Interaction between the accounting model for defined rate regulation and IFRS Standards
Issues Paper

Objective

1 To seek EFRAG TEG members' views on the interaction between the accounting model for regulatory assets and regulatory liabilities (the model) and the requirements of IFRS 3 *Business Combinations* and other IFRS Standards.

Interaction with IFRS 3 *Business Combinations*

2 At its meeting in July 2019, the IASB considered whether the measurement principles in IFRS 3 should apply to regulatory assets and regulatory liabilities acquired in a business combination. The IASB had previously discussed the interaction with IFRS 3 at its meeting in November 2018 and had asked the staff to conduct further analysis.

3 The IASB tentatively decided to require an entity to recognise and measure regulatory assets and regulatory liabilities acquired in a business combination in *accordance with the recognition and measurement principles of the model*, instead of the principles in IFRS 3. Four of the fourteen IASB members did not agree with introducing a further exception to the principles in IFRS 3.

4 The recognition and measurement exception would apply only to regulatory assets and regulatory liabilities acquired in a business combination. All other assets and liabilities acquired would be accounted for under IFRS 3.

Exception to the IFRS 3 principles – acquisition date

5 IFRS 3 requires an acquirer to measure the assets and liabilities acquired at their acquisition-date fair values under IFRS 13 *Fair Value Measurement*, which is a market-based approach. IFRS 13 defines fair value as 'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between *market participants* at the measurement date'. Additionally, IFRS 13 specifies three valuation techniques to measure fair value, - market approach, cost approach and income approach.

6 The IASB staff observed that by their nature regulatory assets and regulatory liabilities do not trade in active markets and there are limited observable inputs that could be incorporated into an estimate of their fair value. Furthermore, an acquirer would not pay for regulatory assets and liabilities in isolation but rather consider how regulatory assets and liabilities would contribute to the cash flows of the business as a whole. Consequently, the market approach has limited application when determining the fair value of regulatory assets and liabilities.

7 Similarly, the cost approach would not be applicable as a market participant would not be able to determine the current replacement cost of an asset similar to a regulatory asset.

8 An income approach, which involves assessment of the amount of the future cash flows, could be considered similar to the measurement principles of the model. However, differences in measurement outcomes may result if the discount rate or rate or return provided by the regulatory agreement is different to the rate which a market participant would pay for the specific regulatory asset or regulatory liability.

9 The IASB agreed with the IASB staff that even if applying the recognition and measurement principles in IFRS 3 to regulatory assets and liabilities might bring benefits to users of financial statements, the costs involved would not warrant the benefits.

Comparison between measurement under the model and fair value

10 The table below summaries the main measurement requirements under the model and a fair value approach.

	Rate-regulated activities	**IFRS 3 approach**
	Initial measurement	
Measurement approach	**Modified historical cost approach** - cash-flow-based measurement technique	**Income approach under IFRS 13** - market participant approach
Estimating future cash flows	Estimate the future cash flows arising from the regulatory asset or regulatory liability	Estimate future cash flows considering the variations in the amount and timing of these cash flows.
Discount rate	Regulatory discount rate	Market discount rate
	Subsequent measurement	
	Modified historical cost approach - **no change in measurement basis**	Assets and liabilities are subsequently measured in accordance with applicable IFRS Standards - **change in measurement basis**

11 Under both approaches, an entity would estimate a stream of future cash flows considering the variations in the amount and timing of these cash flows. Therefore, the estimated future cash flows are likely to be similar under both approaches except in rare cases when the market participant would reach different conclusions about the amount, timing and uncertainty of those cash flows.

12 As explained in paragraph 8, a difference in the measurement outcome can arise from discounting the estimated cash flows using different discount rates. While the market discount rate will reflect what a market participant would demand to receive as a fair compensation for its investment, the regulatory discount rate is established by the regulatory agreement and may only be *updated at infrequent intervals* which would result in a time lag reflecting market developments.

13 In a business combination, measuring the regulatory assets and regulatory liabilities at a discount rate that is different to a market rate may impact the acquired goodwill. The following example, taken from the IASB agenda paper 9A discussed at the IASB July 2019 meeting, illustrates this point.

<u>Application of the IFRS 3 recognition and measurement exception</u>

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)**	-

14 In the above example, applying the exception to the recognition and measurement principles of IFRS 3, an entity would recognise and measure the regulatory asset using the regulatory rate of 5 percent instead of the market rate of 3 percent. This would result in a regulatory asset of CU 100 instead of CU109.2. The difference of CU9.2 would be recognised in goodwill at the date of acquisition and **represents the higher returns** that the regulator agreement allows (CU25) compared to the market (CU15.8). This difference will be received from years X1-X5 through the rates, and, unless there is an impairment will remain in goodwill.

