

Measurement principles

Issues Paper

Objective

- 1 The purpose of this paper is to discuss and obtain EFRAG TEG members views on the measurement aspects of the accounting model for regulatory assets and regulatory liabilities.

Overall measurement principles

- 2 In June 2019, the IASB discussed [here](#) and tentatively decided on the key measurement principles when accounting for regulatory assets and regulatory liabilities in the model being developed for activities within the scope of defined rate regulation. In particular, the IASB tentatively decided to:
 - (a) **general measurement principle:** measure all regulatory assets and regulatory liabilities, except those covered in (b), using a **cash-flow-based measurement technique** by:
 - (i) estimating future cash flows arising from the regulatory assets or regulatory liabilities, including the cash flows relating to the regulatory interest or return; and
 - (ii) discounting the estimated future cash flows using the regulatory interest or return rate unless there is any indication that the regulatory interest or return rate is not adequate.
 - (b) **exception to the general measurement principle:** measure regulatory assets and regulatory liabilities that relate to expenses or income that will be included in or deducted from the future rates when cash is paid or received (for example pension costs and asset retirement obligations) by:
 - (i) using the same measurement basis that the entity uses when measuring the related liability or related asset; and
 - (ii) adjusting the measurement of the regulatory asset or regulatory liability to reflect any risks that are not present in the related liability or related asset.
- 3 The IASB decided to describe the cash-flow-based measurement technique as applying a **modified historical cost measurement basis**.
- 4 Regulatory assets and regulatory liabilities will be measured based on **total allowed compensation** that an entity is entitled to charge its customers for goods and services supplied during a given period. The allowed compensation will generally specify which expenses can be recovered and a target profit (return) that the entity can recover. The total allowed compensation and how it is determined is usually described in the regulatory agreement.
- 5 In some cases, the total allowed compensation also incorporates incentives (bonuses) or penalties an entity may be liable for. The accounting for incentives and penalties is discussed in the second half of this paper.

Features of the general measurement technique

- 6 The accounting model for defined rate regulation uses a cash-flow-based measurement technique that requires an entity to:

- (a) estimate future cash-flows arising from regulatory assets or regulatory liabilities, and updating those estimates when changes occur; and
- (b) discount the estimated future cash flows, keeping the discount rate established at initial recognition unchanged, unless the regulatory agreement changes the future cash flows by changing the interest rate or return rate.

Estimating future cash flows

- 7 When measuring a regulatory asset or regulatory liability, an entity first identifies the amount that will be added to or deducted from the future rates because the 'total allowed compensation' for goods or services already supplied exceeds, or is lower than, the amount already charged to customers for those goods or services. An entity would then estimate when those additions or deductions will be made to or from the future rates to be charged to customers.
- 8 Typically, regulatory assets and regulatory liabilities to which the general measurement model applies are automatic rate adjustments (such as input cost variances); rate adjustments which are explicitly mentioned in the regulatory agreement and rate adjustments which are not explicitly mentioned in the regulatory agreement but which meet the recognition criteria of the model.
- 9 The model requires an entity to estimate future cash flows arising from each regulatory asset recognised using either the **most likely amount** or the **expected value**, depending on which method the entity concludes would better predict the amount of the cash flows arising from a particular timing difference or group of timing differences. The entity should apply the same method consistently from the origination of the timing difference until its reversal. This treatment is consistent with the accounting for uncertain future cash flows in IFRS 15 *Revenue from Contracts with Customers* and IFRIC 23 *Uncertainty over Income Tax Treatments* which require the use of either the most likely amount or the expected value (depending on which method is better suited to the entity's circumstances).
- 10 When estimating future cash flows, an entity would consider the risks associated with those cash flows. The amount and timing of cash flows resulting from regulatory assets and regulatory liabilities, although highly predictable, could be subject to risks such as:
 - (a) **Demand risk** - takes into account the expected level of demand for the rate-regulated goods or services. The demand risk is typically low as entity's customers collectively form a sufficiently large base and, individually, have limited ability to seek alternatives to buying the regulated goods or services from another entity, contributing to the inelasticity of demand.
 - (b) **Customer credit risk** - the regulatory agreement generally treats credit losses as an allowable expense that is compensated for through the rates charged to customers.
 - (c) **Non-performance risk** – generally rate-regulated entities subject to defined rate regulation have low non-performance risk and maintain a high credit rating. This is mainly due to the low risk environment in which they operate and the regulatory objective to establish rates which would support the entity's financial viability when fulfilling the requirements specified in the regulatory agreement for the quality, quantity and supply of goods and services.
 - (d) **Regulatory risk** - the assessment of the characteristics of the broader regulatory framework in which an entity operates, such as the level of development, stability, predictability and supportiveness of the regulatory regime and the degree of independence of the regulatory authorities and any politically motivated interventions, establishes the extent of the regulatory risk. The level of regulatory risk may affect the level of uncertainty when estimating future cash flows. For example, factors such as whether the regulator has pre-

approved the recovery of investments an entity should make, and whether the regulator tends to challenge, disallow or delay the recovery of costs in the entity.

