demand growth, the use of Entity W's infrastructure in the area is nearing capacity. To continue to meet its ongoing water quality and availability obligations, Entity W needs to build a new water facility to increase the capacity of its network. Construction will commence January 20X1 and the new facility will begin operating in January 20X3. The construction is estimated to cost CU90 million, to be incurred on a straight-line basis throughout 20X1 and 20X2.
70. The rate regulator approves the construction plan and determines that Entity W is entitled to recover the cost as follows:

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<sup>11</sup> Paragraphs 28-32 of Agenda paper 9B *Responding to issues raised in ASAF discussions* outline the requirements of IAS 20 for dealing with the receipt of a government grant.

- (a) The rate regulator will provide a CU50 million government grant in January 20X1. This amount will not be reflected in future rates.
- (b) Entity W will borrow CU40 million in January 20X2, which will be recovered through rates on a straight-line basis over 50 years from 1 January 20X1.<sup>12</sup>
71. The expected useful life of the facility is 50 years and, in accordance with IAS 16, Entity X will depreciate the cost of the facility on a straight-line basis over this period. Entity X uses the gross presentation approach in IAS 20, ie the grant is initially recognised in the balance sheet and then is recognised in profit or loss on the same basis as the depreciation of the related asset.
72. In 20X1, Entity X recognises the CU50 million grant received in the balance sheet and capitalises the CU45 million construction costs incurred as an asset within property, plant and equipment. The model proposes that Entity X also recognises a regulatory liability of CU0.8 million (CU40 million/50 years), being the amount recovered through the regulated rate from the customer-base during 20X1.
73. In 20X2, Entity X recognises the CU40 million loan received in the balance sheet and capitalises the CU45 million construction costs incurred as an asset within property, plant and equipment. The model proposes that Entity X also recognises a further CU0.8 million regulatory liability, being the amount recovered through the regulated rate from the customer-base during 20X2.
74. The new water facility begins operating in January 20X3. Entity W begins to depreciate the asset and to recognise the government grant and the regulatory liability in profit or loss on a systematic basis.

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<sup>12</sup> In practice, this amount will be adjusted to reflect loan interest and the time value of money but, for simplicity, please ignore interest for the purposes of this example.

## Appendix A

The Discussion Paper *Reporting the Financial Effects of Rate Regulation* (the DP) describes the features of ‘defined rate regulation’. Paragraphs 4.4-4.7 of the DP provide the following overview.

### Defined rate regulation—an overview

4.4 Defined rate regulation balances the needs of the customers to purchase essential goods or services at a reasonable price with the needs of the entity to attract capital and remain financially viable. Defined rate regulation involves a regulatory pricing (ie rate-setting) framework that includes all of the following:

- (a) it applies in situations in which customers have little or no choice but to purchase the goods or services from the rate-regulated entity because:
  - (i) there is no effective competition to supply; and
  - (ii) the rate-regulated goods or services are essential to customers (such as clean water or electricity).
- (b) it establishes parameters to maintain the availability and quality of the supply of the rate-regulated goods or services and other rate-regulated activities of the entity.
- (c) it establishes parameters for rates (sometimes referred to as prices or tariffs) that provide regulatory protections that:
  - (i) support greater stability of prices for customers; and
  - (ii) support the financial viability of the rate-regulated entity.
- (d) it creates rights and obligations that are enforceable on the rate-regulated entity and on the rate regulator.

4.5 The rate-setting framework for defined rate regulation establishes:

- (a) a 'revenue requirement' (sometimes called 'allowable revenue' or 'authorised revenue'): this is the total consideration to which the entity is entitled in exchange for carrying out specified rate-regulated activities over a period of time; and
- (b) a regulated rate, or rates, per unit that the entity charges to customers for delivering the rate-regulated goods or services during the regulatory period.

4.6 For defined rate regulation, the mechanism used to calculate the regulated rate(s) includes a regulatory adjustment mechanism to reverse specified differences between the amount of the revenue requirement accrued to date and the amounts billed to customers. This regulatory adjustment mechanism seeks to ensure that the rate-regulated entity earns no more and no less than the amount of the revenue requirement and any related profit or return to which it is entitled. The regulatory adjustment to the rate also seeks to reflect the time value of money when increases or decreases in the rate are deferred.

4.7 Consequently, some suggest that defined rate regulation creates a combination of rights and obligations that supports the recognition of the entity's right to recover, or obligation to reverse, the specified differences as assets or liabilities in the statement of financial position. The remainder of this Section outlines the features of defined rate regulation and the combination of rights and obligations that relate to the rate-regulatory mechanism.



**Appendix B: Entity W background information**

- A1. Entity W is a water utility company and is subject to a regulatory framework that includes regulatory adjustments that are within the scope of the proposed accounting model. The other features of the regulatory environment support the enforceability of the rate regulation.
- A2. Entity W:
- (a) is a publicly owned company listed on the Country X stock exchange;
  - (b) prepares IFRS financial statements and a set of regulatory returns for its reporting periods ending 31 December each year;
  - (c) operates under a licence agreement granted by the Secretary of State to be the sole supplier of clean and waste water services in Country X; and
  - (d) is subject to a well-established and stable system of defined rate regulation, as described in the DP.
- A3. The licence grants Entity W the sole supplier right for an indefinite period, in exchange for Entity W agreeing to provide water services in accordance with the regulatory agreement. The rate regulator, which is a government body, can only terminate the agreement if Entity W persistently fails to satisfy its obligations under the regulatory agreement.
- A4. The regulated rate is reviewed and set every four years; this example considers the position for the next rate period from 1 January 20X1-31 December 20X4. For simplicity, please assume that there are no regulatory balances to carry forward as at 31 December 2016.
- A5. In mid-2016, the rate regulator approves Entity W's budgets and forecasts for the four-year period starting 1 January 20X1. Estimated demand for the period is based on population growth forecasts provided by the government of Country X. Steady and continued population growth has occurred around the capital city of Country X and is expected to continue through the next rate review period.