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Regulatory Assets and Regulatory Liabilities IFRS 3 Exception Issues Paper

Objective

1 The IASB Exposure Draft *Regulatory Assets and Regulatory Liabilities* proposes that, as an exception to the recognition and measurement principles in IFRS 3 *Business Combinations*, an entity should recognise and measure regulatory assets acquired and regulatory liabilities assumed in a business combination applying the recognition and measurement principles proposed in the ED (modified historical cost), rather than recognise and measure them at fair value.

2 The objective of this paper is to present for discussion, the IFRS 3 exception, where EFRAG did not come to a conclusive position in its draft comment letter (‘the DCL’). The aim of the session is to further evaluate IASB’s reasoning for the IFRS 3 exception requirements and discuss any practical application issues that need to be considered, and thereafter, get to a consensus between the EFRAG RRAWG and EFRAG TEG members in developing a position for EFRAG’s final comment letter.

EFRAG DCL analysis of IFRS 3 exception

3 The paragraphs below provide a summary of EFRAG’s response to the proposal on the IFRS 3 exception (part of Question 11 of the ED).

4 EFRAG seeks stakeholders’ views on the IASB decision to provide an exception to the recognition and measurement principles in IFRS 3 and permit an entity to recognise and measure regulatory assets acquired and regulatory liabilities assumed in a business combination applying the recognition and measurement principles proposed in the model (modified historical cost instead of fair value at the acquisition date as required under IFRS 3).

5 EFRAG acknowledges the IASB’s arguments that measuring regulatory assets and liabilities at fair value at the date of acquisition and subsequently remeasuring them by applying the measurement principles of the model, could result in the recognition of subsequent period gains or losses that do not represent any economic event but simply reflect the change of one measurement basis to another. EFRAG also notes that, as highlighted in paragraph BC 260, IFRS 3 has a different recognition threshold than that of the proposed Standard (more likely than not) and, as such, may fail to recognise some acquired regulatory assets (or liabilities). There could also be significant costs associated with discounting as noted in paragraph BC 260.

6 However, EFRAG also notes that measuring the acquired regulatory assets and liabilities at fair value could be seen as conceptually consistent with other IFRS Standards and provide relevant information for users. The subsequent measurement (day two gain or loss) could be avoided by discounting the future cash flows for the acquired regulatory assets and liabilities at an adjusted regulatory rate, similar to the approach used for measuring a loan banking book acquired at fair value and discounted at an adjusted discount rate similar to the effective yield to arrive at the subsequent amortised cost measurement in accordance with IFRS 9.

7 The results of the early-stage effects analysis also showed that many preparers considered that exempting acquired regulatory assets and regulatory liabilities from the scope of IFRS 3 will have unintended consequences. To further assess these unintended consequences, EFRAG recommends that the IASB should further assess the interaction between IFRS requirements for assets, like property plant and equipment measured at fair value, as part of IFRS 3, and the recognition and measurement of regulatory assets and liabilities.

Developing an EFRAG position - points for further consideration by EFRAG RRAWG and EFRAG TEG

Recognition of acquired regulatory assets and assumed regulatory liabilities

8 As highlighted in the summary in paragraphs 31 to 41 below, EFRAG RRAWG and EFRAG TEG discussions while developing the DCL mainly focused on subsequent measurement considerations and less so on the implications of different recognition thresholds between IFRS 3 and the proposed Standard. In this regard, EFRAG Secretariat points to paragraph BC 260 (a), which notes that without the IFRS 3 exception, an entity might not recognise regulatory assets acquired, or regulatory liabilities assumed, in a business combination if it is uncertain that they exist. In contrast, applying the proposals in the ED, an entity would recognise regulatory assets or regulatory liabilities if it is 'more likely than not' that they exist. In other words, if IFRS 3 requirements were applied, there may be a need to derecognise some regulatory assets and regulatory liabilities.

Operational constraints and costs

9 Paragraph BC 260-b points to operational constraints and costs associated with the determination of fair value under IFRS 3 requirements. An entity would incur significant costs in:

(a) Determining the discount rate needed to measure regulatory assets and regulatory liabilities at fair value. The entity might incur significant costs because regulatory assets and regulatory liabilities are not traded in active markets and there are generally few observable inputs that could be used in determining the appropriate discount rate- one that market participants would use when pricing those assets and liabilities.

