asian-oceanian standard-setters group

To:	**AOSSG members**	**Date:**	28 November 2013
From:	**Korea Accounting Standards Board**	**Agenda Item:**	11.1
Subject:	**A Multiple Recognition of Rate-regulated Assets and Liabilities**	**File:**	

Introduction

1. Many requests for recognition of regulatory assets and regulatory liabilities were made toward both the International Accounting Standards Board (IASB) and IFRS Interpretations Committee for years. In July 2009, the IASB released Exposure Draft (2009 ED) *Rate-regulated Activities.* However, as no consensus had been reached the project was subsequently suspended. In September 2012, the IASB reinstated the project as a research project. A consultative group (CG) was also established to assist with the project in July 2013.

2. The purpose of this paper is to provide input to the DP development by analyzing relevant papers and related arguments and determine several potential bases for recognition and measurement of regulatory assets or liabilities

Rate regulation - schemes and examples

Types of rate regulation

Cost-based (cost-of-service or return-on-base-rate) rate regulation

3. The specific operating costs, capital costs of the assets and a specific targeted rate of return are considered when deciding the price of regulated goods/services. To recognize the variance or deferral accounts, the formula focuses on the entity's actual input with a 'true-up' mechanism.

Incentive-based (price-cap or revenue-cap) rate regulation

4. The starting point for setting the initial rate is usually 'benchmarks' or target costs, expenditure and return rate; adjusted for inflation and for a variety of output-based objectives, with incentives or penalties applied through the rate formula.

5. Few items are tracked for variances between actual and estimated amounts. The formula used to calculate the rate is focused on targeted outputs, with little or no 'true-up' to actual results.

Examples of Rate Regulation in Korea and Other Jurisdictions

Examples of Rate Regulation - Korea

Korea Electric Power Corporation (KEPCO)

6. KEPCO provides the transmission, distribution and sales of electricity as a monopolist in Korea's electricity market. Electricity rate is determined by estimated overall costs and then approved by the regulator. There is no procedure to recover or refund the variance of estimated overall costs and actual incurred costs in a subsequent period.

7. The fuel cost pass-through adjustment refers to adjusting the different amounts between the actual fuel costs incurred and the rate collected to the next period. The fuel cost adjustment rates are calculated by the difference between the base fuel costs and the actual fuel costs. Specifically, the accumulated difference between the base fuel cost and the fuel cost per unit exceeding more than ±3%, but not exceeding 50%, is adjusted.

8. There is no impact on the balance of net assets for the year ended 31 December 2012 because rights arising from the fuel cost pass-through adjustment are recognized as an asset which would be subsequently written-off when the possibility of recovery was not high.

Korea Gas Corporation (KOGAS)

9. Most of the natural gas consumed in Korea is imported as LNG type. KOGAS has a monopoly on domestic natural gas and 30 private city-gas companies own the local gas distribution networks.

10. The fuel cost for city-gas is adjusted every 2-months and the fuel cost for generation is adjusted every 1-month by approval of the Minister of Trade, Industry & Energy based on the

fuel cost pass-through adjustment reflecting the fuel cost fluctuation which is determined by the oil price and exchange rates.

11. Wholesale supply cost is adjusted once a year following the criteria of pricing the natural gas supply. The adjustment is then approved by the Ministry of Trade, Industry & Energy in consultation with the Ministry of Strategy and Finance.

12. More than 90% of the price of natural gas is the fuel cost. The fuel cost cannot be controlled by KOGAS because the fuel cost is primarily affected by the international oil price. The fuel cost pass-through adjustment applies to the fuel cost for city-gas/generation.

13. The fuel cost for city-gas is adjusted every two months when the accumulated differences between the base fuel cost and the fuel cost per unit exceed more than ±3%. Differences of less than ±3% are reflected through the settlement. The fuel cost pass-through adjustment has been effective from 1998 and under- and over-recovery costs were recognized as an asset and a liability, respectively, from 1999.

Korea District Heating Corporation (KDHC)

14. KDHC is a public company and Korea's largest provider of integrated energy of electricity and district heating. District heating rate is determined by the cost-plus mechanism and price-cap mechanism.

Cost-plus mechanism

15. An increase in the fuel cost due to a change in the international oil price and exchange rates is adjusted to heating rate on a three month basis and rate adjustment is determined by dividing the sum of the fuel cost per unit and fixed cost per unit by the current sales price per unit. Sales price per unit is adjusted when rate adjustment is more than ±1% or ±3% but not exceeding 10%. However, when the regulator does not approve reflection of the different amount due to an emergency situation within one year, the right or obligation becomes invalid.

Price-cap mechanism

16. The regulator establishes a maximum limit on certain costs such as personnel expenses, maintenance fees and overhead, except for fuel costs.

Examples of Rate Regulation – other jurisdictions

UK - Gas and Electricity

17. In the UK, energy transportation businesses are natural monopolies and all private-sector businesses. The price controls set the maximum amount of revenue which energy network owners can raise through the charges they levy on users of their networks to cover their costs and earn a return on capital in line with agreed expectations. The price control is set based on forecasted costs and includes uncertainty mechanisms to allow for changes in demand, most of which have to be forecast years in advance.

