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Need to know

IASB proposes new Standard on *Regulatory Assets and Regulatory Liabilities*

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This *Need to know* outlines the proposed new IFRS Standard *Regulatory Assets and Regulatory Liabilities* set out in Exposure Draft ED/2021/1 of the same title, published by the International Accounting Standards Board (Board) in January 2021.

- The new Standard, if finalised, would replace IFRS 14 *Regulatory Deferral Accounts* by introducing a new comprehensive accounting model for regulatory assets and liabilities.
- The Standard is proposed to apply when the entity is party to a regulatory agreement that determines the regulated rate the entity charges for the goods or services it supplies to customers.
- Regulatory assets and liabilities arise when part or all of the total allowed compensation for goods or services supplied in one period is charged to customers through the regulated rates for goods or services supplied in a different past or future period.
- An entity recognises all regulatory assets and liabilities as defined in the proposals, and as a result, regulatory income and expense.
- Regulatory assets and liabilities would be measured at historical cost, modified for subsequent measurement by using updated estimates of the amount and timing of future cash flows. The estimated future cash flows of a regulatory asset or liability would be discounted to their present value by using the regulatory interest rate.
- In the statement(s) of financial performance, an entity would present all regulatory income minus all regulatory expense as a separate line item immediately below revenue. In the statement of financial position, an entity would present line items for regulatory assets and liabilities, with offsetting permitted in certain circumstances.
- The new Standard would be applied retrospectively, with an exemption available for past business combinations.
- The Board does not propose an effective date, however preparers would be given at least 18-24 months between finalisation of the new Standard and the initial application. Earlier application is proposed to be permitted.
- The comment period for the ED ends on 30 June 2020.

For more information please see the following websites:

www.ukaccountingplus.co.uk

www.deloitte.co.uk

Background

The lack of specific guidance in IFRS Standards addressing the accounting for rate-regulated activities has resulted in a number of requests for guidance to the Board. As a consequence, the Board started a comprehensive project on rate-regulated activities in September 2012.

The ED follows **Discussion Paper DP/2014/2** *Reporting the Financial Effects of Rate Regulation* that was published in September 2014 and examined a certain type of rate regulation where customers have little or no choice but to purchase the rate-regulated goods or services from the entity.

Previous to the publication of the DP, the Board published the limited-scope Standard IFRS 14 *Regulatory Deferral Accounts* to provide a short-term, interim solution for rate-regulated entities that previously did not apply IFRS Standards and recognised regulatory deferral balances under their previous GAAP. This was to address the concern that the lack of guidance may be a barrier to the adoption of IFRS Standards for such entities.

Once the ED is finalised, IFRS 14 will be withdrawn.

The proposed requirements

Objective

The proposed Standard sets out the principles and requirements for the recognition, measurement, presentation and disclosure of regulatory assets, liabilities, income and expense. The objective of those principles and requirements is for an entity to provide relevant information that faithfully represents how regulatory income and expense affect the entity's financial performance, and how regulatory assets and liabilities affect its financial position.

Scope

The new Standard would apply to all regulatory assets and liabilities that meet the definition as set out in the ED.

Regulatory assets and liabilities arise when:

- the entity is party to a regulatory agreement;
- the regulatory agreement determines the regulated rate the entity charges for the goods or services it supplies to customers; and
- differences in timing arise because part or all of the total allowed compensation for goods or services supplied in one period is charged to customers through the regulated rates for goods or services supplied in a different past or future period.

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'. Only some regulatory agreements are capable of creating regulatory assets or regulatory liabilities. For example, some regulatory agreements place a cap on the price that companies can charge customers for their goods or services. Such agreements do not create regulatory assets or regulatory liabilities if they do not give rise to:

- rights to increase future rates because of goods or services already supplied; or
- obligations to decrease future rates because of amounts already charged to customers.

The total allowed compensation is the full amount of compensation for goods or services supplied 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.

A difference in timing would arise, for example, if the regulated rate was based on estimated input rates in Year 1, but by the end of that year the entity had determined that actual input costs were higher. In line with the regulatory agreement, the entity includes those excess input costs in the regulated rate for goods or services to be supplied in Year 2. In this case, the entity would report the excess input costs that will be charged via the regulated rate in Year 2 as a regulatory asset and regulatory income in its financial statements for Year 1.