(b) Tracking separately regulatory assets acquired or regulatory liabilities assumed in a business combination at a discount rate that is not explicit in the regulatory agreement.

(c) Determining the discount rate to use subsequently if the regulatory agreement changes the applicable regulatory interest rate.

Subsequent measurement implications

10 In addition to subsequent measurement implications highlighted in the June 2019 IASB meeting (paragraphs 25 and 26 below), what would be the practical implications of having two tiers of measurement for regulatory assets and regulatory liabilities?

Consistent view on interaction with other IFRS Standards

11 EFRAG agreed with the IASB tentative decision to exclude the regulatory assets from the scope of the measurement requirements of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* and to measure them at modified historical cost instead of fair value. EFRAG considers that this approach removes the complexity of determining a discount rate to be used for the fair value measurement. Hence, a question arises whether EFRAG can respectively have differing positions towards the IFRS 3 exception and exclusion of regulatory assets and regulatory liabilities from the scope of measurement of IFRS 5.

Consistent accounting of measurement exception items

12 EFRAG agreed with the measurement exception for items that are reflected in or deducted from rates at or near the period cash is received or paid for these items. These items are measured using the same measurement basis applied for the related asset or related liability. In paragraph BC 261, the IASB concluded that the proposed exception would provide a simple and understandable outcome for these regulatory assets and regulatory liabilities and allow consistent accounting in their subsequent measurement.

Background - Summary of the IASB discussions on the IFRS 3 exception

13 The summary of past IASB meetings below where the IFRS 3 exception was discussed, highlights and help to contextualise the reasoning underpinning the ED's proposed requirements.

November 2018 IASB Meeting

14 The IASB first discussed the interaction of the proposed accounting model with other IFRS Standards in November 2018. The starting point was that Paragraph B18 of IFRS 14 *Regulatory Deferral Balances* contains an exception to the general recognition and measurement principles of IFRS 3 for the regulatory deferral account balances using IFRS 14.

15 At the November 2018 meeting, IASB staff presented a paper (IASB Staff Paper 9B) recommending that the accounting model for regulatory assets and regulatory liabilities should not retain the exception to the requirement of IFRS 3 under IFRS 14. At the time, the IASB staff gave the following reasons for their proposal:

(a) the unit of account - the timing difference was also applicable for IFRS 3;

(b) terms and conditions of regulatory agreement –the IASB Staff expected the fair value of the asset to reflect the regulatory terms and conditions, including the rate of return within the regulatory agreement.

(c) Regulatory assets acquired and regulatory liabilities assumed in a business combination –the IASB Staff concluded that at the acquisition date, the fair value of a regulatory timing difference would approximate the carrying amount determined by using the cash-flow based measurement technique of the proposed accounting model. At the time, they assumed the regulatory rate would also cater for the risks and uncertainties of the market and, hence, would be approximately the same as the market rate.

16 However, the Board sought further analysis on the interaction and raised two questions for the IASB staff to consider in subsequent meetings:

(a) Would the fair value of regulatory assets or regulatory liabilities generally approximate their pre-acquisition carrying values? If so, would the costs of applying IFRS 3 outweigh the benefits?

(b) If initially measured at fair value under IFRS 3, would subsequent adjustments result when the entity reverts to applying the recognition and measurement principles prescribed by the model?

17 The July 2019 IASB meeting further evaluated the interaction and addressed the Board's questions outlined in paragraph 16-a above.

July 2019 IASB Meeting

18 The IASB staff presented the results of its analysis in July 2019 (Staff Paper 9A) covering the interaction of the model measurement principles, which have been substantially finalised by that time, with IFRS 3 as well as subsequent measurement.

19 In assessing the question of whether the fair value of regulatory assets or regulatory liabilities generally approximate their pre-acquisition carrying values, the IASB staff considered the measurement of fair value based on IFRS 13 *Fair Value Measurement* requirements (Paragraphs 61-66), where three widely-used valuation techniques are identified: the market approach, the cost approach and the income approach.

