

Rate-regulated activities

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- Introduction
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- *Conceptual Framework*
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 - What is ‘Defined rate regulation’?
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Rate-regulated Activities

Why we are doing the project

- Many stakeholders have told the Board that, for entities that are subject to some types of rate regulation,
 - current **predominant IFRS practice** does not reflect the economic substance of the rights and obligations created by the rate regulation; and
 - IFRS financial statements currently do not provide investors and lenders with sufficient **relevant information** needed to make investing and lending decisions.

Current predominant IFRS practice

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- Except for specified first-time adopters that apply IFRS 14 *Regulatory Deferral Accounts*, almost all entities:
 - eliminate ‘**regulatory deferral account balances**’ when adopting IFRS Standards; and
 - do not recognise such balances in IFRS financial statements; and
 - recognise revenue by using the regulated rate and the quantity of goods or services delivered to customers in the period (ie based on the entity’s contracts with its customers).

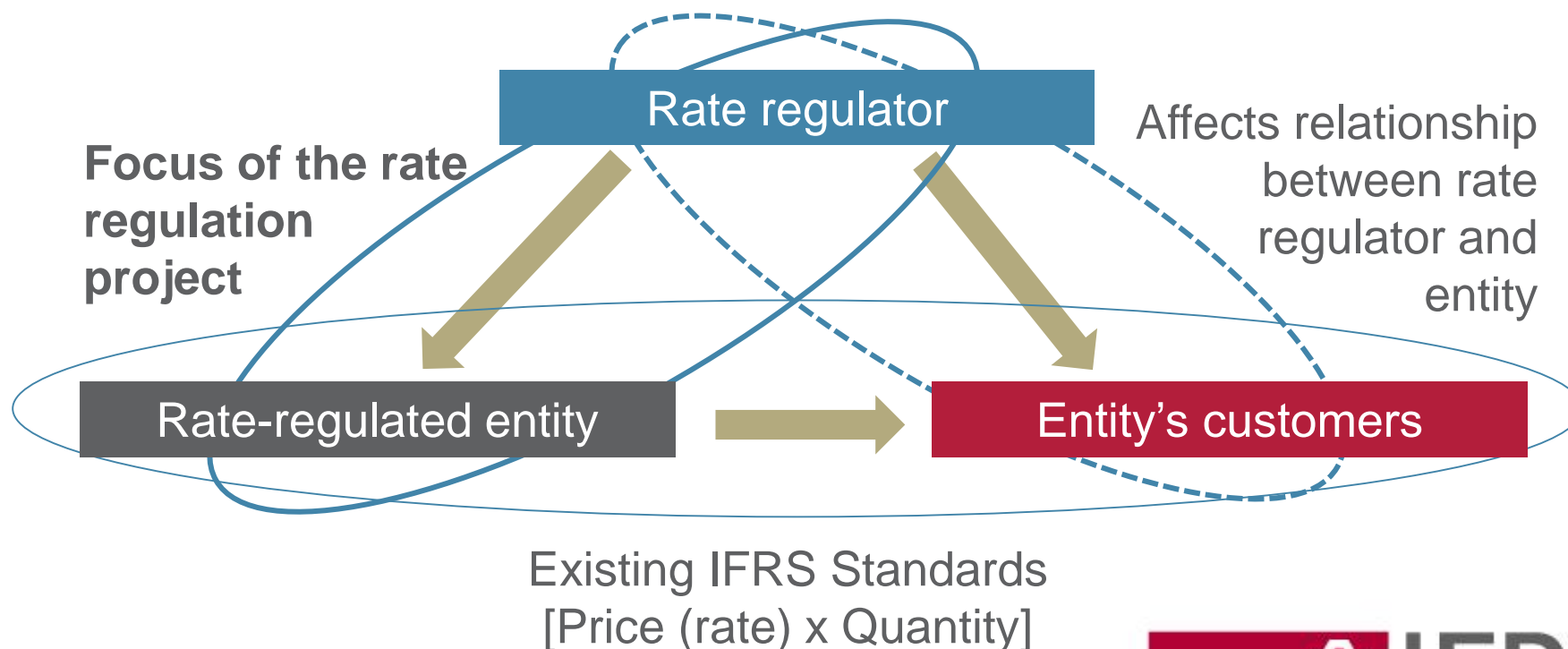
$$\text{Revenue} = \text{Price (rate)} \times \text{Quantity}$$

Discussion Paper

Reporting the financial effects of rate regulation

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- Identified rights and obligations created by different types of rate regulation, focusing on '**defined rate regulation**'
- Explored possible viable financial reporting approaches to reflect the 'overlay' of the regulatory agreement between entity and rate regulator



Discussion Paper

Reporting the financial effects of rate regulation

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- Responses to DP suggest strong support for recognising some '**regulatory deferral account balances**'
- Most common suggestion is focus on a 'revenue-based' approach, using either:
 - an Interpretation of / amendment to IFRS 15 *Revenue from Contracts with Customers*; or
 - a separate Standard based on the principles in IFRS 15
- Many requests to relate the rights and obligations to the definitions of asset and liability in the revised *Conceptual Framework*

Rate-regulated Activities

Applying the Board's *Conceptual Framework*

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- Is the regulatory agreement analogous to an executory contract?
- Do the rights and obligations create assets/ liabilities?
- If so:
 - Should they be recognised?
 - What is the nature of those assets/ liabilities?
 - When should they be recognised?
 - How should they be measured?
 - How should they be presented?
- How should changes in any assets/ liabilities recognised be presented in the statement(s) of profit or loss and other comprehensive income?
- What is meant by 'performance'?
 - Transfer to customers?
 - Transfer to rate regulator?
 - Other?