Updating estimated cash flows

- 11 The model for regulatory assets and regulatory liabilities requires an entity to update the estimated cash flows at each reporting date and to account for those changes in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Consequently:
 - (a) the effect of a change in estimated future cash flows would be recognised prospectively in profit or loss in the period of the change (or the period of the change and future periods, if the change affects both); and
 - (b) if the change in estimated cash flows gives rise to a change in a regulatory asset or regulatory liability, the change would be recognised by adjusting the carrying amount of the related asset or liability in the period of the change.
- 12 The model does not require separate impairment procedures because updating the estimates of future cash flows would capture any downward remeasurements. Therefore, IAS 36 *Impairment of Assets* does not apply to regulatory assets.

Estimating cash flows from performance incentives

- 13 A regulatory agreement may include performance incentives for achieving indicated performance criteria such as targeted levels of quality and reliability of service, customer satisfaction, level of operational efficiency etc. Once an entity becomes entitled to a bonus or liable for a penalty, these amounts form part of the total allowed compensation that an entity is entitled to for supplying goods and services and is included as an adjustment to the rates charged to customers in the same or a subsequent period.
- 14 The accounting model for regulatory assets and regulatory liabilities **only considers** bonuses or penalties which are included in the rates charged to customers as part of the total allowed compensation. Bonuses or penalties which are not included in the total allowed compensation are outside the scope of the model for defined rate regulation and are accounted for under applicable IFRS Standards.

Recognition

- 15 The regulatory agreement established the mechanism for the performance incentives which would result in a right to add an amount to (or the obligation to deduct an amount from) future rates, subject to the outcome of the entity's performance against the incentive criteria.
- 16 When the incentive performance period concludes within, or at the same time, as the financial period, there will generally be little or no uncertainty as to whether the entity earned a bonus or incurred a penalty as to whether it should recognise a regulatory asset or a regulatory liability.
- 17 Therefore, an entity would recognise a regulatory asset in the period that it acquired a right to include a bonus in the total allowed compensation as a result of the total allowed compensation being higher than the amount already charged to customers. And conversely, an entity would recognise a regulatory liability in the period that it incurred an obligation to deduct a penalty as a result of the total allowed compensation being lower than the amount already charged to customers.
- 18 However, there might be uncertainty as to the **outcome** of the entity's performance with respect to the amount of the inflow or outflow of economic benefits that will result. In line with the model's measurement principle, any outcome uncertainty associated with performance incentives is reflected in the measurement of the regulatory asset or regulatory liability.

Measurement

- 19 The regulatory agreement usually establishes a period over which an entity's performance has been monitored and evaluated against the performance criteria in the regulatory agreement – the incentive performance period. The incentive performance period may or may not align with the entity's financial reporting period.
- 20 When the incentive performance period differs from the financial reporting period, it may be uncertain at the reporting date whether the entity will achieve the incentive target and whether any adjustments should be made to the estimate of the total allowed compensation for the portion of the incentive performance period falling within the current reporting period.
- 21 Considering the recognition principles of the model, the IASB decided to reflect the outcome uncertainty in the measurement of the regulatory assets or regulatory liabilities by estimating the total allowed compensation taking into account the expected outcome of the entity's performance against the incentive criteria to measure the resulting regulatory asset or regulatory liability.
- 22 In accordance with the measurement principles of the model, an entity estimates the cash flows arising from performance incentive schemes using **the most likely amount** or the **expected value** method, depending which method would better predict the amount of the cash flows.
- 23 The amount of any bonus or penalty arising under an incentive performance scheme in the current period forms part of the total allowed compensation for goods and services supplied in this period. In some cases, it will be easier to determine how much of the bonus or penalty relates to the current period than to a future period containing the remaining part of the incentive performance period (e.g. when a penalty is a set percentage of the selling price charged to customers or a fixed price per unit supplied).
- 24 Once an entity has estimated the cash flows resulting from an incentive scheme to be included in the total allowed compensation, it should **apportion** the bonus or penalty as the incentive period progresses, rather than only at a point in time.
- 25 When estimating the total allowed compensation for the current period and measuring the resulting regulatory assets or regulatory liabilities, an entity would apply the requirements of IAS 10 *Events after the Reporting Period* and consider all available information, including any information that becomes available after the reporting date.
- 26 Additionally, in accordance with the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* an entity should:
 - (a) consider any additional evidence provided by events after the reporting period which provide insights into the entity's performance against the incentive performance criteria; and
 - (b) incorporate these insights into the estimate of the total allowed compensation for the incentive performance period.