18. Within their overall annual revenue cap, the onshore networks have the flexibility to set unit prices to different groups of consumers and for electricity at different voltages. The networks set revenues on a real price basis and these are uplifted for inflation, using retail price inflation (RPI).

Germany - The Air Traffic Service

19. Based on laws, Deutsche Flugsicherung (DFS) has been appointed to ensure safety of air traffic in Germany and to provide respective control services. DFS is owned by the German state and is acting as a monopolist. To ensure a long-term full-cost recovery mechanism, yearly differences between budgeted and actual financial results of year 'n' are currently transferred into the year 'n+2'. The forecasted total costs of year 'n+2' are based on an estimate of customer demand for year 'n+2'.

Forecasted total costs of year 'n+2' ± Actual over/under-recovery of year 'n' = Total charges to be received in year 'n+2'

Canada - Electrical Industry

20. The Canadian Electricity Companies fall into two general categories within Canada. Many companies are government-owned utilities, while others are investor-owned utilities. A utility could operate under an incentive-based form of regulation. Typically, the rates set under

incentive-based regulation are determined based on costs-of-service plus a reasonable return. For subsequent periods, the rates are modified using a formula-based approach.

21. Retrospective rate making is not permitted. If there is significant uncertainty regarding whether certain costs would be incurred or the amounts cannot be reasonably forecasted, the regulator approves predetermined deferral or variance accounts including a methodology for how each deferral or variance is calculated.

22. There were actual business transactions that demonstrate the value of regulatory assets and liabilities.

23. On April 29, 2002, AltaLink, a Canadian company, acquired substantially all of the electrical transmission assets and operations of TransAlta Energy Corporation located in Alberta, Canada for total cash consideration of $828,222 including acquisition costs of $9,684 (Decision 2002-038, 093). The consideration of $828,222 included long-term regulatory liabilities of $14,973.

24. In 2007, FortisAlberta Inc. securitized Alberta Electric System Operator (AESO) charges deferral account amounts in regulated assets by approval of Alberta Energy and Utilities Board.

Decision 2007-049

FortisAlberta Inc. 2008 Transmission Adjustment Rider and ***Securitization of AESO Charges Deferral Account Amounts*** (June 19, 2007)

2006 ACDA Conclusion

In respect of the 2006 ACDA, subject to the Board's views respecting true-up of securitization costs, the Board is persuaded that securitization will provide a net cost benefit to customers and will improve FAI's financial position and support an appropriate credit rating. Therefore, the Board considers that it is in the public interest to approve the Application as it relates to the 2006 ACDA balance.

2007 and Future ACDA Balances

FAI has also requested Board approval for FAI to securitize any balances in ACDA for 2007 and future years, which are, of course, unknown and unapproved at the present time. The Board is prepared to approve the securitization of FAI's 2007 ACDA and other future (...)

- the ACDA balance and securitization costs will be trued-up and approved, as required, in the ACDA Application;
- securitization costs (funding and program costs combined) in any year must not

exceed the amount of interest to which FAI would otherwise be entitled according to IL 2000-01 in that year;

- on its own motion or the application of an interested party, on written notice and following any appropriate process, the Board may rescind or vary its approval of future securitizations, if it is satisfied, for any reason, that securitization of FAI's ACDA is no longer in the public interest.

BOARD ORDER

For and subject to the reasons and conditions set out in this Decision, the Board hereby orders as follows:

- The sale of FortisAlberta Inc.'s ACDA for 2006 and future years is approved pursuant to section 101(2)(d) of the Public Utilities Board Act.
- FortisAlberta Inc. shall have the right, for and on behalf of the Issuer, to collect the full, approved balance of its ACDA from time to time, plus interest determined in accordance with the Securitization Agreement(s), from all customers within FAI's service area.

USA - Gas and Electricity

25. Due to high industry start-up costs, market size and economies of scale, rate-regulated utilities in the U.S. operate as natural monopolies.

Regulatory Mechanism Categories: Base Rates, Actual Cost Recovery Mechanism (Trackers) and Policy or Incentive

- Base rates are a cost-based mechanism in which a regulator sets rates for services that are designed to recover approved operating costs including a fair return on investment used in utility service. Retroactive ratemaking is not allowed. The regulator determines the time frame over which a rate-regulated utility may recover its allowable costs.

- Trackers are usually narrower in scope, providing recovery of a specific category of costs, such as fuel costs, and are reconciled, i.e. "trued-up", on an annual or periodic basis as the costs incurred may vary widely.

- Policy or incentive mechanisms are designed to achieve a particular objective of a third-party regulatory authority, government, or other policy maker that often is in addition to the primary objective of substituting for the absence of market pricing, while compensating the rate-regulated entity for participating in that objective. Policy and

incentive mechanisms may have a variety of such additional objectives including incentivizing behavior of the rate-regulated entity and/or its customers.

