Transition requirements of the model for defined rate regulation
Issues Paper

Objective

1 The objective of this paper is to obtain EFRAG TEG's preliminary views on the IASB tentative decisions on transition requirements for the model for defined rate regulation.

Transition requirements

2 In September 2019, the IASB discussed the transition requirements for the accounting model for regulatory assets and regulatory liabilities.

3 The IASB tentatively decided:

(a) that an entity that currently applies IFRS Standards should, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, apply the model retrospectively to each prior reporting period presented;

(b) that a first-time adopter of IFRS Standards should apply the model at the date of transition to IFRS Standards, as defined in IFRS 1 *First-time Adoption of International Financial Reporting Standards*;

(c) to retain the deemed cost exemption in paragraph D8B of IFRS 1; and

(d) that an entity that currently applies IFRS Standards should be permitted to elect not to apply the model retrospectively to business combinations that occurred before the beginning of the earliest period presented.

4 Additionally, the IASB tentatively decided that, if an entity elects not to apply the model retrospectively to past business combinations, the entity should:

(a) recognise only those regulatory assets and regulatory liabilities arising from all past business combinations which still exist at the date of transition to the model; and

(b) recognise any resulting change as an adjustment to the carrying amount of goodwill. If that adjustment reduces the carrying amount of goodwill to zero, the entity should recognise any remaining adjustment in retained earnings or, if appropriate, another category of equity.

5 If an entity elects to apply the model retrospectively to past business combinations, it should apply that election **to all of its** past business combinations.

6 In some situations, an entity may have previously recognised regulatory balances that arose because a regulatory agreement gives the entity a right to include amounts relating to goodwill in future rate(s) charged to customers. The model does not treat such rights as regulatory assets and, therefore, they would not be recognised as assets. The IASB tentatively decided that on transition to the model

an entity that currently applies IFRS Standards and a first-time adopter of IFRS Standards should reclassify those balances to goodwill.

7 The transition requirements of the model consider the requirements of the Conceptual Framework, users' preferences and the costs and benefits of those transition requirements.

8 In general, users find information more useful if it allows them to compare similar information across different entities or compare information of the same entity across different periods. Applying the retrospective requirements of IAS 8 for transition to the model, would result in comparable information that would facilitate trends analysis in the financial performance of entities and would be the preferred approach by users.

9 Under the full retrospective approach, on transition to the model for defined rate regulation, an entity applying IFRS Standards would:

(a) recognise regulatory assets and regulatory liabilities in accordance with the recognition requirements of the model;

(b) derecognise regulatory balances that in accordance with the model do not qualify for recognition as regulatory assets or regulatory liabilities;

(c) reclassify items that in accordance with the model must be recognised as a regulatory asset or a regulatory liability but in accordance with previous GAAP were recognised as a different type of asset or liability;

(d) apply the measurement requirements of the model to all recognised regulatory assets and regulatory liabilities; and

(e) recognise any resulting adjustment to retained earnings (or other component of equity) at the beginning of the earliest comparative period presented.

10 An entity that is a first-time adopter is required to apply the model at the date of transition to IFRS Standards as defined in IFRS 1 and restate comparative information applying IFRS 1 requirements throughout its financial statements. This would create comparability within an entity over time, between different first-time adopters and between first-time adopters and entities that already apply IFRS Standards.

11 Additionally, for first-time adopters, paragraph D8B of IFRS 1 provides an exemption permitting entities to use the previous GAAP carrying amount of an item that is used, or was previously used, in rate-regulated activities as its deemed cost. The IASB tentatively decided to retain this exemption in IFRS 1 for the following reasons:

(a) it eliminates significant practical challenges in restating such items retrospectively, removing non-qualifying amounts or using fair value as deemed cost; and

(b) most first-time adopters with rate regulated activities account for property, plant and equipment in accordance with a historical cost model consistent with IAS 16 *Property, Plant and Equipment* and the item for which the exemption is used is required to be tested for impairment using IAS 36 *Impairment of Assets* at the date of transition.

Transition requirements for past business combinations

12 Past business combinations are business combinations that occurred before the date of initial application of the model or for first-time adopters before the date of transition to IFRS Standards.