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

Pre-acquisition	X0	X1	X2	X3	X4	X5	Total
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).

Subsequent measurement – post acquisition

15 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.

16 Under the *Conceptual Framework*, the choice of measurement basis should consider both initial and subsequent measurement of assets and liabilities in a way that a subsequent period Day 2 gain or loss would not be recognised without a change in underlying economic circumstances. Specifically, paragraph 6.48 of the *Conceptual Framework* states that:

'[…]If the initial measurement basis is inconsistent with the subsequent measurement basis, income and expenses might be recognised at the time of the first subsequent measurement solely because of the change in measurement basis. Recognising such income and expenses might appear to depict a transaction or other event when, in fact, no such transaction or event has occurred. Hence, the choice of measurement basis for an asset or liability, and for the related income and expenses, is determined by considering both initial measurement and subsequent measurement.'

17 The IASB staff identified two ways in which the inconsistencies described in the Conceptual Framework could arise if regulatory assets and liabilities are accounted for initially in accordance with IFRS 3:

(a) a regulatory asset or regulatory liability is recognised and measured at fair value under IFRS 3; however, in **subsequent periods** the entity would apply the model and remeasure the regulatory assets/liability based on the 'most likely amount' of estimating future cash flows which would result in a Day 2 gain or loss.

(b) if an entity subsequently updates its estimate of future cash flows and at the same time updates the discount rate because of a **change in the rate of interest or return** in the regulatory agreement (different to a fair value discount rate/rate of return), this would result in a subsequent gain or loss.

18 To prevent the situations described above, IFRS 3 already contains recognition and/or measurement exceptions for the following items:

(a) the recognition of contingent liabilities;

(b) the measurement of reacquired rights, share-based payment transactions, assets held for sale and insurance contracts; and

(c) both the recognition and measurement of income taxes, employee benefits, indemnification assets and some leases.

19 For the same reason, and in order to avoid the inconsistencies described in paragraph 17, the IASB tentatively decided that an exception to the recognition and measurement principles of IFRS 3 for regulatory assets and regulatory liabilities was required.

Feedback from EFRAG Rate-regulated Working Group (RRAWG)

20 EFRAG RRAWG members generally agreed that it make sense for an entity to recognise and measure regulatory assets and regulatory liabilities acquired in a business combination in accordance with the recognition and measurement principles of the model, rather than measuring these at a market value that did not apply to the entity.

Questions for EFRAG TEG members

21 Do you agree with the IASB's tentative decision to provide an exception to the recognition and measurement principles in IFRS 3 for regulatory assets and liabilities? If not, please explain why.

22 At this stage do you have any other comments on the application of IFRS 3 to regulatory assets and liabilities?

Interaction with other IFRS Standards and amendments required

23 The IASB discussed amendments to other IFRS Standards at its meeting in September 2019. The IASB had previously considered this topic at its meeting in November 2018.

24 The IASB tentatively decided that the model should include application guidance on the interaction with IAS 12 *Income Taxes*, similar to the guidance in paragraph B10 of IFRS 14 *Regulatory Deferral Accounts*.[1]

25 The IASB also considered whether application guidance should be developed to provide clarity on how the model would be applied alongside the requirements of existing IFRS Standards. In particular:

(a) IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* – the IASB tentatively decided that the measurement requirements of IFRS 5 should *not* be applied to regulatory assets;

(b) IAS 1 *Presentation of Financial Statements* - the IASB tentatively decided to require presentation of regulatory assets, regulatory liabilities and regulatory

[1] Paragraph 14 of IFRS 14 *Regulatory Deferral Accounts* states: 'In some rate-regulatory schemes, the rate regulator permits or requires an entity to increase its future rates in order to recover some or all of the entity's income tax expense. In such circumstances, this might result in the entity recognising a regulatory deferral account balance in the statement of financial position related to income tax, in accordance with its accounting policies established in accordance with paragraphs 11–12. The recognition of this regulatory deferral account balance that relates to income tax might itself create an additional temporary difference for which a further deferred tax amount would be recognised.'

income or regulatory expense *as separate line items* in the statement of financial position and financial performance respectively;

(c) IAS 36 *Impairment of Assets* - the IASB tentatively decided that the measurement requirements of IAS 36 should *not* apply to regulatory assets and regulatory liabilities.

