

## **Recognition and derecognition of regulatory assets and regulatory liabilities (including regulatory boundary)**

### **Issues paper**

#### **Purpose of this paper**

- 1 The purpose of this paper is to seek preliminary views from EFRAG TEG members on the IASB's tentative decision on:
  - (a) recognition and derecognition of regulatory assets and regulatory liabilities; and
  - (b) assessing the boundary of the regulatory agreement.

#### **Recognition and derecognition principle**

##### *Recognition*

- 2 In [March 2018](#), the IASB tentatively decided that the accounting model for regulatory assets and regulatory liabilities (the model) would:
  - (a) require that regulatory assets and regulatory liabilities are recognised if **it is more likely than not that they exist** (ie the model sets a symmetrical recognition threshold for regulatory assets and regulatory liabilities in cases of existence uncertainty); and
  - (b) if there is a low probability of an inflow or outflow or high measurement uncertainty, such probability and measurement uncertainty is considered in the measurement.
- 3 The model **establishes a threshold only for existence uncertainty**; all other uncertainties are reflected in the measurement. In reaching this tentative decision, the IASB considered the guidance in the *Conceptual Framework*, what is meant by existence uncertainty and the probability of cash flows and measurement uncertainty.
- 4 Appendix 1 provides a simple example of the recognition of a regulatory asset and a regulatory liability.

##### *Derecognition*

- 5 The model requires that when an entity recovers part or all of a regulatory asset by adding the related amount to the rate(s) charged to customers, or fulfils part of all of a regulatory liability by deducting the related amounts from the rate(s), the entity derecognises that part of the regulatory asset (liability) and recognises a corresponding regulatory income or regulatory expense.
- 6 The model would measure regulatory assets and regulatory liabilities at a current measurement basis (referred to as adjusted historical cost). This measurement requires the estimated cash flows (outflows) arising from the regulatory asset (liability) to be updated at each reporting date (refer to agenda paper 08-04). Such changes are treated as changes in estimates and are adjusted prospectively. It follows that if the revised cash flows (outflows) are zero, the underlying regulatory asset (liability) would be derecognised.

*Feedback from EFRAG Rate-regulated Working Group (RRAWG)*

- 7 EFRAG RRAWG members supported the recognition and derecognition principles and agreed with the IASB's rationale that recognition of regulatory rights and obligations will enhance the way performance for activities within the scope of the model will be reflected in the entity's profit or loss, and also provide a more faithful reflection of the entity's rights and obligations stemming from defined-rate regulation.

**Question to EFRAG TEG members**

- 8 Do you agree with the recognition principle in paragraphs 2 and 3, and the derecognition principle in paragraphs 5 and 6?

**Regulatory agreement boundary**

- 9 Some IASB members asked whether, and if so how, an entity should account for regulatory assets that would be recovered (or regulatory liabilities that would be fulfilled) through the rates charged to customers over a period beyond the current term of the regulatory agreement (i.e. outside the boundary of the agreement).

*IASB discussion in July 2019*

- 10 To respond to the request in paragraph 9, in [July 2019](#), the IASB discussed the regulatory agreement boundary.
- 11 The IASB staff noted that in situations where the regulatory agreement is set to expire and must be renewed in the near term, or the regulatory agreement can be terminated by one party giving notice, the definitions of assets and liabilities as well as the recognition principles from the *Conceptual Framework* would help determine whether the regulated entity has a present, enforceable right or obligation and, as a result, whether it should recognise a regulatory asset or regulatory liability.
- 12 The IASB staff concluded that when determining the boundary of a regulatory agreement:
- (a) An entity would need to consider not only the legal form, but also the economic substance of the terms of the regulatory agreement, in determining the period for which the agreement is binding and thus gives rise to enforceable rights or obligations which would result in the recognition of regulatory assets or regulatory liabilities (the 'regulatory agreement boundary').
  - (b) If items are due to be recovered or fulfilled outside of the regulatory agreement boundary, then they are not enforceable and thus would not be recognised as regulatory assets or regulatory liabilities.
  - (c) An entity would also consider factors such as:
    - (i) the existing term of the regulatory agreement;
    - (ii) the presence of any renewal or cancellation options;
    - (iii) clarity and ease with which the process for invoking the renewal or cancellation options could be exercised;
    - (iv) penalties or make-whole clauses payable upon exercise of a cancellation option; and
    - (v) other facts and circumstances specific to the arrangement which could impact the analysis (eg the presence of competition to provide the regulated goods or services and barriers to entry or exit).