Companies are allowed to recover utilities' operating cost and to earn a reasonable return, however regulators can allow utilities to defer all or part of a cost for their own purpose.

Brazil - Distribution of Electricity

26. Brazil has adopted IFRS since 2010. During the process of IFRS convergence in Brazil, regulatory assets and liabilities were fully written-off as a vast majority of people believed that their recognition was not in accordance with IFRS Conceptual Framework.

27. The Brazilian utility companies are a mix of private sector (more commonly comprised by energy distributors and transmitters) and government entities (more commonly energy generators).

28. To establish distribution tariffs, the regulator divides the costs of distribution companies between (i) costs that are not under the control of the distributor, named as Parcel A Costs, and (ii) costs that are under control of distributors, or Parcel B Costs. Regarding Parcel A costs, if a deviation occurs related to those comprised on the tariff, the operator has a right to receive from (or an obligation to refund) in the next annual tariff adjustment and, therefore, a regulatory asset (or liability) should be recorded. CVAs (Parcel A variation accounts) are accounts for price variation of non-manageable costs, such as energy prices. Parcel A calculation considers current prices on the date of the tariff review/adjustment.

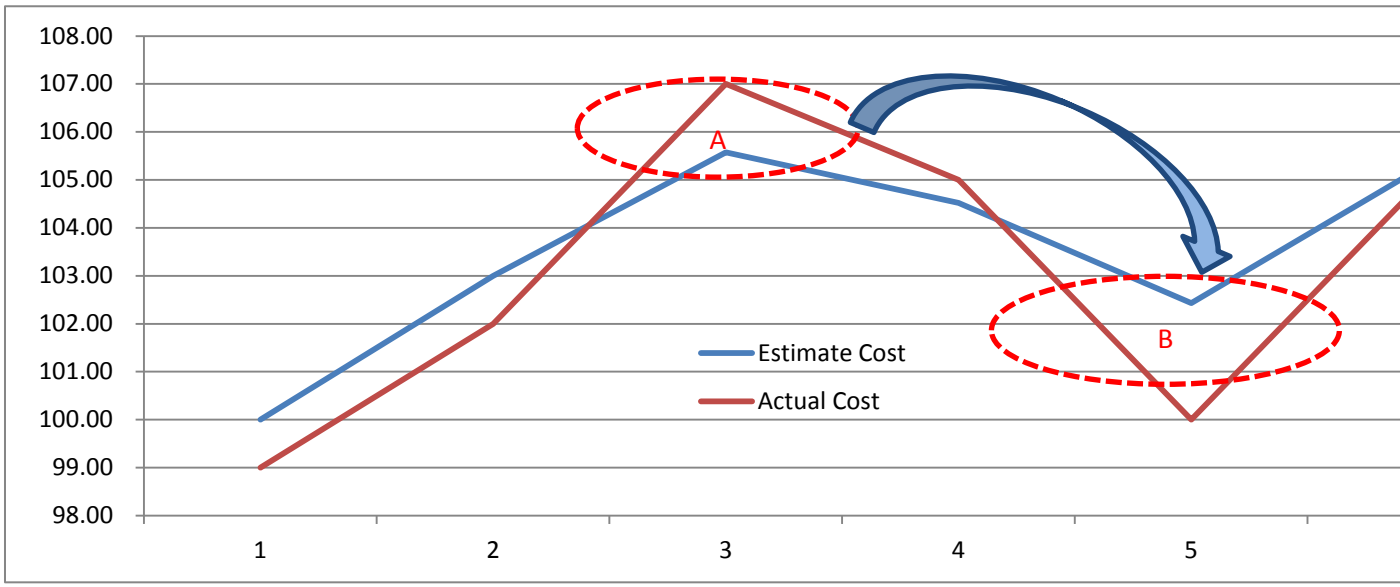
Application of rate regulation on various schemes

29. As described in the previous paragraphs there are two types of rate regulation; cost of service and incentive based mechanism. However, rate regulation has various types and applications by each jurisdiction. Therefore, it is difficult to classify the types of rate regulation into only two, such as cost of service and incentive based mechanism.

30. In case of cost of service mechanism, all costs incurred by an entity will be included in the determination of current or future rates to ensure full recovery of all costs plus a return to compensate for the time value of money and the risk premium required by creditors and equity providers to fund any timing differences in cash flows and the investment in assets.