20 The IASB staff analysis was that the income approach would be employed in most situations to measure the fair value of regulatory assets and regulatory liabilities. This observation was premised on the following:

(a) Regulatory assets and regulatory liabilities do not trade in active markets and there are a few unobservable inputs that could be incorporated into an estimate of their fair value. Furthermore, an acquirer would typically not consider or pay for regulatory assets or regulatory liabilities in isolation. Accordingly, the market approach would generally not be applicable in determining the fair value of regulatory assets or regulatory liabilities.

(b) Cost approach will generally not be applicable as a market participant would not be able to acquire or construct an asset similar to a regulatory asset.

21 The IASB staff then analysed whether measurement based on the proposed accounting model's measurement requirements of modified historical cost by applying a cash flow-based measurement technique differed from a fair value measurement based on the income approach. The IASB staff analysis is outlined in the below paragraphs.

The proposed accounting model vs IFRS 3 requirements

22 The IASB staff concluded that although the estimated cash flows would be the same under the proposed accounting model and fair value measurement, the discount rate applied under the model (in most cases the rate provided by the regulatory agreement) could be different from the rate that a market participant would demand to compensate for the time value of money, the uncertainty inherent in the cash flows and any other factors.

23 Therefore, the resulting measurement outcome would be different. The IASB Staff prepared the below example 1, to illustrate such situations where the fair value of the regulatory asset differs from the pre-acquisition carrying value due to differences in the discount rate applied. An application of 5% for regulatory interest rate versus 3% for market rate results in a fair value of 109.2 versus a carrying value of pre-acquisition carrying value of 100.

Example 1

Entity S is subject to defined rate regulation and applies the accounting model for regulatory assets and regulatory liabilities. It has one regulatory asset with a carrying amount of CU100 at the end of X0. The amount of CU100 is due to be included in the rates charged to customers in Year X5. The regulatory agreement provides a rate of return of 5% on this item and permits the return to be included in the rates charged to customers each year as it accrues. The next rate review under the regulatory agreement is scheduled for Year X2. There are no indications that the 5% rate is inadequate (or provides excess compensation or excess charge for an identifiable transaction or event), and as a result, the entity uses this rate as the discount rate in its measurement of the regulatory asset:

Regulatory asset		X0	X1	X2	X3	X4	X5	Total
Opening balance			100.0	100.0	100.0	100.0	100.0	-
Return at:	5%	-	5.0	5.0	5.0	5.0	5.0	25.0
Recovery through the rate(s)		-	(5.0)	(5.0)	(5.0)	(5.0)	(105.0)	(125.0)
Closing balance		100.0	100.0	100.0	100.0	100.0	-	-

Entity S is acquired by Entity P at the end of X0. Entity P applies the fair value measurement principle of IFRS 3 in accounting for the acquisition of Entity S's regulatory asset. Assume that Entity P arrives at the same estimate of the future cash flows to be received from the regulatory asset as Entity S did prior to the acquisition. However, Entity P determines that a market participant would demand a discount rate of only 3% to compensate it for the time value of money, uncertainties inherent in the cash flows and other market factors at the measurement (acquisition) date, and thus utilises this rate to determine the initial measurement of the regulatory asset, resulting in a fair value of CU109.2 as illustrated as below:

Regulatory asset		X0	X1	X2	X3	X4	X5	Total
Opening balance			109.2	107.4	105.7	103.8	101.9	-
Return at:	3%	-	3.3	3.2	3.2	3.1	3.1	15.8
Recovery through the rate(s)		-	(5.0)	(5.0)	(5.0)	(5.0)	(105.0)	(125.0)
Closing balance		109.2	107.4	105.7	103.8	101.9	(0.0)	-

A comparison of the impact on the statement of profit and loss pre- and post-acquisition is as follows:

	X0	X1	X2	X3	X4	X5	Total
Pre-acquisition							
Forecast regulatory income/(expense)		-	-	-	-	(100.0)	(100.0)
Post-acquisition							-
Forecast regulatory income/(expense)		(1.7)	(1.8)	(1.8)	(1.9)	(101.9)	(109.2)
Difference	-	**(1.7)**	**(1.8)**	**(1.8)**	**(1.9)**	**(1.9)**	**(9.2)**

The higher regulatory expense recognised by Entity P in the post-acquisition accounting effectively represents the reduced return that Entity P earns as a result of paying a higher amount (CU109) to acquire the regulatory asset. As a result, Entity P effectively does not report a return of its investment as though it were income (ie as it would have had it not recognised the increase to the value of the regulatory asset).