- 13 The IASB staff concluded that if an entity considers that the supply of goods or services in the current period or a past period may ultimately lead to an adjustment to the regulated rate in a future period **beyond the boundary** of the regulatory agreement, **no regulatory asset or regulatory liability exists**.
- 14 Several IASB members were not convinced with the IASB staff reasoning and conclusion in paragraph 13. Some also thought that it was not clear whether the boundary affected the scope of the model or only affected recognition of rights and obligations. The IASB asked the staff to conduct further analysis on the issue.

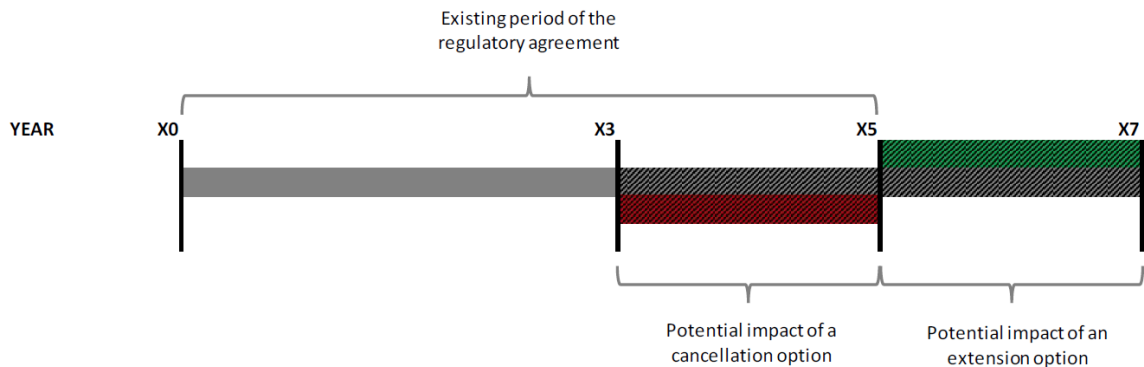
*IASB tentative decision in September 2019*

- 15 In [September 2019](#), the IASB reconsidered the regulatory agreement boundary . At this meeting, the IASB tentatively decided that when determining the regulatory agreement boundary, an entity **should consider all options** that could affect that boundary, but:
  - (a) should **disregard those options** that the holder will not have the practical ability to exercise in any circumstances; and
  - (b) should **not consider** the likelihood of exercise or either party's intentions in respect of any option.
- 16 In reaching its tentative decision, the IASB considered the guidance in other IFRS Standards that require an entity to determine the impact of renewal and extension options on the contract/agreement period. For example, IFRS 16 *Leases* provides application guidance to determine how extension options affect the period of the lease agreement. IFRS 15 *Revenue from Contracts with Customers* and IFRS 17 *Insurance Contracts* provide guidance to determine the contract period.
- 17 The IASB also acknowledged that the following was required to be in the scope of the model:
  - (a) the model applies to defined rate regulation established through a formal regulatory framework that is binding on both the entity and the regulator.
  - (b) the regulatory framework must establish a basis for setting the rate that gives rise to rights to add amounts to, and obligations to deduct amounts from, future rate(s) because of goods or services already supplied or because of amounts already charged to customers.
- 18 The IASB noted that in some cases the boundary of the regulatory agreement, particularly when the agreement is subject to options, either by the entity or the customer, or both, determining the boundary can be complex.

*Options impacting the boundary of the regulatory agreement*

- 19 Regulatory agreements may contain a variety of terms which could impact their boundary. Such terms include extension, renewal or cancellation clauses which can be exercised by the entity, the regulator or both (referred to as options).
- 20 Figure 1 (taken from the IASB [agenda paper 9A](#) discussed at the September 2019 IASB meeting) illustrates a situation where the outcome of this analysis could result in an entity determining any of years X3, X5 or X7 as the regulatory agreement boundary, depending on the terms of the regulatory agreement and the facts and circumstances.