IFRS 5 Non-current Assets Held for Sale and Discontinued Operations

26 IFRS 5 provides measurement exclusions in certain cases. Under IFRS 5, non-current assets should be excluded only if (i) they are already carried at fair value with changes in fair value recognised in profit or loss or (ii) there would be difficulties in determining their fair value less costs to sell. In addition, all financial assets within the scope of IFRS 9 *Financial Instruments* are excluded from the measurement requirements of IFRS 5.

27 Determining a fair value for regulatory assets and regulatory liabilities is not always possible given that the regulatory agreement provides rights and imposes obligations on the entity that do not exist in a competitive market. In addition, the entity might be the sole supplier (or one of a few suppliers) in the market and so finding observable inputs against which to benchmark regulatory interest or return rates is difficult.

28 Consequently, the IASB tentatively decided that the conditions in IFRS 5, (paragraph 26) are sufficiently met to support excluding regulatory assets from its measurement requirements.

IAS 1 Presentation of Financial Statements

29 IASB tentatively decided to require presentation of regulatory balances as separate line lines in the statement of financial position and performance statement, in addition to the line items required by IAS 1.

IAS 36 Impairment of Assets

30 IAS 36 excludes from its scope various assets for which other IFRS Standards provide more specific measurement requirements in relation to impairment. Examples include inventories, contract assets recognised using IFRS 15 *Revenue from Contracts with Customers* and financial assets within the scope of IFRS 9.

31 The model for defined rate regulation requires an entity to apply a cash-flow-based measurement technique to measure regulatory assets and regulatory liabilities at the amount of the estimated cash flows that will result from that regulatory asset, discounted at an adequate discount rate.

32 Changes in estimates of those cash flows will be recognised in profit or loss. Those requirements eliminate the need for a specific impairment test for regulatory assets given that an ongoing review of the estimates used to measure the regulatory asset is required. Therefore, IAS 36 would be amended to exclude regulatory assets from its scope.

Feedback from EFRAG Rate-regulated Working Group (RRAWG)

33 EFRAG RRAWG members thought that the IASB needed to further consider the interaction between IFRS 5 and IAS 36 and the accounting model, particularly when regulatory assets form part of a CGU being assessed as a disposal of a unit or assessed for impairment under IAS 36. It was not clear how the interaction with a CGU that included regulatory assets would work in practice and there was a risk of unintended consequences unless clear guidance was provided.

34 One EFRAG RRAWG member asked whether the interaction with IAS 23 *Borrowing Costs* had considered the implications of applying IAS 36 to an item of PPE that included capitalised borrowing costs and was used to provide defined-rate regulated

goods or services. This member questioned whether in such cases it would create an impairment loss because of the different treatment for borrowing costs by the entity and the regulator.

Question for EFRAG TEG members

35 Do you agree with the IASB's tentative decision(s) in paragraph 25 on the interaction with IFRS 5, IAS 1 and IAS 36? If not, please explain why.

Other IFRS Standards for which neither amendment nor application guidance are required

36 Other than the IFRS Standards referred to in paragraph 25, the IASB tentatively decided that, for the reasons discussed in the paragraphs below, application guidance on the interaction of the model and other IFRS Standards was not required.

(a) IFRIC 12 *Service Concession Arrangements* – all service concession arrangements are subject to some form of rate regulation where the revenue for the provided services is accounted for in accordance with IFRS 15. Determining whether the terms of a service concession arrangement give rise to regulatory assets and regulatory liabilities will be highly dependent on the contractual terms and conditions.

(b) IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* – the model for regulatory assets and regulatory liabilities is supplementary and does not impose a requirement on how an entity should apply IAS 20 before it applies the model.

(c) IAS 34 *Interim Financial Reporting* – there is no need for separate line items for regulatory deferral account balances and movements in the condensed interim financial statements as the requirements in IAS 34 are sufficient to provide an understanding of the changes in financial position and performance of the entity.

(d) IAS 19 *Employee Benefits* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* – a right to reimbursement which is virtually certain would be recognised in accordance with the requirements of IAS 19 and IAS 37, prior to the application of the model. There would be no conflict between the measurement and presentation requirements of those Standards and those of the model for defined rate regulation.

IFRIC 12 Service Concession Arrangements

37 IFRIC 12 addresses the accounting by operators for public-to-private service concession arrangements in which the grantor controls any significant residual interest in the infrastructure at the end of the contract and regulates:

(a) what services the operator provides with the infrastructure;

(b) to whom services must be provided; and

(c) the price to be charged for the services.

38 The revenue for all services provided by the operator of a service concession arrangement is accounted for in accordance with IFRS 15 *Revenue from Contracts with Customers*. The consideration received in exchange for construction or upgrade services may be rights to:

(a) a financial asset if there is an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor (financial asset model); or

(b) an intangible asset if there is a right to charge users of the public service that is not an unconditional right to receive cash (intangible asset model).

