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IFRS Developments

IASB issues Exposure Draft on regulatory assets and regulatory liabilities

What you need to know

- The IASB proposes to issue a new standard to account for the effects of rate regulation.
- The proposals include new recognition, measurement, presentation and disclosure requirements of regulatory assets, regulatory liabilities, regulatory income and regulatory expense.
- Comments are due by 30 June 2021.

Highlights

On 28 January 2021, the International Accounting Standards Board (the IASB or Board) issued an Exposure Draft (ED) *Regulatory Assets and Regulatory Liabilities*. The ED sets out proposals for the recognition, measurement, presentation and disclosure of regulatory assets, regulatory liabilities, regulatory income and regulatory expense. When adopted, these proposals would replace IFRS 14 *Regulatory Deferral Accounts*.

Regulatory agreements are a contractual arrangement that determine the regulatory rate that an entity is able to charge its customers. In some cases, a difference in timing arises when the regulatory agreement administering the rate regulation specifies that some or all of the total allowed compensation for goods or services supplied in a period is charged to customers in a different (future or past) period. The [draft] Standard addresses this issue so that entities reflect the total allowed compensation for the period in which those goods or services are supplied and will remove the impact when rate regulation causes differences in timing to occur.

When an entity has an enforceable right to add an amount in determining the regulated rate in future periods, because part of the total allowed compensation for goods and services already supplied will be included in revenue in the future, it must recognise this as a regulatory asset.

Conversely, a regulatory liability exists when an entity has an enforceable present obligation to deduct an amount in determining the regulated rate 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.

The comment period will end on 30 June 2021.

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Key terms

Regulatory assets and regulatory liabilities

The ED defines a regulatory asset as "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 the total allowed compensation for goods or services already supplied will be included in revenue in the future".

The ED defines a regulatory liability as "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."

Regulatory agreement

The ED defines a regulatory agreement as "a set of enforceable rights and obligations that determine a regulated rate to be applied in contracts with customers".

Total allowed compensation

The ED defines total allowed compensation for goods or services supplied as "the full amount of compensation for those goods or services that a regulatory agreement entitles an entity to charge customers through the regulated rates, in either the period when the entity supplies those goods or services or a different period."

Key proposals

Scope

The ED proposes that an entity apply the [draft] Standard to all of its regulatory assets and regulatory liabilities. Regulatory assets and regulatory liabilities exist due to a regulatory agreement that determines the regulated rate in such a way that some or all of the total allowed compensation for goods or services supplied in one period is charged to customers in a different period.

The [draft] Standard would not apply to any other rights or obligations created by the regulatory agreement - an entity would continue to apply other IFRS Standards in accounting for the effects of these rights or obligations. For example, a contractual right to increase regulated rates in the future, say for the impact of inflation, is not a regulatory asset as the revenue relates to the period of performance and not to a future or past period.

How we see it

The scope of the guidance is not limited to any particular (regulated) industry, regulatory agreements with a particular legal form or only to those enforced by a regulator with particular attributes. All entities could therefore have activities that are in the scope of this [draft] Standard.

Recognition

The ED proposes that:

- An entity recognises all of its regulatory assets and regulatory liabilities existing at the end of the reporting period
- An entity recognises all of its regulatory income and expense arising during the reporting period

Furthermore, the proposal provides further guidance if the entity is uncertain about whether a regulatory asset or regulatory liability exists, by stating that it would recognise that regulatory asset or regulatory liability if it is 'more likely than not' that it exists.

As a principle, the ED requires entities to account for the right or obligation arising from each individual difference in timing as a separate unit of account. However a portfolio approach is permitted if this does not have a material effect on the outcome.

How we see it

Determining whether a regulatory asset or regulatory liability exists may require significant judgement and the collection of much information, including contractual documents, discussions with regulator(s), court rulings and/or information from other less straightforward sources.

Measurement

The ED proposes that an entity measures regulatory assets and regulatory liabilities at historical cost, modified by using updated estimates of future cash flows. An entity would implement that measurement basis by applying a cash-flow-based measurement technique. That technique would involve estimating future cash flows from a regulatory asset or liability, including future cash flows arising from regulatory interest.

The cash flows to be used in this estimate are those that result from adding amounts to, or deducting amounts from, a regulated rate when the entity has an enforceable, present right or obligation at the reporting date.

Entities will need to determine whether they or the customer bear any risk arising from uncertainty in the cash flows. Customers will bear the risk if the entity is able to pass on the effects of this uncertainty to the customers. In predicting this uncertainty, the "most likely amounts" and "expected value" methods are proposed as appropriate alternative methods.

The future cash flows should be discounted at the regulatory interest rate, unless the regulatory interest rate for a regulatory asset is insufficient. The [draft] Standard includes additional guidance to determine whether that rate is sufficient and what discount rate to use if it is insufficient. For a regulatory liability, an entity must always use the regulatory interest rate as the discount rate.

When the interest rate in a regulatory agreement varies throughout the life of the agreement, at initial recognition, the [draft] Standard requires an entity to "translate those uneven regulatory interest rates into a single discount rate that it shall use throughout the life of the regulatory asset or regulatory liability".

How we see it

The requirement to both initially estimate and update the estimated future cash flows at the end of each reporting period may have a significant impact on the systems, processes and procedures of entities that currently do not account for regulatory assets and liabilities.

Presentation

The ED proposes that an entity presents all regulatory income or regulatory expense as a separate line item immediately below revenue. It also proposes that regulatory income and regulatory expense include regulatory interest income and regulatory interest expense respectively.

In terms of the balance sheet, the ED proposes the presentation of line items for regulatory assets and regulatory liabilities. Where appropriate, these lines should be further bifurcated as current or non-current. It is also important to note that offsetting of regulatory assets and liabiities is permitted if they arise from the same regulatory agreement, the right to offset them is legally enforceable and the entity expects to include them in determining regulated rates in the same future period or periods.

How we see it

New presentation requirements are proposed that will affect the layout of the income statement and the statement of financial position. This may be an opportunity to reassess the structure of the financial statements to improve usefulness.

Disclosure

The ED states that the proposed "overall objective of the disclosure requirements is for an entity to disclose information about regulatory income and regulatory expense, and about regulatory assets and regulatory liabilities", that, together with all the other information provided in the financial statements, provides users of financial statements with a basis for:

(a) Understanding the "relationship between an entity's revenue and expenses as completely as would have been possible if the total allowed compensation had been fully reflected in revenue in the period in which the entity supplied those goods or services, and will provde insights into the entity's prospects for future cash flows"

(b) Understanding the "entity's regulatory assets and regulatory liabilities at the end of the reporting period" and assessing how they will "affect the amount, timing and uncertainty of the entity's future cash flows"

How we see it

Entities will need to consider the level of detail necessary to satisfy the overall disclosure objective. This may require dialogue with users to understand the specific information needs resulting from rate regulated activities.

Next Steps

Comments are due by 30 June 2021. We encourage stakeholders to provide feedback to the IASB on the proposed new standard.

How we see it

We support the Board's initiative to provide guidance on the accounting for regulatory assets and regulatory liabilities under IFRS, as we believe information about the financial effects of an entity's regulatory environment will be useful and relevant to users of financial statements in making their investment and lending decisions.

The current lack of guidance in IFRS Standards has led to diversity in practice, leading to the topic being discussed by the IASB and the IFRS Interpretations Committee on several occasions. How the effects of an entity's regulatory environment are reflected in its financial statements is a significant issue for IFRS preparers.

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ED None