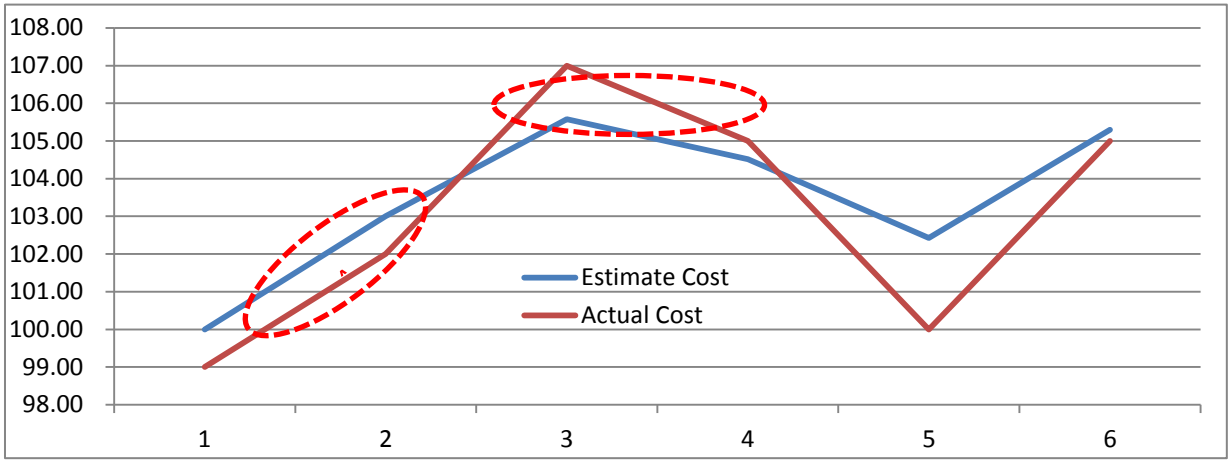
Variance or deferral accounts are used to manage the unrecovered portion and true-up is required to measure the unrecovered or over-collected amount.

31. As shown in the below graph, in the case of cost-of-service scheme, if the actual cost is greater than estimated cost (part A), the following year's rate is determined to recover the difference. Therefore, the actual cost in the next period is set lower than the estimated cost which allows the entity to collect the unrecovered portion (par B).



32. In the USA or Canada, if a certain cost is not reflected into rate making the regulator allows an entity to collect the unrecovered cost for a certain period.

33. In case of incentive based mechanism, it is very common that the regulator sets the targets at the beginning of a rate period. The targets could be based on several different factors such as total revenue, price per unit, industry average costs, etc., but always attempt to get an entity to provide the goods or services to the customer in a more efficient manner. If an entity is able to successfully operate the business with costs less than targeted by the regulator, the entity will have an increased profit margin. Unlike the cost-of-service mechanism, an increased profit margin above the target determined by the regulation is not required to be returned to customers through future rates. For example, if an entity has lower actual costs than estimated through better management strategy or cost saving as shown in the graph (part A) it can experience a gain. Whereas, if the actual costs are higher than estimated then a loss is incurred.



34. Under incentive based mechanism, there are various factors and further, such factors are different by each jurisdiction. The unrecovered costs or over-collected amount could be one of the factors that determine the future rates but the incentive based mechanism does not aim to collect or refund such costs. Normally the unrecovered portion or over-collected amount is not separately shown in the utility bill. There are more countries that are adopting an incentive based mechanism, in particular Europe. The regulators allow utility companies to enjoy the margin driven from their efficiency movement. Unlike the incentive mechanism, cost of service mechanism may require utility companies to refund the margin as a result of cost saving.

35. To be qualified for rate regulated activities accounting it is important whether or not a framework incorporates variance or deferral accounts or true-up process to fully recover the costs or to refund the over-collected amount. This is because the conceptual framework defines assets and liabilities as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity and a present obligation of the entity arising from past events, the settlement of which is expected to resulted in an outflow from the entity of resources embodying economic benefits.

36. In other countries' examples described in the previous paragraphs, variance or deferral accounts or true-up is characterized as a cost of service mechanism. According to the responses to RFI, there are some hybrid cases such as cost of service mechanism for only certain items under incentive based mechanism which is applied overall. For example, Canada applies incentive based mechanism overall but certain items including overhaul costs are recovered through adjusting future rates.

37. Therefore, in applying rate regulated activity accounting it is not important whether the regulation itself is classified as either cost of service based mechanism or incentive based

mechanism. We think the existence of variance or deferral account or true-up process is more important.

Brief analysis on potential application of rate regulated activity accounting – by jurisdiction

38. Assuming the following criteria are the requirements for applying rate regulated activity accounting:

(a) existence of variance or deferral accounts: through true-up process or tracking system an entity can separately manage the unrecovered costs or over-collected amount

(b) the cash flows arising from transactions and establishes the rate based on collective customers: through a monopolistic or near-monopolistic supply there is low possibility of changes of customer base

(c) determination of cost of recovery period and method by regulator: regulators reviews the costs reported from entities and designates recovery method (i.e. base rate plus certain additional rate) and period

39. Below is a brief analysis based on the above assumed requirements:

Country/requirements		a	b	c	Remark
KOREA	KEPCO	V	V	-	▪ Deferral accounts are separately maintained and monopoly. Low possibility of change in customer base
	KOGAS	V	V	V	▪ Deferral accounts are separately maintained. Certain additional rate is added for specified period. Monopoly in wholesale LNG market. Low possibility of change in customer base.
	KDHC	-	V	-	▪ True-up process is established but no deferral account is maintained. Monopolistic on designated district. Low possibility of change in customer base.
UK (water)		-	V	-	▪ The rate is set by a formula which results in no adjustments when there is difference between actual and estimated costs. Monopolistic on designated district. Low possibility of change in customer base