Conceptual Framework

Proposed revisions

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- In May 2015, the Board published proposals to revise the *Conceptual Framework*
- Project objectives: To improve financial reporting by providing a more complete, clearer and updated *Conceptual Framework* that can be used by:
 - the Board when it develops International Financial Reporting Standards (IFRS Standards); and
 - others to help them understand and apply IFRS Standards.

The Board is currently considering the feedback from the Exposure Draft

Conceptual Framework

Elements

- Elements are the basic building blocks from which financial statements are constructed

Statement of financial position

Assets

Liabilities

Equity

Statement(s) of financial performance

Income

Expenses

Conceptual Framework

Proposed definitions of Elements

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Asset: Present economic resources controlled by the entity as a result of past events

Liability: Present obligations of the entity to transfer an economic resource as a result of past events

Equity: Assets - Liabilities

- An economic resource is a right that has the potential to produce economic benefits.
- A present obligation is an obligation [that has the potential to require the entity] to transfer economic resources that:
 - the entity has no practical ability to avoid; and
 - has arisen from a past event (ie economic benefits already received or activities already conducted)

Conceptual Framework

Proposed concepts—executory contracts

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- An executory contract is a contract that is **equally unperformed**:
 - neither party has fulfilled any of its obligations, or
 - both parties have fulfilled their obligations partially and to an equal extent.
- An executory contract establishes a right and an obligation to exchange economic resources. The entity has:
 - an asset if the terms of exchange are favourable; or
 - a liability if the terms of exchange are unfavourable.
- To the extent that a party fulfils its obligations under the contract, the contract ceases to be executory.
 - If the reporting entity performs first under the contract, that **performance** is the event that changes the reporting entity's right and obligation to exchange economic resources into a right to receive an economic resource (ie an asset).

Defined rate regulation

‘Defined rate regulation’

What we mean by the term

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Defined rate regulation:

- Restricts the setting of prices that an entity can charge to customers for essential goods or services
- Regulates the timing and amount of revenue (and profit) that an entity can bill to its customers
- Requires an entity to adjust the selling price (rate) to
 - recover ‘allowable’ costs and unbilled revenue amounts, or
 - eliminate ‘excess’ revenue or profits
- Establishes rights and obligations for an entity (and a rate regulator) through a ‘**regulatory agreement**’

Defined rate regulation creates differences between amounts reported to the rate regulator and those reported in IFRS financial statements
(‘**regulatory deferral account balances**’)

The regulatory agreement

Rights and obligations

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- The **regulatory agreement** establishes the entity's:
 - **obligations** to:
 - ensure the rate-regulated services are available without disruption to supply;
 - deliver rate-regulated services on demand;
 - carry out other specified activities to achieve other government policies, eg social, environmental, fiscal policies.
 - **right** to receive a determinable amount of consideration in exchange for satisfying its obligations (the **revenue requirement**).

Regulatory agreement

Revenue requirement

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- The **revenue requirement** for the period is the amount of consideration that an entity has a right to bill its customers in exchange for satisfying its regulatory obligations
- The regulatory agreement includes a mechanism for determining the revenue requirement. This mechanism establishes:
 - the **regulated rate** for the period, which is based on the combination of:
 - estimated revenue requirement; and
 - estimated demand
 - a rate adjustment mechanism to:
 - ‘correct’ for variances from estimates
 - adjust the timing of when the revenue requirement is billed to customers to enable the rate regulator to moderate rate fluctuations/ cash flows

Regulated rate comprises: a rate per unit, and/or a ‘standing charge’, ie a fixed amount.

Revenue requirement

Regulated rate

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- The **regulated rate** typically includes amounts related to:
 - goods or services delivered to customers:
 - in the current period; and
 - in a different period
 - other specified activities (that may not meet the definition of a ‘performance obligation’ in IFRS 15), which are carried out
 - in the current period; and
 - in a different period
 - adjustments for variances from estimates relating to past periods

Revenue requirement

Accounting question

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Should the entity recognise a 'regulatory asset' or 'regulatory liability' when:

- the regulated rate reflects activities that:
 - occur in a different period?
 - do not meet the definition of a 'performance obligation' in IFRS 15?
- the regulated rate will be adjusted in the next or subsequent period(s) to reverse any under- or over-recovery by the entity

Revenue Requirement Example

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Fact Pattern

- Entity A's rate regulator determines a fixed revenue requirement of CU200million per year for 3 year period (x1, x2 and x3)
- Determination includes:
 - CU7m per year for project to install insulation free of charge in the homes of specified customers (project starts in x2)
 - CU10m per year for storm repair costs (no costs in x1 or x2, CU30m in x3)
 - CU5m per year for CU15m under-recovered in periods prior to x1
- In x1, A actually receives CU210m due to higher than estimated demand

**How much revenue should Entity A report in x1?
If not CU210m, what should happen to the difference?**

Next steps

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- Continue research with targeted consultation/ field work
- Develop proposals for an accounting model
- Consider implications of the responses to the *Conceptual Framework* proposals
- Consult more widely through a second Discussion Paper

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