IASB PUBLISHES EXPOSURE DRAFT - *REGULATORY ASSETS & REGULATORY LIABILITIES*

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BACKGROUND

Entities conducting rate regulated activities are required to establish prices to be charged to customers in accordance with a pricing framework that is subject to oversight and/or approval by a rate regulator, often a statutory body.

Rate regulation often gives rise to a difference in timing between the period when the entity supplies goods and services to customers and the period when it is entitled to charge the customers for those goods and services. In such cases, the revenue reported by the entity in its statement of financial performance and the assets and liabilities reported in its statement of financial position do not reflect the 'complete picture' of the compensation that the entity is entitled to for the goods and services supplied during that period. Currently, IFRS Standards do not require entities to inform investors about such differences in timing, except in the limited circumstances in which IFRS 14 *Regulatory Deferral Accounts* applies.

STATUS
IASB has released the Exposure Draft of a new standard *Regulatory Assets & Regulatory Liabilities*. This standard would be intended to replace IFRS 14.

ACCOUNTING IMPACT
The proposed standard is intended to provide better information to users by requiring entities subject to rate regulation to record regulatory assets and regulatory liabilities if certain criteria are met.

In January 2012, as an interim measure, the International Accounting Standards Board (IASB) issued IFRS 14. IFRS 14 permitted entities conducting rate regulated activities to continue to recognise and measure their regulatory deferral account balances in accordance with their previous GAAP in their first and subsequent IFRS financial statements. As IFRS 14's scope was limited to entities applying IFRS for the first time, the number of entities applying it has been limited.

In January 2021, the IASB has published the Exposure Draft (ED) of a new standard, *Regulatory Assets and Regulatory Liabilities* that is intended to replace IFRS 14.

The ED may be accessed here. The IASB has also provided a Snapshot that provides an overview of the proposals and a debrief video that introduces the proposed requirements.

The ED is open for comments until 30 June 2021.

The proposed standard is expected to have a significant effect on entities in rate regulated sectors such as power, telecommunication, public infrastructure, public transport. For entities that are currently not accounting for regulatory deferral account balances as permitted by IFRS 14 in limited circumstances, the proposed standard may significantly affect financial performance metrics and ratios such as EBITDA, operating profit, net income, earnings per share, return on investment and current ratio. Such entities will need to evaluate effects of these changes on their loan covenants, credit ratings and other key performance indicators.

PROPOSALS OF THE EXPOSURE DRAFT

RECOGNITION & MEASUREMENT REQUIREMENTS

The ED introduces the concept of 'total allowed compensation'. Total allowed compensation for goods or services supplied is 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.

The ED proposes that the total allowed compensation to which the entity is entitled for the goods and services supplied in a period should be reflected in the financial performance in the same period. This would be achieved by recognising regulatory assets and regulatory liabilities in the statement of financial position and regulatory income and regulatory expense in the statement of financial performance.

Regulatory asset with corresponding regulatory income

A regulatory asset would arise in the case of under-recovery of compensation in the period in which the goods or services are supplied.

Example 1 - The rate a company charges customers during the current period includes an estimated amount of input costs. Actual input costs incurred in that period exceeded this estimate. The regulatory agreement gives the company the right to add that under-recovery of input costs in the rates to be charged to customers in the future.

This under-recovery is accounted for as regulatory income and a regulatory asset in the current period. The total of revenue and regulatory income accounted in the current period should equal the total allowed compensation for the goods and services provided in the current period.

The regulatory income and regulatory asset would be reversed in a subsequent period, when it is included in the amount charged to the customers and accounted for as revenue.