Observation
The Board believes that if investors do not have information about such differences in timing, it is difficult for them to understand how much of the fluctuations in the relationship between an entity's revenue and expenses from one period to another was caused by differences in timing. It is also difficult to understand the entity's rights and obligations arising from the differences in timing and to assess the entity's prospects for future cash flows.

Recognition

To apply the principle described above, an entity would recognise:

- a regulatory asset to depict the entity's enforceable present right to add an amount in determining the 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; and

- a regulatory liability to depict the entity's enforceable present obligation to deduct an amount in determining the 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.

Observation
A regulatory asset is not a financial asset—it does not entitle an entity to require customers or any other party to pay the entity cash: the entity ultimately receives cash when customers pay the increased regulated rate. Likewise, a regulatory liability is not a financial liability.

Recognising regulatory assets and liabilities, and changes in them, results in an entity recognising:

- regulatory income to depict a part of the total allowed compensation for goods or services supplied in the current period that was recognised in revenue in past periods or will be included in revenue in future periods; and

- regulatory expense to depict an amount included in revenue in the current period that provides part of the total allowed compensation for goods or services that were supplied in past periods or will be supplied in future periods.

The information provided under the new Standard would supplement the information that companies already provide by applying IFRS Standards, including IFRS 15 *Revenue from Contracts with Customers*.

Observation
If an entity that is not subject to a regulatory agreement is able to increase the prices of its goods or services at any time, that ability does not create an asset similar to a regulatory asset. This is, because that ability does not create an enforceable present right to increase the prices with the aim of recovering a fixed or determinable amount as a result of goods or services already supplied.

Measurement

Regulatory assets and liabilities would be measured at historical cost, modified for subsequent measurement by using updated estimates of the amount and timing of future cash flows.

Estimating future cash flows

Entities would use a cash flow-based measurement technique that includes an estimate of all future cash flows arising from the regulatory asset or liability and discounts those estimates to their present value.

The estimate would include all reasonable and supportable information that is available without undue cost or effort about past events and about conditions existing at the end of the reporting period, as well as current expectations about future conditions other than future changes in the regulatory agreement or in legislation.

Cash flows arising from a regulatory asset or liability are those that result from the entity charging customers a regulated rate that recovers the regulatory asset by including part of the total allowed compensation for goods or services supplied in past periods or fulfils the regulatory liability by deducting amounts included in revenue recognised in past periods. This includes regulatory interest.

Cash flows would have to be within the boundary of the regulatory agreement, i.e. they would have to result from an enforceable present right or an enforceable present obligation that the entity has at the end of the reporting period to add or deduct amounts in determining a future regulated rate and that addition or deduction would occur on or before the latest future date at which that right or obligation permits the addition or requires the deduction.

For any uncertain cash flows, the entity would be required to determine whether the entity or the customers bear the uncertainty. For example, if the customers bear the credit risk for future cash flows arising from a regulatory asset because the regulatory agreement treats amounts uncollected as allowable in determining regulated rates for a later future period, the entity would include in its estimates of future cash flows the cash it will collect in that later future period. If the entity bears the credit risk, it would estimate future cash flows after deducting an estimate of the amounts that it might not be able to collect.

Uncertain future cash flows would be estimated by either the 'most likely amount' method or the 'expected value' method—whichever better predicts the cash flows. The selected method would be applied consistently until the regulatory asset is recovered or the regulatory liability is fulfilled, however different methods can be chosen for different regulatory assets or liabilities.

Regulatory assets or liabilities are proposed to be treated as monetary items applying IAS 21 *The Effects of Changes in Foreign Exchange Rates.*

Discounting estimated future cash flows

The estimated future cash flows of a regulatory asset or liability would be discounted to their present value by using the regulatory interest rate, i.e. the interest rate provided by a regulatory agreement to compensate an entity for the time lag until recovery of a regulatory asset or to charge the entity for the time lag until fulfilment of a regulatory liability. Consequently, an entity would recognise regulatory interest income or expense over the life of the related regulatory asset or liability.