Country/requirements	a	b	c	Remark
Germany (network)	-	V	-	▪ Incentive-based revenue-cap-regulation scheme. ▪ Non-influenceable cost incurred in N-2 period will be charged to N period through price cap ▪ Changes in regulatory account: All variances between revenue-cap and actual revenues of a calendar year are recorded on a regulatory account. This account sums up the total position of the TSO ▪ Low possibility of change in customer base due to monopolistic situation.
Canada (utility)	V	V	V	▪ The rates are set under incentive-based regulation (costs-of-service plus a reasonable return) ▪ The recoveries/refunds arising from the approval of deferral and variance account balances are included in the rate orders issued by the OEB to the utilities. (Ontario) ▪ Low possibility of change in customer base due to monopolistic situation. ▪ The rate orders have designated "rate riders" to recover / refund the approved balances over a specified period (i.e. up to the expiry date set for the rate rider).
USA (utility)	V	V	V	▪ Base Rate: Retroactive ratemaking is not allowed. This key feature distinguishes base rates from rates that are established to recover specific costs typically subject to periodic reconciliation. ▪ Trackers are usually narrower in scope, providing recovery of a specific category of costs, such as fuel costs, and are reconciled, i.e. "trued-up", on an annual or periodic basis as the costs incurred may vary widely.

Country/requirements	a	b	c	Remark
				▪ The regulator determines the appropriate time frame over which a rate-regulated utility may recover costs associated with Trackers. In balancing the interests of customers and the rate-regulated utility, the regulator exercises judgment in determining the time frame over which costs are recovered.
Brazil (electricity)	V	V	-	▪ In case of electricity market, competition market and monopolistic market are run separately. ▪ Deferral accounts are titled as CVA. ▪ Low possibility of change in customer base due to monopolistic situation. ▪ CVA is reflected into future rates but subject to volume.
Australia (electricity)	-	-	-	▪ Competition features are incorporated in the market. Price cap is applied. ▪ No adjustment on a difference between the actual and estimated costs.

Potential bases for recognition and measurement of assets arising from rate regulation

40. We would seek potential bases for recognition of the asset arising from rate regulated activities by exploring the definition of an asset under *Conceptual Framework*, revenue recognition standard and intangible asset standard.

Conceptual Framework

41. The current Conceptual Framework 4.4 defines 'asset' as a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Resource

42. An entity subject to rate regulation may have 'resource' as rate regulations create a right to recover specific previously incurred costs and to earn a specified return or an obligation to refund previously collected amounts and to pay a specified return. This right comes from a regulator's enforceable permission or promise that let an entity subject to rate regulations charge its customers to the extent of the unrecovered costs when the company has incurred costs in excess of its anticipated costs used to determine the current period rates charged to customer for the sales of goods and services.

43. It is arguable whether the right to recover the incurred costs by increasing the future price is distinguishable from the existing intangible asset - i.e., right to operate the rate regulated activities in a jurisdiction. This argument is about whether a new asset has been acquired or the economic benefits derived from the existing asset are merely enhanced by the right to recover the costs.

44. The main argument of seeing it as an expenditure to existing rights is that regulatory approval to increase future price does not result in a new or separable cash flow stream for the entity. However, DP/2013/1 - Review of the Conceptual Framework for Financial Reporting issued in July (hereafter, DP/2013/1) defines an economic resource as "a right, or other source of value, that is capable of producing economic benefits" and does not require new streams of economic benefits.

45. We think that the new economic resource subject to rate regulations creates an additional right to increase price on top of the right to operate the business. The changes in expected cash flows would be triggered by the fact that the entity has not recovered its costs and the regulator's promise to get the entity recovery of the costs rather than by external factors such as changes in demand of the goods or services of the entity.

Control

46. Although the current Conceptual Framework does not define the term 'control', according to Revenue Recognition ED, control is the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. Further, the ED proposed that control is the ability to restrict the other party's access to the asset. With regard to rate regulated activities, it could be argued that the entity subject to rate regulation has no control over collectability of excess costs. Instead, the regulator has the control.

47. However, the entity holds the right to recover the actual cost and the approved return and the customers cannot collectively avoid the payment when they consume the goods or services. Also, whether the customers will use the service is a matter of measurement rather than definition or recognition.

48. DP/2013/1 proposed that definition of assets does not require that inflows of economic benefits should be expected. According to the DP/2013/1, it would be enough to meet the control criteria if the entity could receive economic benefit by increasing the price when the customers use its goods or services in future periods.

Past event

49. Past event is an event that results in an entity having the resource that would be recognised as an asset. With regard to rate regulated activities, an entity may have a right to set its price for a future period at a higher level than a price at which the entity could earn the approved return.

50. In this regard, a past event related to the right would be an event that creates such a right and there could be two cases depending on rate regulations.

- Case 1: the right to set future price at the higher level does not relate to revenue or costs incurred in current period and instead it only relates to future sales.
- Case 2: The past event may be current period sales that give rise to the right to recover the costs and the approved return that are not recovered through the current sales.