24 While acknowledging that fair value at acquisition versus pre-acquisition carrying value differences can result as shown in the above example, the IASB Staff also took into account the costs associated with estimating the fair value of regulatory assets or regulatory liabilities acquired, such as:

(a) challenges in determining an appropriate market discount rate;

(b) the need to separately track regulatory assets and regulatory liabilities measured initially at these market discount rates, which are not specified by the regulatory agreement; and

(c) the potential issues caused for subsequent measurement of these items (discussed below).

Thus, the IASB staff concluded that the costs would outweigh the benefits resulting from the application of IFRS 3 requirements.

Subsequent measurement

25 The IASB noted that if an acquirer were required to recognise regulatory assets and regulatory liabilities initially at fair value in accordance with IFRS 3, but thereafter is required to revert to applying the model's measurement principles, this could result in the recognition of subsequent gains or losses that do not depict any economic event but simply reflect a movement from one measurement basis to another.

26 The subsequent measurement differences could arise when:

(a) applying 'most likely amount' method of the model compared to 'more likely than not' principle in IFRS 3; and

(b) an entity at the same time updates the estimates of future cash flows together with a regulatory discount rate which is illustrated in Example 2 below:

Example 2

Assume the same fact pattern as Example 1.

Subsequent to initial recognition Entity P applies the requirements of the accounting model for regulatory assets and regulatory liabilities. At the time of the rate review at the end of Year X2, the regulatory agreement changes the applicable rate of return (for the category of item to which the regulatory asset belongs) to 4%. Because the regulatory agreement has changed the future cash flows by changing the interest rate or return rate, Entity P updates those cash flows and also updates the applicable discount rate in its measurement of the regulatory asset in accordance with the requirements of the model. This results in the following outcome:

Regulatory asset	X0	X1	X2	X3	X4	X5	Total
Opening balance		-	-	**105.7**	-	-	-
Loss	-	-	-	**(5.7)**	-	-	-
Revised opening balance	-	-	-	**100.0**	**100.0**	**100.0**	-
Return at: 4%	-	-	-	4.0	4.0	4.0	12.0
Recovery through the rate(s)	-	-	-	(4.0)	(4.0)	(104.0)	(112.0)
Closing balance	-	-	-	**100.0**	**100.0**	-	-

In contrast, no loss would have been recognised had there been no business combination (ie the closing balance and revised carrying amount upon the rate review at the end of Year 2 in Entity S would have both been CU100).

Staff believe that this example illustrates how an exception to the measurement principle of IFRS 3 avoids the reporting of a loss that arises solely from a change in measurement basis.

27 The IASB also analysed the existing exceptions from the measurement and recognition principles of IFRS 3, such as for IAS 12 *Income Taxes* and IAS 19 *Employee Benefits*, avoiding the recognition of post-combination gains or losses by using the measurement and recognition principles of these standards, and decided that it would be consistent to provide the same exception for the model.

28 The IASB also considered an exception for items included in/deducted from the future rates when cash is paid/received, required under the proposed model.

29 The IASB concluded that providing the exception to IFRS 3 would allow consistent recognition and measurement of regulatory assets and liabilities. Given the exception contained in the model for the measurement of such regulatory assets and liabilities, the IASB concluded that to achieve consistency in their subsequent measurement, an exception to the recognition and measurement principles of IFRS 3 would be required for these items.

30 However, if a broader exception to the recognition and measurement principles of IFRS 3 was provided for all regulatory assets and liabilities, this would encompass this category of items as well, and a separate exception would not be required solely for these items.