Regulatory liability with corresponding regulatory expense

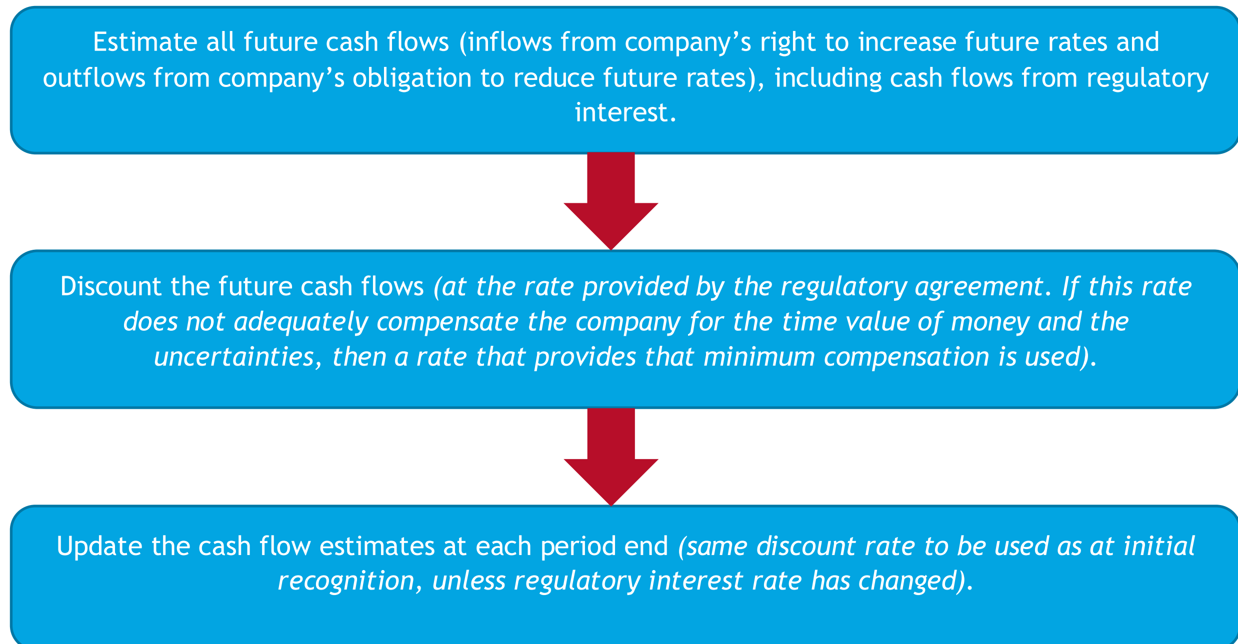
A regulatory liability would arise in the case of over-recovery of compensation in the period in which the goods or services are supplied.

Example 2 - The rate a company charges customers during the current period includes an estimated amount of input costs. Actual input costs incurred in that period were lower than this estimate. The regulatory agreement obliges the company to deduct the over-recovery of input costs in the rates to be charged to the customers in the future.

This over-recovery is accounted as regulatory expense and a regulatory liability. In the current period, revenue net of regulatory expense would equal the total allowed compensation for the goods and services supplied during the current period. Regulatory expense and regulatory liability would be reversed in a subsequent period, when it is deducted through lower rates charged to the customers.

Over the life of the regulatory agreement, the total allowed compensation would equal the revenue charged.

Measurement of regulatory assets and liabilities would involve following steps:



PRESENTATION

- All regulatory income minus all regulatory expense shall be presented in a separate line item immediately below revenue in the statement of financial performance.
- Regulatory assets and regulatory liabilities shall be presented in separate line items (with separate classification for current & non-current) in the statement of financial position.

DISCLOSURE

The ED contains extensive disclosure requirements to enable users to understand the relationship between the company's revenue and expenses and the effect of rate regulation.

Some of the critical disclosure requirements include:

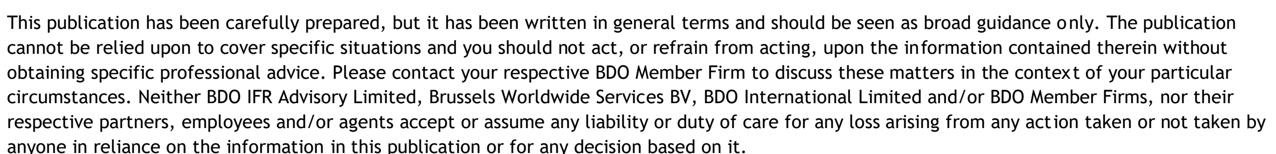
- Components of regulatory income and regulatory expenses to enable users to understand the impact of differences in timing;
- Quantitative information about when the company expects to recovery regulatory assets and fulfil the regulatory liabilities;
- The risks and uncertainties affecting the recovery of regulatory assets and the fulfilment of regulatory liabilities;
- Discount rate(s) used in measuring regulatory assets and regulatory liabilities; and
- Reconciliation from the opening to closing carrying amounts of regulatory assets and regulatory liabilities.

EFFECTS OF THE PROPOSED STANDARD

The effects of the proposed standard on the financial statements of entities subject to rate regulation would be significant for entities that currently do not recognise regulatory balances. For companies that currently recognise regulatory balances, the effects would depend on how they currently account for such balances.

The transitional provisions in the ED require retrospective application in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The date of transition would be the beginning of the earliest annual reporting period presented in the financial statements for the annual reporting period that includes the date of initial application (i.e. the first day of the comparative period). This would require entities to gather data for all reporting periods presented in the financial statements and also to evaluate estimates for all those reporting periods.

Estimating future cash flows may involve significant judgement as these are based not only on rates permitted by the rate regulation, but also on future demand for goods and services (e.g. forecasted demand for electricity). Entities will also need to evaluate disclosure requirements under IAS 1 *Presentation of Financial Statements* for the significant judgements and sources of estimation uncertainty involved.



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