Figure 1



- 21 Paragraph 4.61 of the *Conceptual Framework* states that terms that have no substance are disregarded. A term has no substance if it has no discernible effect on the economics of the contract. Terms that have no substance could include, for example:
- (a) terms that bind neither party; or
  - (b) rights, including options, that the holder will not have the practical ability to exercise in any circumstances
- 22 In the context of a discussion of whether an entity has an obligation, paragraph 4.34 of the *Conceptual Framework* discusses the factors used to assess whether an entity has a **practical ability** to avoid transferring an economic resource.
- 23 On this basis, the IASB tentatively decided that, **when determining the regulatory agreement boundary**, an entity should consider all options that could affect that boundary, but:
- (a) should disregard those options that the holder will not have the practical ability to exercise in any circumstances; and
  - (b) should not consider the likelihood of exercise or either party's intentions in respect of any option.

#### *Assessing the practical ability to exercise*

- 24 In assessing whether the party holding an option will have the practical ability to exercise the option, that party should consider all the terms of the regulatory agreement and other facts and circumstances, including the environment in which it operates.
- 25 The IASB discussed whether an entity should revisit the assessment of the effect of options at each reporting date because the passage of time, or other factors, may impact on whether either or both parties have the practical ability to exercise an option, or on the date at which they will have the practical ability to exercise that option. For example:
- (a) as a renewal date approaches, a regulator may not be able to replace a regulated entity without significant adverse economic consequences (eg significant costs and/or significant disruption to service), leading to the conclusion that the regulator no longer has the practical ability to exercise the option at this stage.
  - (b) if a regulatory agreement is subject to a rolling cancellation option that one or both parties has the practical ability to exercise after 18 months, the regulatory

agreement boundary will advance by 12 months at each annual reporting date.

- 26 Consider the following simple example.
- (a) An entity has a regulatory asset of CU 100 and can recover only in year 5. The regulatory agreement has a renewal option in year 4.
  - (b) A question that would arise at this point is which party holds this option—ie is it the entity, the regulator or both? For this analysis, we assume it is the regulator. The entity will need to assess whether the regulator has the practical ability to exercise the option to renew the agreement (ie whether the option is substantive). In this assessment the entity will not consider the likelihood that the regulator will, or will not, exercise the option.
  - (c) If in year 1, the entity assesses that the regulator has the practical ability to exercise the option to renew, it will consider that the cash flows from the regulatory asset falling in year 5 **are within the boundary of the regulatory agreement** (ie because the agreement can be renewed) and, consequently, would recognise CU 100. Instead of an option to renew in year 4, the regulatory agreement may have stipulated the regulator has an option to cancel the regulatory agreement (with immediate effect, assume) in year 4. The analysis would be similar to the above. In this case, if the entity assesses the regulator does not have the practical ability to exercise the option to cancel, it will consider the cash flows from the regulatory asset falling in year 5 as being within the boundary.
  - (d) Alternatively, if the regulator does not have the practical ability to exercise the renewal option (or has the practical ability to exercise a cancellation option in year 4 because it can easily replace the entity with another supplier), then the regulatory agreement boundary would be determined to be year 4 and the cash flows falling in year 5 would be **outside the regulatory agreement** boundary and the **entity would not recognise a regulatory asset in year 1**.

*Accounting once the regulatory agreement boundary has been determined*

- 27 Once the regulatory agreement boundary has been determined, an entity would apply the model to the rights and obligations which meet the definition of a regulatory asset or a regulatory liability—ie the present rights to add, or the present obligations to deduct, amounts from future rate(s) charged to customers up until the regulatory agreement boundary.
- 28 The recognition threshold ('more likely than not') would apply equally if it is uncertain whether an option exists or whether there are any circumstances in which the entity or a regulator has the practical ability to exercise it. Therefore, an entity would recognise a regulatory asset or regulatory liability only to the extent that it is more likely than not that it has an enforceable right or obligation to adjust the rate(s) charged to customers for the period in question.
- 29 An entity will **not have enforceable rights or obligations arising from the regulatory agreement beyond the regulatory agreement boundary**. Thus, amounts which might be added to, or deducted from, the future rates to be charged to customers beyond the regulatory agreement boundary do not arise from any regulatory asset or regulatory liability, and the resulting cash flows would not be included in the measurement of any regulatory asset or regulatory liability.
- 30 Therefore, if the recovery or fulfilment of an item through the rate(s) charged to customers spans the regulatory agreement boundary, the entity only has the enforceable right to add amounts to, or obligation or deduct amounts from, the

rate(s) up until the boundary, and thus only those amounts are incorporated into the measurement of a regulatory asset or regulatory liability.