The measurement basis – modified historical cost

- 27 The *Conceptual Framework* distinguishes a measurement basis from a measurement technique. Paragraph 6.91 of the *Conceptual Framework* notes that measurement techniques are used in applying a measurement basis. When using a particular measurement technique, one should consider the extent to which that technique reflects the factors applicable to the respective measurement basis.
- 28 The cash-flow-based measurement technique for regulatory assets and regulatory liabilities was developed to reflect the nature of regulatory assets and regulatory liabilities which is to add an amount to or deduct an amount from the future rates

charged to customers. It requires an entity to update estimates of cash flows but to keep the discount rate established at initial recognition unchanged unless the regulatory agreement changes the future cash flows by changing the interest rate or return rate.

- 29 The measurement of regulatory assets and regulatory liabilities is based on reflecting the price of the transaction, the 'total allowed compensation' in the regulatory agreement, which is considered a historical cost in the model. However, the model only allows for limited updating of the discount rate used at initial recognition of regulatory account balances, which is contrary to the requirements of a current measurement basis. Consequently, the IASB tentatively decided to describe the measurement basis of the model as a **modified historical cost measurement basis** which better reflects its mechanics.

Exception to the general measurement principle

- 30 The model for regulatory assets and regulatory liabilities considers regulatory assets and regulatory liabilities that relate to expenses or income that will be included in or deducted from the future rates **when cash is paid or received** to be distinct in nature and as a result proposes an exception to the measurement approach used for all other regulatory assets and regulatory liabilities.
- 31 In general, the regulatory agreement does not permit such items to be included in allowable expenses and charged through the rate to customers until a future date when the entity pays or receives the related cash. Examples of items typically treated this way include pension costs, deferred taxation, asset retirement obligations, environmental clean-up provisions and derivatives used for hedging.
- 32 Under this exception, regulatory assets and regulatory liabilities falling within this category would be measured by:
- (a) using the same measurement basis as the related liability or asset; and
 - (b) adjusting their measurement to reflect any risks that are not present in the related items.
- 33 For instance, a regulatory asset is recognised when the entity incurs allowable expenses (e.g. decommissioning costs) and recognises the resulting amount payable as a liability in its financial statements in accordance with existing IFRS Standards.
- 34 This approach would provide users with the most relevant and understandable information because it uses the same measurement basis for the related liability or asset and for the regulatory asset or regulatory liability that generates the same cash flows and is subject to the same risks. This is also consistent with paragraph 6.58 of the *Conceptual Framework* which discusses how using different measurement bases for cash flows from an asset and liability which are directly linked to cash flows from another asset or liability could create measurement inconsistency.

EFRAG RRAWG feedback on measurement principles

- 35 Generally, EFRAG RRAWG expressed broad support for the proposed measurement technique. However, members raised a few practical concerns with respect to:
- (a) impairment test of regulatory assets – some members explained that separating the cash flows from regulatory assets when performing impairment test of the cash generating unit (CGU) would be operationally difficult and the outcome might not be significantly different. Another member agreed that regulatory assets should not be tested for impairment individually as separating the cash flows could be quite complex. However, there was a

concern of overstatement of assets based on adding regulatory assets to the balance sheet and at the same time having the cash flows unchanged. Therefore, suggestion was made to include regulatory cash flows in a CGU and consider them in the impairment test in accordance with IAS 36. This would serve both as a safeguard and would be operationally simpler;

- (b) regulatory risk – when discussing the risks affecting the estimated future cash flow, EFRAG RRAWG members agreed that the regulatory risk should be considered in the measurement of regulatory cash flows. Members acknowledged that the regulatory risk affected the binding power of the regulatory agreement, however, they observed that the regulatory risk had more significant influence over the predictability of the regulatory cash flows;
- (c) accounting for incentives – members agreed that currently entities account for regulatory incentive in the way proposed in the model. However, the main practical difficulty would be to estimate the amount of the penalty or bonus to be included in the rate at the year end. Examples mentioned were incentives based on climate-related events or performance targets. Members agreed that the most likely amount method would better capture the measurement of such incentive schemes. However, there would be always misalignment with the amount approved by the regulator.

Questions for EFRAG TEG members

- 36 Do EFRAG TEG members agree that a cash-flow-based measurement technique is appropriately capturing the specific features of regulatory assets and regulatory liabilities? In particular:
 - (a) when estimating future cash flows, do you agree with the requirement to use either the **most likely amount** or the **expected value**, depending on which method gives a better prediction of the expected outcome as reflected in paragraph 9;
 - (b) do you consider that the risks detailed in paragraph 10 sufficiently reflect the uncertainty around the amount and timing of the future cash flows arising from regulatory assets and regulatory liabilities;
- 37 Do EFRAG TEG members agree that the impairment model in IAS 36 should not be applied to regulatory assets and regulatory liabilities as proposed by the model? If you disagree, please explain your view.
- 38 Do EFRAG TEG members agree with the proposed accounting for regulatory bonuses and penalties within the general measurement model described in paragraphs 13 - 26?
- 39 Do EFRAG TEG members agree with the proposed measurement exception to measure regulatory assets and regulatory liabilities that relate to expenses or income which will be considered in the future rates when cash is paid or received as reflected in paragraphs 30 - 34?