51. We believe that if there is a direct relationship between costs incurred or sales in current period and the right to recover its incurred cost and approved return for the current sales, the right should be seen as arising as a result of the rate regulation over the current sales.

52. Overall, we propose the following criteria for recognition of the right as an asset:

- ✓ The entity has the present right to charge customers unrecovered costs in the expected future sales.
- ✓ The entity has an ability to direct the use of and obtain substantially all of the remaining benefits from the right.
- ✓ There is a direct relationship between costs incurred or sales in current period and the right to recover incurred costs and approved return for the current sales.
- ✓ It is probable that the future economic benefits will flow to the entity and the asset has a cost or value that can be measured reliably.

53. Applying the proposed recognition criteria would lead to three possible scenarios depending on rate regulations.

- ✓ All costs incurred in current period would be expensed when the above-mentioned recognition criteria of an asset are not met.
- ✓ Receivable and revenue would be recognised when the above-mentioned recognition criteria of an asset and the revenue recognition criteria under IAS 18 (or future revenue recognition standard) are met.
- ✓ Intangible asset would be recognised when the above-mentioned recognition criteria of an asset are met but the revenue recognition criteria are not met.

Asset recognition as a part of revenue recognition

54. The analysis under Conceptual Framework indicates that the rights to recover the cost and the approved return constitute (economic) resource and we proposed the criteria to recognise those resources as an asset.

55. If the right to recover the cost and the approved return is obtained as a part of consideration for the entity's current sales of goods or services subject to rate regulation, asset would be recognised when that portion of consideration is recognised as revenue.

56. It is necessary to understand a typical price setting mechanism under rate regulation in order to derive criteria to determine whether the right to recover the cost and the approved return comprises consideration for the current sales rather than for future sales.

Understanding of price setting mechanism under rate regulation

<u>Setting goal of rate regulation</u>

57. The goal of the rate regulation would be to set the price at a just and reasonable level so that customers are protected from paying higher prices or rates for these goods or services than otherwise would occur in the absence of competition. Usually, target rate of return is approved by a regulator in order to achieve the goal and by doing so, rate regulation also guarantees a certain level of profit/return of the rate-regulated entity.

Determining price applied to sales in current period

58. Based on expectations on different variables such as anticipated sales volumes and costs, the regulator also determines current period's price at which it expects the entity would earn the approved rate of return.

Determining the difference between the target return and actual return

59. Although the price was set so that the entity earns the target return, it is usual for the entity to fail to meet the target. This is because costs of providing goods or services subject to rate regulation are volatile and the rate regulation makes the timely adjustment to the current price hard or impossible.

Determining the amount that has not been recovered through sales in the current period

60. Target revenue is the amount that should have been earned through sales in current period if target rate of return were achieved and it would be calculated by applying target rate of return to actual costs incurred. The difference between the target revenue and the actual revenue should be recovered through sales in subsequent periods if the rate regulation guarantees the return from the current period's sales approved in ① above and it establishes a tracking mechanism in which the approved unrecovered balances are tracked and adjusted to future price setting as described in ⑤.

Determining the price to apply for the sales in subsequent periods

61. The price for the subsequent periods would consist of the price for the next year's sales, which is determined in the same way as described in ② to achieve the approved return and the amount determined to recover the difference calculated in ④ above.

62. The right to recover the approved return and the cost would be given when the entity fails to earn the target return through current period's sales by incurring costs in excess of its anticipated costs, used to determine the current period price charged to customer for the sales of goods and services. If the expectation were accurate, the revenue earned in the current period would be exactly the same as the sum of the costs incurred and the approved return.

63. Such price setting mechanism has the following key characteristics to ensure that the rate regulated entity has rights/obligations to recover/refund the full amount of their approved return for the current period sales in subsequent periods.

- ✓ the goal of the regulation is to guarantee the target return for sales occurring in current period,
- ✓ departure from anticipation that is used to determine the current price triggers the adjustment to future prices, and
- ✓ the tracking system makes sure the entity achieves the guaranteed return.

64. As a result of the above price setting mechanism, the rate regulation ensures a rate regulated entity to charge customers to the extent of the target return and costs incurred in relation to sales occurring in the current period, which would be total transaction price of the current sales.

65. In other words, the right to recover the approved return and the cost constitutes the part of consideration for the sales occurring in current period because the right arises as a result of the unexpected but unavoidable changes in variables used to determine the current period price. Therefore, the rate regulation gives rise to rights to charge the unbilled amount that unavoidably occurs due to inability to accurately expect variables such as costs or sales volume, etc.

Contract with customers

66. For the entity to recognise the consideration which is the right to recover the approved return and the unrecovered cost as revenue, it is necessary for the entity to have contract with customers according to exposure draft of revenue recognition issued in 2011.

67. It could be argued that there is no contractual relation between the entity subject to rate regulation and the customers. However, if the regulatory environment is taken into account the conclusion could be different. Due to the requirement for significant investment, most of the regulated industries are in a monopoly or near-monopoly situation which is needed to protect the availability and stability of the supply and to set just and reasonable rates.

