Regulatory Assets and Regulatory Liabilities Cover Note

Objective

1 The Exposure Draft *Regulatory Assets and Regulatory Liabilities* ('ED') is expected to be published in January 2021 with a comment period of 150 days. The ED will set out the proposed accounting requirements for regulatory assets and regulatory liabilities (referred to as the proposed model).

2 The objective of the session is to ask EFRAG TEG-CFSS members

(a) how EFRAG TEG-CFSS members could help with EFRAG early-stage analysis outreach activities;

(b) what sort of outreach activities the IASB should undertake once it publishes the ED;

(c) how EFRAG TEG-CFSS members could help with the IASB's outreach activities; and

(d) how the IASB could support ASAF members outreach activities.

Agenda Papers

3 In addition to this cover note, agenda paper 05-02 – *ASAF presentation of Regulatory Assets and Regulatory Liabilities* – has been provided as background information.

Background

EFRAG's outreach activities

4 EFRAG is conducting its own outreach activities as input to an early-stage effects analysis that aims to identify the potential impact, expected benefits and costs of the proposed model. EFRAG's outreach is targeted at users and preparers of financial statements.

5 A key objective of the early-stage effects analysis will be to assess the anticipated impact of the proposed model on financial statements for entities that have but are not currently recognising regulatory assets and regulatory liabilities in their financial statements.

6 The early-stage effects analysis is also assessing possible economic consequences such as the potential impact on decision making (e.g. capital allocation by users) and costs versus benefits of the model from both a preparer and user perspective.

7 On 28 October 2020, EFRAG launched a news item which included a survey seeking input from users of financial statements with a comment period ending 7 December 2020. This outreach to specialist users that follow companies with rate-regulated activities, is to assess the usefulness and benefits of information on the

effects of rate-regulated activities on the performance, position and prospects of reporting entities. The aim is to ascertain users' information needs and whether the proposed accounting model meets their needs given that many IFRS reporting companies, other than those that applied IFRS 14 *Regulatory Deferral Balances*.[1]

8 On 10 November 2020, EFRAG launched a news item seeking input from preparers of financial statements with a comment period ending 18 December 2020. This outreach is aimed to gather the likely effects on financial statements, high-level assessment of possible implementation challenges, and anticipated costs and benefits.

9 Other outreach activities include outreach to EFRAG RRAWG and EFRAG CFSS with the main goal being to leverage their access to existing contacts within the industry.

Summary of proposals

10 The ASAF presentation (agenda paper 05-02) provides a summary of proposals for the upcoming ED which includes the sections discussed in the paragraphs below.

What is the problem?

11 A rate-regulated company supplies goods or services to customers at rates (prices) determined by a regulatory agreement. The amount of revenue recognised depends on those rates.

12 Rates for goods or services supplied in a period are set in such a way that part of the compensation for goods or services supplied in one period is included in the rates charged in a different period. This causes differences in timing.

13 These timing differences lead to mismatches between the recognition of revenue and expense or other income. This arises as expenses or other income are recognised in the period that the goods or services are supplied, whereas revenue may include compensation related to goods or services supplied in a different period (past or future) or exclude part of the compensation allowed for goods or services supplied in a particular period. Therefore, if the expenses (or other income) incurred and the revenue related to those expenses are not within the same period, unrecognised rights or obligations can occur and the entity's reported financial performance and financial position is incomplete.

How do the proposals solve the problem?

14 The ED proposes that an entity should provide information about regulatory income, regulatory expense, regulatory assets and regulatory liabilities which supplement the information that companies already provide by applying IFRS 15 *Revenue from Contracts with Customers* and other IFRS Standards. The ED proposes amongst other things to recognise the rights and obligations mentioned in paragraph 13 that may occur as a result of timing differences.

Which companies would be affected?

15 The proposals in the ED shall be applied to all an entity's regulatory assets and regulatory liabilities.

16 Regulatory assets and regulatory liabilities can only exist if:

(a) There is an enforceable regulatory agreement;

[1] IFRS 14 permits an entity which is a first-time adopter of IFRS Standards to continue to account, with some limited changes, for 'regulatory deferral account balances' in accordance with its previous GAAP, both on initial adoption of IFRS and in subsequent financial statements. IFRS 14 was originally issued in January 2014 and applied to an entity's first annual IFRS financial statements for a period beginning on or after 1 January 2016.

(b) The regulatory agreement determines the regulatory rate and when it will be charged to customers; and

(c) Part of the compensation for goods or services supplied in one period is charged to customers in a different period (part or future) period.

17 In contrast to regulatory agreements which create regulatory assets or regulatory liabilities, another mechanism of rate regulation is also market regulation (for example regulation that caps prices but does not create enforceable rights and enforceable obligations). For market regulation:

(a) There are no rights to add amounts to future rates because of goods or services already supplied; and

(b) There are no obligations to deduct amounts from future rates because of compensation already charged.

18 The EFRAG Secretariat understands that the forthcoming ED is not intended to apply to self-regulation.

19 The ED will not impact all entities within its scope in the same way. The impact will be varied and the impact thereof depends as follows:

(a) Significant impact for entities that currently do not recognise regulatory balances and where regulatory requirements are not closely aligned to accounting requirements; and

(b) Minimal impact for entities that currently recognise regulatory balances and where regulatory requirements are closely aligned to accounting requirements.