31 Based on the above considerations, the IASB decided that as an exception to the recognition and measurement principles of IFRS 3, an entity should recognise and measure a regulatory asset acquired or regulatory liability assumed in a business combination in accordance with the measurement principles in the accounting model for regulatory assets and regulatory liabilities.

32 In its deliberations, the IASB did not discuss booking the valuation differences between fair value and modified historical cost to goodwill if the IFRS 3 exception was not provided.

Summary of EFRAG RRAWG and EFRAG TEG discussions on IFRS 3 exception

33 EFRAG discussed this issue with EFRAG RRAWG in October 2019 and June 2020 and with EFRAG TEG in September 2020 and March 2021.

34 EFRAG RRAWG members agreed with the proposed exception to the recognition and measurement principles of IFRS 3. However, they considered that interaction between measuring assets like PP&E at fair value as part of IFRS 3 and the recognition and measurement of regulatory assets and liabilities should be further explored. Members also noted that there might be issues with the treatment of and impact on goodwill.

35 EFRAG TEG members, however, expressed mixed views on whether the exception from the measurement and recognition principles of IFRS 3 should be retained.

36 During the March 2021 meeting, some EFRAG TEG members questioned the measurement exception proposed in amendments to IFRS 3 and suggested that fair value measurement of the acquired regulatory assets and liabilities would be preferable in order not to distort profit margins.

37 On the question of a discount rate used for subsequent measurement, members suggested that an approach similar to the valuation of an acquired loan banking book could be used where it was first measured at fair value and then discounted at an adjusted rate (effective yield) to arrive at subsequent amortised cost measurement.

38 EFRAG TEG members also doubted that attributing the valuation differences between fair value and modified amortised cost to goodwill would be a correct approach given that these balances relate to regulatory assets/liabilities with finite useful lives (usually quite short) whereas goodwill has a perpetual useful life.

39 EFRAG TEG members agreed that these valuation differences did not represent goodwill and it would be more appropriate to call them some sort of regulatory-related asset (not a regulatory asset as per the ED definition) that should subsequently be amortised.

40 One EFRAG TEG member noted that when users valued a business, they would like to see the fair value of acquired assets and the return which was consistent with the acquired net regulatory assets. Booking these valuation differences to goodwill, which was not amortised would, in his opinion, distort this return.

41 Another EFRAG TEG member agreed with the IASB proposals and initial EFRAG's response as it was important to avoid day one gains or losses and that EFRAG historically always supported this position. This member also noted that it would be difficult to establish the appropriate market rate for discounting.

42 EFRAG TEG also questioned the proposed treatment of goodwill-related regulatory balances. Members did not consider that these balances represented goodwill, but rather some sort of regulatory-related asset (not a regulatory asset as per the ED definition) that should be amortised.

43 Based on the discussions with working group members, it was decided that in its DCL EFRAG would seek stakeholder views on the proposed exception of acquired

regulatory assets (or liabilities) from the recognition and measurement requirements of IFRS 3. EFRAG should seek stakeholders' views on the recognition and fair value measurement at acquisition as required by IFRS 3 and by the application of an adjusted discount interest rate for discounting during subsequent measurement.

Feedback from the outreach activities

44 So far, EFRAG has not received any feedback from stakeholders on this issue. One stakeholder commented that it was not common to acquire the rate-regulated entities by acquisition in their jurisdiction.

Questions for EFRAG TEG-RRAWG

45 Based on the considerations outlined in paragraphs 8 to 12 (i.e., recognition considerations, cost of fair value measurement, consistency with EFRAG position on interaction with IFRS 5, and consistent accounting of measurement exception items), the cost considerations and subsequent measurement implications of fair value measurement highlighted in the June 2019 IASB meeting (paragraphs 18 to 32), which of the following options do EFRAG TEG-RRAWG members agree with:

(a) the proposed IFRS 3 exception for acquired regulatory assets and regulatory liabilities

(b) No exception with fair value measurement and subsequently discounting using adjusted regulatory interest rate, in a manner similar to the provisions of IFRS 9

46 Do EFRAG TEG-RRAWG members have any additional considerations to help arrive at an EFRAG position on this issue?