68. Regulator monitors the cash flows arising from transactions and establishes the rate based on collective customers. Regulation itself creates a quasi-contract (implied-in-scheme contract) between the entity and the collective customers. The entity has an obligation to provide the service to collective customers although it may not have the obligation to individual customers. Under the scheme, regulatory assets will be measured on the basis of collective customers.

69. Under these unique circumstances it is believed that the regulators act on behalf of the individual customers. Therefore, contracts (or quasi-contracts, implied-in-scheme contract) between an entity subject to rate regulation and its customers cannot be understood without reference to the regulation in place as the IASB staff described in the December 2008 IASB meeting. The contracts in the regulated operations are different from normal contracts among non-regulated companies. The entity has the right to impose regulated price(s) on the customer group as a whole based on the regulation in place.

70. Therefore, it is construed that a contract (or quasi-contract, implied-in-scheme contract) exists between the entity and the regulator on behalf of the customers as the customer cannot practically avoid the entity's supply. Due to the monopolistic nature, it is very unlikely that the customers seek alternatives for utilities. Although the individual customers may change over time, what the regulator oversees is the customer base as a whole.

71. Exposure draft Revenue recognition says "contracts can be written, oral, or implied by an entity's customary business practices and the customers are required to have approved contract in writing, orally, or in accordance with other customary business practices."

72. Even though the actual contract with customers do not mention rate regulation to which the contract is subject, it appears that customers would be aware of the price setting mechanism under the rate regulation and that in effect the mechanism would be terms of contract that would be established business practices.

73. Therefore, in order for rate regulation to be seen as a contract, we believe that customers should have sufficient understanding about price setting mechanism under the rate regulation and have access to the specific terms of that.

Transaction price of the current sales

74. We assume that rate regulation itself could become a contract if key terms of the rate regulation are known to customers when the customers enter into the transactions. As analysed in "Understanding of price setting mechanism", certain rate regulations create agreements between the entity, regulator and customers subject to the rate regulations to set the reasonable level of return of rate regulated activities. The right to recover or the obligation to refund the unbilled or overcharged amount arises incidental to the rate regulation.

75. Exposure draft Revenue recognition requires an entity to consider terms of the contract and its customary business practices to determine the transaction price. Consistently with this concept, considering the goal of the rate regulation and the fact the customers agreed with the terms of rate regulation, the right to recover unbilled amount effectively arises from the contract with customers. In other words, the transaction price of the current sales is the target revenue at which the entity would achieve the approved return and the deficit would be the deferred consideration.

76. We believe that if rate regulation specifies the direct relationship between 'unrecovered costs and profit' and the right to recover them in the rate regulation, the transaction price for the current sales would include the rights to recover incurred cost and approved return.

77. As criteria for revenue recognition, we believe that the right to recover the current period's unrecovered cost and approved return through sales in subsequent periods represents the deferred consideration for the current period sales if the rate regulation specifies:

- target return and costs to recover, and
- price setting mechanism that tracks the unrecovered target return and the costs to recover in the subsequent periods.

78. We also believe that customers should have sufficient understanding about the price setting mechanism that allows the entity to recover the current period's unrecovered cost and approved return in the subsequent periods.

Impact of contingency

79. The deferred consideration of the current sales is actually contingent consideration because it could be recovered as part of future sales. As the deferred consideration is charged in addition to the price for future sales, it is necessary to determine whether the contract requires additional performance obligation - i.e. future sales for the entity to be entitled to that specific consideration. If we only look at the form of the contract, it could be seen as requiring future sales because the right to payments does not exist anymore when the contract terminates before the future sales occurs.

80. However, understanding of the goal of rate regulation and price setting mechanism indicates that this contingency is designed merely as a manner of collection of deferred consideration, instead of requiring additional performance obligation. This collection method would be

regarded safe because significant level of termination of contract resulting in the entity failing to recover the approved return and unrecovered costs is unlikely to occur given the monopoly nature of the rate regulated activities and the collective nature of contract - i.e. regulation involving collective customers.

81. It would be inappropriate to conclude that the entity does not have rights to payments for the current period sales merely because contractual terms do not provide unconditional rights to payments. We should not oversee that the contractual terms in effect are designed only to facilitate collection of deferred consideration rather than regarding future sales as an additional performance obligation.

82. In addition, revenue recognition ED[1] does not require an entity to have unconditional rights to payments. Instead, it requires:

- ✓ to consider whether it would have an enforceable right to demand and/or retain payment for performance completed to date if the customer were to terminate the contract without cause prior to completion
- ✓ to assess the existence and enforceability of a right to payment for performance completed to date – e.g. an entity shall consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms.

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[1] 36.6. Furthermore, the entity's right to payment for performance completed to date does not need to be a present unconditional right to payment. In many cases, an entity will have that right only at an agreed-upon milestone or upon complete satisfaction of the performance obligation. Therefore, in assessing whether it has that right, the entity should consider whether it would have an enforceable right to demand and/or retain payment for performance completed to date if the customer were to terminate the contract without cause prior to completion.