If the regulatory interest rate is insufficient to compensate the entity for the time value of money and for the uncertainty in the amount and timing of the future cash flows arising from a regulatory asset, an entity would apply the minimum interest rate sufficient to provide such compensation.

If the regulatory agreement provides regulatory interest unevenly by applying different interest rates for different periods over the life of the regulatory asset or liability, an entity would translate those uneven regulatory interest rates into a single discount rate that it uses throughout the life of the regulatory asset or liability. In determining that single discount rate, an entity would not consider possible future changes in the regulatory interest rate.

Subsequent measurement

After initial recognition, the estimated amounts and timings of future cash flows arising from the regulatory asset or liability would be updated at the end of each reporting period to reflect conditions existing at that date. The entity would continue to use the discount rate determined at initial recognition, except in certain circumstances.

For example, the carrying amount would be updated for the recovery of part or all of the regulatory asset or fulfilment of part or all of the regulatory liability. It would also be updated for any accrual of regulatory interest that is not yet reflected in the regulatory rate to customers.

If facts and circumstances change or new information comes to light, the estimates of the amount or timing of future cash flows would be revised. Examples of these include the resolution of an uncertainty, examinations or other actions by a regulator, and changes in the regulatory interest rate, the regulatory agreement or its boundary.

When the regulatory interest rate changes, it is proposed that the entity uses the new rate to update the estimates of future cash flows.

In some cases, a regulatory agreement includes an item of expense or income in determining the regulated rates in the period only when an entity pays or receives the related cash, or soon after that, instead of when the entity recognises that item as expense or income in its financial statements. In such cases, an entity would measure any resulting regulatory asset or liability using the measurement basis that the entity would use in measuring the related liability or related asset by applying IFRS Standards. An entity would adjust that measurement to reflect any uncertainty that is present in the regulatory asset or regulatory liability but not present in the related liability or related asset.

When these measurement proposals apply and result in regulatory income or expense arising from remeasuring the related liability or asset through other comprehensive income (OCI), an entity would also present the resulting regulatory income or expense in OCI.

Presentation

In the statement(s) of financial performance, an entity would present all regulatory income minus all regulatory expense as a separate line item immediately below revenue, unless it is presented in OCI as described above. Regulatory interest income and expense would be included in that line item.

In the statement of financial position, an entity would present line items for regulatory assets and liabilities. These would be separated into current and non-current in accordance with IAS 1 *Presentation of Financial Statements,* unless the entity presents all assets and liabilities in order of liquidity.

It is proposed that an entity is permitted to offset regulatory assets and liabilities if the entity has a legally enforceable right to offset them by including them in the same regulated rate and if the entity expects to include the amounts resulting from the recovery or fulfilment of those regulatory assets and liabilities in the same regulated rate for goods or services supplied in the same future period.

Observation

The proposals would not affect the cash flows entities report in the cash flow statement.

Disclosure

The ED proposes that the entity provide information about regulatory assets, liabilities, income and expense that provides a basis for understanding:

- the relationship between an entity's revenue and expenses as completely as it would have been possible if the total allowed compensation for goods or services supplied had been fully reflected in the period in which the entity supplied those goods or services. This includes an understanding of how the entity's financial performance was affected because part of the total allowed compensation for the goods or services supplied in one period was (or will be) included in determining the regulated rates, and hence included in revenue, for goods or services supplied in a different period.

- the entity's regulatory assets and liabilities at the end of the reporting period.

- whether any changes in regulatory assets and liabilities were not caused by regulatory income or expense.

To achieve these objectives, the ED proposes detailed disclosure requirements.

Transitional provisions, effective date and comment period

Should the new Standard be finalised, the Board proposes that an entity applies the new Standard retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. Entities would be able to elect not to apply the new Standard retrospectively to a past business combination. If the entity makes that election, the ED provides detailed guidance about how to account for those past business combinations.

The Board does not propose an effective date, but proposes to set the effective date so that the new Standard is applied after a transition period of 18-24 months starting on the date of publication. Earlier application is proposed to be permitted.

The comment period for the ED ends on 30 June 2021.

Further information

If you have any questions about the ED *Regulatory Assets and Regulatory Liabilities*, please speak to your usual Deloitte contact.

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