13 IFRS 1 exempts a first-time adopter from applying IFRS 3 retrospectively to past business combinations. In line with this exemption, the IASB tentatively decided to adopt a similar approach for entities that currently apply IFRS Standards and

recognise regulatory balances in accordance with their previous accounting policies or using IFRS 14.

14 Consequently, entities that currently apply IFRS Standards, irrespective of whether they currently recognise regulatory balances, should be permitted to elect not to apply the model retrospectively to past business combinations. If an entity uses that election, it should recognise and measure, using the model, only those regulatory assets and regulatory liabilities arising from all past business combinations that still exist at the date of initial application of the model. Any resulting change should adjust the carrying amount of goodwill. If that adjustment reduces the carrying amount of goodwill to zero, any remaining adjustment should be recognised in retained earnings or another category of equity.

15 This election should be applied for **all past business combinations and not on a case-by-case basis**. It would provide relief to entities from revising the purchase price allocations for past business combinations retrospectively.

Transition requirements for goodwill-related regulatory assets

16 In some jurisdictions, entities that currently recognise regulatory balances are allowed to consider goodwill in the total allowed compensation and include a charge to customers through the regulatory rate. Such assets are referred to as goodwill-related regulatory assets.

17 Both for entities that currently apply IFRS Standards and for first-time adopters of IFRS Standards, such goodwill-related regulatory assets are neither directly nor indirectly related to the supply of goods and services. The model would not recognise a regulatory asset relating to goodwill even if the regulator allows it to be included in the rate charged to customers.

18 Consequently, entities that currently recognise such goodwill-related regulatory assets would have to derecognise them on transition to the model. The IASB tentatively decided to require an entity to reclassify such goodwill-related regulatory assets to goodwill because:

(a) if such goodwill-related regulatory assets had not been recognised as part of the acquisition-date amounts of the identifiable assets acquired and the liabilities assumed, goodwill recognised would have been higher; and

(b) the outstanding balances of the goodwill-related regulatory assets are yet to be included in the rates charged to customers and consequently have not yet resulted in the recognition of revenue which makes it appropriate to reclassify them to goodwill.

19 This requirement would apply only to outstanding balances of goodwill-related regulatory assets as of the date of initial application of the model and any amounts that have already been derecognised in accordance with previous GAAP would not be reclassified.

20 The drawback of this approach is that once such outstanding goodwill-related regulatory assets are reclassified to goodwill, they will not be derecognised in line with their inclusion in the rates charged to customers. However, the requirements of IAS 36 to some extent could capture an impairment loss in the cash-generating unit to which the goodwill-related regulatory asset has been allocated, if not offset by other items in the cash-generating unit.

21 Nevertheless, this approach would result in outcomes consistent with the outcomes for business combinations that occur after the transition to the model. Any amounts relating to goodwill that are permitted by the regulator to be included in the rates charged to customers will be subsumed in goodwill by the acquirer.

Feedback from EFRAG RRAWG

22 EFRAG RRAWG members were supportive of the transition requirements for the accounting model for defined rate regulation. Suggestion was made to apply a kind of modified retrospective approach from the first day of the first comparative period presented.

23 With respect to the permitted choice to apply the model retrospectively to past business combinations, a view was expressed that entities with significant business combinations will have very different numbers from other entities.

Questions for EFRAG TEG

24 Do EFRAG TEG members agree that entities that currently apply IFRS Standards should apply the retrospective approach on transition to the model in accordance with the requirements in IAS 8? If not, please explain why.

25 Do EFRAG TEG members agree that an entity that currently applies IFRS Standards should be permitted to elect not to apply the model retrospectively to past business combinations as reflected in paragraph 4? Do you agree that any resulting change should adjust the carrying amount of goodwill?

26 Do EFRAG TEG member agree with the IASB tentative decision to retain the deemed cost exemption for first-time adopters in paragraph D8B of IFRS 1, which permits entities to use the previous carrying amount of regulatory balances as their deemed cost? If you disagree, please explain.

27 Do EFRAG TEG members agree with transition requirements for the goodwill-related regulatory assets in the model as described in paragraphs 16 - 21?