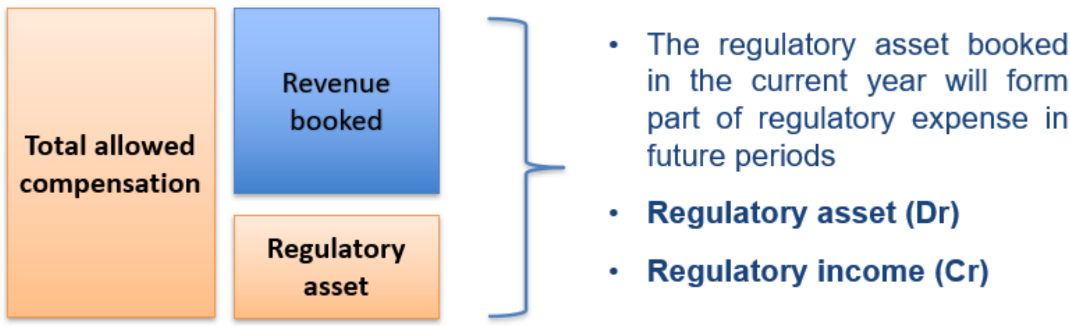
Summary of the model

20 A summary of the model can be found on slide 14 of paper 05-02.

Definitions of a regulatory asset and regulatory liability

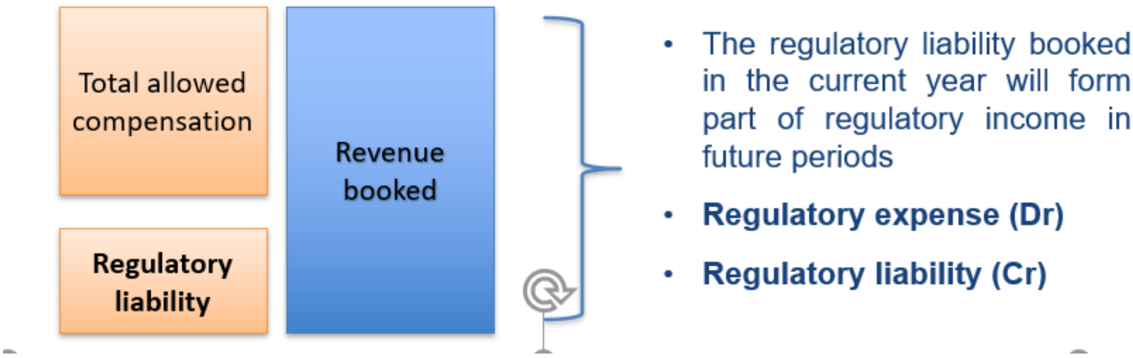
Regulatory asset

21 An **enforceable present right**, created by a regulatory agreement, to **add an amount** in determining a regulated rate to be charged to customers in future periods because part of the total allowed compensation for goods or services already supplied will be included in **revenue in the future**.



Regulatory liability

22 An **enforceable present obligation**, created by a regulatory agreement, **to deduct an amount** in determining a regulated rate to be charged to customers in future periods because the revenue already recognised includes an amount that will provide part of the total allowed compensation for goods or services to be supplied in **the future**.



Total allowed compensation

23 The amount that an entity is entitled to charge customers, in the same or a different period, in exchange for the goods or services supplied in a specified period, in accordance with the regulatory agreement.

24 Therefore, total allowed compensation consists of the following components which affects profit or loss at these time intervals:

(a) *Allowable expenses less income* – When expenses and income are incurred and the recognition requirements of IFRS have been applied.

(b) *Performance incentives* – In the period in which the entities' performance occurs.

(c) *Regulatory returns* - When the regulatory agreement entitles the entity to add it in determining the regulatory rate.

(d) *Regulatory interest income/(expense)* – As the discount unwinds until recovery of the regulated asset or the fulfilment of the regulatory liability.

Recognition

25 The model will require an entity to recognise all regulatory assets and all regulatory liabilities that meet the definition of a regulatory asset or regulatory liability and the corresponding regulatory income and regulatory expense.

26 If uncertain of whether a regulatory asset or a regulatory liability exists, an entity shall recognise the regulatory asset or regulatory liability if it is more likely than not that it exists.

Measurement

27 Under the general measurement principle of the model: all regulatory assets and regulatory liabilities, except those covered in the following paragraph, are measured using a cash-flow-based measurement technique that measures regulatory assets and regulatory liabilities at historical cost, modified for subsequent changes in the estimates. This is done by:

(a) estimating future cash flows arising from the regulatory assets or regulatory liabilities, including the cash flows relating to the regulatory interest or return; and

(b) 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.

28 An exception to the general measurement principle exist in cases where 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).

Presentation

29 Regulatory assets and regulatory liabilities are presented as a separate and single item (subject to the offsetting and normal current and non -current classification requirements).

Disclosure

30 The disclosure objective is to disclose information about regulatory income, regulatory expense, regulatory assets and regulatory liabilities to provide users with a basis for understanding of:

(a) the relationship between an entities' revenue and expenses to provide insights into the entities' prospects for future cash flows; and

(b) the entities' regulatory assets and regulatory liabilities to provide insights into how regulatory assets and regulatory liabilities will affect the amount, timing and uncertainty of the entities' future cash flows.

Questions for EFRAG TEG-CFSS

31 How can EFRAG TEG-CFSS members help with EFRAG's outreach activities as mentioned in paragraphs 4 to 9?

32 What sort of outreach activities should the IASB undertake?

33 How can EFRAG TEG-CFSS members help with the IASB's outreach activities?

34 How do you think the IASB can support ASAF members, including EFRAG's, outreach activities?