39 The IASB staff considered that a service concession arrangement where consideration for the construction or upgrade services is accounted for as a right to a financial asset will not result in regulatory assets or regulatory liabilities, as any right(s) to future cash flows will already be recognised as part of the financial asset.

40 The IASB staff acknowledged that some service concession arrangements may be within the scope of the model if consideration for the construction or upgrade services is accounted for as a right to an intangible asset.

41 Determining whether the terms of a service concession arrangement give rise to rights or obligations meeting the definitions of regulatory assets or regulatory liabilities will be highly dependent on the contractual terms of the arrangement as well as other facts and circumstances.

42 The IASB agreed with the IASB staff analysis on the basis that revisiting the requirements of IFRIC 12 is beyond the scope of this project. The model has been developed as a supplementary model, meaning that an entity applies other IFRS Standards, including IFRIC 12, without modification first before applying the model.

IAS 20 Accounting for Government Grants and Disclosure of Government Assistance

43 IAS 20 permits an entity to choose, when accounting for grants related to assets:

(a) a net presentation approach; ie to deduct the grant in arriving at the carrying amount of the asset; or

(b) a gross presentation approach; ie to recognise the asset at its full cost in accordance with IAS 16 *Property, Plant and Equipment* and recognise a grant liability.

44 The IASB staff noted that when a regulated entity receives a government grant to (partly) fund the construction of an asset (eg plant) that will be used to supply regulated goods or services, the regulatory agreement deducts the grant from the regulatory carrying amount of the asset. This means that the entity cannot include (fully) the depreciation of the plant in the future rate(s) charged to customers when it delivers regulated goods or services using the plant. Some entities may prefer to use the net presentation approach in IAS 20 to be consistent with the regulatory accounting treatment.

45 When a regulated entity receives funding from customers in advance for the construction of an asset (eg plant), the regulatory agreement deducts the prefunded customer income from the regulatory carrying amount of the asset, in the same way as it deducts government grant income. On the other hand, applying the model, an entity would measure the plant initially at its construction cost in accordance with IAS 16 and would recognise a regulatory liability for the prefunding from customers, leading to a presentation similar to the gross presentation approach in IAS 20.

46 The IASB noted that requiring entities to present government grants in a consistent manner would provide more useful information to users of financial statements. However, given the supplementary nature of the model, changes to IAS 20 are beyond the scope of this project.

IAS 34 Interim Financial Reporting

47 The IASB staff considered whether the existing requirements of IAS 34, combined with the presentation and disclosure requirements of the model, are sufficient to provide users with relevant information regarding regulatory balances.

48 Some respondents to the exposure draft preceding IFRS 14 had requested additional guidance on the application of IAS 34. However, the IASB agreed with the IASB staff recommendation that additional guidance was not needed.

IAS 19 Employee Benefits and IAS 37 Provisions, Contingent Liabilities and Contingent Assets

49 Paragraph 116(a) of IAS 19 specifies that when it is 'virtually certain' that another party will reimburse some or all of the expenditure required to settle a defined benefit obligation, an entity recognises its right to reimbursement as a separate asset measured at fair value.

50 Similarly, paragraph 54 of IAS 37 specifies that when some or all of the expenditure required to settle a provision is expected to be reimbursed by another party, and it is 'virtually certain' that reimbursement will be received if the entity settles the obligation, the reimbursement is recognised as a separate asset and the expense related to the provision may be presented net of the amount recognised for a reimbursement.

51 The IASB tentatively decided that a right to reimbursement which is virtually certain would be recognised in accordance with the requirements of IAS 19 or IAS 37, before applying the model. Therefore, there was no need for further guidance.

Feedback from EFRAG Rate-regulated Working Group (RRAWG)

52 Some EFRAG RRAWG members considered that it would be useful to have guidance on the interaction with IFRIC 12 given the overlay nature of the model. It was not clear how to apply the intangible asset model under IFRIC 12 in combination with the model for regulatory assets and regulatory liabilities.

Questions for EFRAG TEG members

53 Do you agree with the IASB's tentative decision that application guidance in relation to the interaction of the model with IFRIC 12, IAS 20, IAS 34, IAS 19 and IAS 37 is not required? If you do not agree please specify what guidance would be useful. Please provide examples that illustrative why guidance might be useful (in case you consider it would be).

54 At this stage, do you consider there are other areas of interaction for which application guidance would be useful to help preparers apply the model?