#### Feedback from EFRAG RRAWG

- 31 Most (if not all) EFRAG RRAWG members had difficulties with understanding how in practice an entity would determine the boundary of a regulatory agreement and why it was important to make this assessment, given the nature of the regulatory environment to which the model would apply.
- 32 It was also not clear how to assess practical ability in the context of defined-rate regulation as this type of regulation operated within a wider regulatory framework that was also linked to EU law and the licence to operate. The IASB representative present at the EFRAG RRAWG meeting explained that the reference to 'practical ability' and 'ability to exercise', was based on guidance in the *Conceptual Framework*. The IASB representative agreed that it would be necessary to explain this in the application guidance of the forthcoming exposure draft.
- 33 One EFRAG RRAWG member questioned how the boundary would be determined in case both the entity had an option to renew (say in year 5) and the regulator had to option to cancel (say in year 3). In this case, which option would 'come first' in determining the boundary. The IASB representative thought that it would be the shorter period of 3 years that would determine the boundary.
- 34 EFRAG RRAWG members considered that the key problem was that the guidance was mixing the licence to operate (which was for a much longer period) and the regulatory agreement. The latter was subject to periodic reviews (and renewals); however, these reviews were used to assess whether changes to the rates charged to customers and recovery periods were needed. Such renewals did not imply that the regulatory agreement would come to an end and that no regulatory assets and regulatory liabilities would be recognised for periods outside the 'boundary'. If there are no regulatory assets and regulatory liabilities, this raised a key question about the future flows supporting assets such as PPE.
- 35 Another EFRAG RRAWG member noted that in some jurisdictions there might not be a regulatory agreement *per se* as the regulation stemmed from a broader regulatory framework under EU law. In these cases, it was not possible to link the boundary to the regulatory agreement.
- 36 Another member highlighted that in practice most defined-rate regulated entities would be recognising regulatory assets and regulatory liabilities beyond the renewal period set out in the regulatory agreement which had a different purpose to potential cancelation of the agreement and the right for the entity to continue to operate beyond that renewal period.

#### Questions to EFRAG TEG members

- 37 What are your views on the IASB tentative decision in paragraph 15 on the determination of the regulatory agreement boundary? What type of operational difficulties in determining the 'boundary' do you foresee?
- 38 At this stage, do you have any other comments on determining the regulatory agreement boundary?

#### Changes in the regulatory agreement boundary

- 39 In some cases, the boundary of a regulatory asset or regulatory liability changes, for example because of the passage of time, or because of the exercise (or non-exercise) of an option. As a result, some future cash flows previously outside the

boundary may now occur within the boundary. For example, suppose the following fact pattern:

- (a) In X1, Entity A supplied goods or services and the regulatory agreement will allow it to increase the amount charged to customers in X4 by CU100 as a result. However, the entity concludes at the end of X1 that **the boundary of the regulatory agreement is the end of X3**. As a result, the entity does not have a present right to include the CU100 in the future rate(s) charged to customers, and thus does not recognise a regulatory asset for this amount.
- (b) At the end of X2, the entity reassesses the boundary of the regulatory agreement to be the end of X4. Thus, the CU100 has now come within the boundary and the entity now has the present right to add the amount to the rates charged to customers in X4.
- (c) The question is whether and if so when the entity should account for the CU100.

40 At its meeting in September 2019, IASB discussed the accounting for changes in the boundary of the regulatory agreement and considered two potential alternatives for the accounting in X2 for the example in paragraph 39:

- (a) The **first alternative** would be not to recognise anything in X2 and to only disclose the change in circumstances on the basis the regulatory asset or regulatory liability originally arose in X1. That period has now passed and the economic impact of the regulatory agreement on the reported results for that period cannot be captured by recognising the regulatory asset or regulatory liability subsequently (in X2). In fact, subsequent recognition (in X2) may make it difficult for users of financial statements to understand the entity's financial performance in X2 because the entity would recognise in X2 regulatory income of CU100 relating to goods and services supplied in X1 and for which the revenue (of CU100) will be recognised in X4.
- (b) The **second alternative** would be to recognise the amounts now (in X2) – the period in which they fall within the boundary – on the basis that it provides a more understandable depiction of the entity's financial performance. Recognising a regulatory expense of CU100 in X4 would show that revenue of that amount in X4 arose because of goods or services supplied in a different period. Moreover, recognising the CU100 as a regulatory asset in X2 (and throughout X3) shows that the entity has an enforceable right to increase future rates with the aim of recovering that amount.

41 The IASB agreed with the IASB staff recommendation to support the second alternative.

42 The IASB also tentatively agreed that these rights and obligations should be **disclosed separately** from other sources of regulatory assets or regulatory liabilities; and, in the period of the change, the entity should:

- (a) recognise the rights and obligations that will generate cash flows within the reassessed boundary as regulatory assets and regulatory liabilities if they meet the model's recognition criteria;
- (b) disclose these regulatory assets and regulatory liabilities separately from other additions to regulatory assets or regulatory liabilities in:
  - (i) the breakdown of regulatory income or regulatory expense for the period; or
  - (ii) the reconciliation of the carrying amounts of regulatory assets and regulatory liabilities from the beginning to the end of the period; and

- (c) disclose the circumstances that led to the recognition of such regulatory assets and regulatory liabilities, including the factors the entity considered in its reassessment of the boundary.

*Feedback from EFRAG RRAWG*

- 43 EFRAG RRAWG members generally agreed with the IASB's tentative decisions on how to account for changes to the boundary agreement and the required disclosure to explain the changes. However, they reiterated that their main concern was the guidance on the determination of the boundary agreement (discussed in paragraphs 31 - 36).

**Question to EFRAG TEG members**

- 44 What are your views on the IASB tentative decisions in paragraphs 41 and 42 ?



## Appendix 1 – Illustrative examples (extracted from the Rate-regulated Activities presentation discussed at the World Standard-setters Conference in September 2019)

### Example 1 – regulatory asset

#### Fact pattern

- 1 Entity C is subject to a regulatory agreement that includes a basis for setting the rate that allows it to include any variances between estimated and actual input costs incurred in the rate(s) charged to customers in the following year.
- 2 Entity C incurred actual input costs of CU1,100 during year X0, but was only compensated for estimated input costs of CU1,000 through the rate(s) charged to customers in X0. Entity C has the present right to increase rate(s) in X1 to recover the variance of CU100.

#### Applying of the model

- 3 For the year X0, the total allowed compensation for services already supplied (CU1,100) exceeds the amount already charged to customers (CU1,000).
- 4 As a result, Entity C **recognises a regulatory asset** reflecting its present right to add the amount of the variance (CU100) in the rate(s) to be charged to customers in year X1.

In CU	X0	X1	Total
<b>Statement of financial performance</b>			
Revenue	1,000	100	1,100
Regulatory income (expense)	100	(100)	-
Operating expenses	(1,100)	-	(1,100)
<b>Profit / (loss)</b>	-	-	-
<b>Statement of financial position</b>			
<b>Regulatory asset</b>	<b>100</b>	-	-

### Example 2 – regulatory liability

#### Fact pattern

- 5 Entity D is bound by a regulatory agreement for the provision of water services to customers. The regulator requires Entity D to upgrade a network of water pipelines during years X1–X2 that will require an investment of CU1,000. The upgraded network will be used for the supply of services from the start of year X3 and will have a useful life of 10 years.
- 6 To support the cash flow requirements for the upgrade, the regulator allows Entity D to charge a higher rate to customers in year X1 which provides incremental cash flows of CU500. As a result, Entity D has an obligation to deduct CU500 from the future rate(s).

#### Applying of the model

- 7 In year X0, the total allowed compensation for the water services supplied in the period using the upgraded network (ie nil because the upgraded network has not

yet been placed into service) is lower than the amounts already charged to customers (CU500).

- 8 As a result, Entity D **recognises a regulatory liability** reflecting its present obligation to deduct the pre-funded CU500 in the rate(s) to be charged to customers in years X3–X12.

In CU	X1	X2	X3	X4-X11	X12	Total
<i>Statement of financial performance</i>						
Revenue	500	-	50	...	50	1,000
Regulatory income / (expense)	(500)	-	50	...	50	-
Operating expenses (depreciation)	-	-	(100)	...	(100)	(1,000)
<b>Profit / (loss)</b>	-	-	-	...	-	-
<i>Statement of financial position</i>						
<b>Regulatory liability</b>	<b>500</b>	<b>500</b>	<b>450</b>	...	-	-
<b>PPE (upgraded network)</b>	-	<b>1,000</b>	<b>900</b>	...	-	-