36.7. In assessing the existence and enforceability of a right to payment for performance completed to date, an entity shall consider the contractual terms as well as any legislation or legal precedent that could supplement or override those contractual terms. This would include an assessment of whether:

a. Legislation or legal precedent confers to the entity a right to payment for performance to date even though that right is not specified in the contract with the customer.

b. A court has previously decided that similar rights to payment for performance to date in similar contracts have no binding legal effect.

- ✓ to assess whether it has enforceable right to payment even though it will have the contractual rights to payments upon complete satisfaction of the performance obligation.

83. The ED implies that determination of whether an entity has an enforceable right to payment is a matter of judgement based on substance of a contract.

84. We believe that if collective customers do not have practical ability to terminate contract and to avoid payments of deferred consideration, performance obligation is already complete with regard to the rights to deferred payments. This is because the rate regulation links the payment to future sales for the purpose of convenience based on the expectation that future sales are certain to occur in subsequent periods.

Classification as a financial asset

85. Someone argues that regulatory assets do not meet the definition of financial asset, because IAS 32 defines a financial asset as follows:

> A financial asset is any asset that is:
> (a) cash;
> (b) an equity instrument of another entity;
> (c) a contractual right:
> (i) to receive cash or another financial asset from another entity; or
> (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or (omitted hereafter)

86. By regarding rate regulation as a contract, the right to recover the unrecovered costs and the approved return would meet the definition of a financial asset.

87. We could find a similar argument in FASB Discussion Memorandum issued in December 1979 stating in paragraph 115 that:

> Supporters point out, however, that it is an asserted right to receive future revenues from customers, not the cost or loss, that is an asset. The asset is unique, but nonetheless a valid, form of receivable. It is an equitable right, rarely enforceable by law. Collectability generally depends on continued operations because collection can occur only upon delivery of future service (in that respect, the right has some attributes of an unbilled receivable under a long-term contract). The receivable seldom attaches to specific customers; rather, it

is collectible from customers as a class. The precise amount that will be collected is not normally determinable, although in many cases it can be reasonably estimated. In such case, it is argued, a valid and reasonably measureable asset exists that should be included in the enterprise's balance sheet.

Measurement

88. Under IAS 18 Revenue, revenue is measured at the fair value of consideration received or receivable. Therefore revenue and the resulting asset would be measured at fair value of deferred consideration that is recovered when future sales occurs.

Deriving revenue recognition criteria

89. The revenue recognition criteria discussed so far could be summarised like below.

(a) The rate regulation to which an entity is subject has the following key characteristics to ensure that the rate regulated entity has rights/obligations to recover/refund the full amount of their approved return for the current period sales in subsequent periods.

- ✓ the goal of the regulation is to guarantee the target return for sales occurring in current period,
- ✓ departure from anticipation that are used to determine the current price triggers the adjustment to future prices, and
- ✓ the tracking system makes sure the entity achieves the guaranteed return.

(b) Customers should have understanding of terms and mechanism of rate regulation by having access to information about the regulation and the regulation should specify

- ✓ target return and costs to recover
- ✓ price setting mechanism that tracks the unrecovered target profit and the costs to recover in the subsequent periods.

(c) Collective customers do not have practical ability to terminate contract and to avoid payments of deferred consideration.

Intangible asset

90. If the rights to recover the approved return and the unrecovered cost do not constitute deferred consideration for the current sales, this would be the consideration for future sales.

And this right could be seen as being obtained because the current price fails to cover the costs incurred and the approved return due to rate regulation. Therefore, the right arises as a result of past event and revenue is not recognised because future sale is a significant performance obligation that remains.

91. It would be appropriate for the rate regulated entity to recognise the right as intangible asset based on analysis below.

Similar feature to a right under IFRIC 12

92. This right granted by a regulator involves third parties - i.e., customers of the goods or services subject to a rate regulation because the entity is able to charge the customers to the extent that the rate regulation permits the entity to recover its costs. This is a very similar feature to intangible assets recognized in accordance with IFRIC 12. The interpretation identifies the operator's rights in service concession arrangements, which are given by a grantor and enable the operator to charge users of the public service.

Recognition criteria under IAS 38 Intangible Asset

93. Paragraphs 8-17 of IAS 38 provide a definition of intangible asset and guidance of application of the definition to various intangible items. IAS 38 defines an intangible asset as 'an identifiable non-monetary asset without physical substance' and provides separate guidance on the following aspects: identifiability, and control over resource.

<u>Identifiability</u>

94. IAS 38.12 states that an asset is identifiable if it either:

- is separable, i.e., is capable of being separated or divided from the entity and sold, transferred, license, rented or exchanged, either individually or together with a related contract, identifiable asset or liability, regardless of whether the entity intends to do so; or

- arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

95. We think that the right subject to rate regulation meets the second requirement for identifiability because the right arises from 'contractual or other legal rights'. Contractual or other legal rights are an integral aspect of regulations and therefore the economic resource that should be accounted for in rate regulated activities is the contractual or other legal right to recover the incurred cost.

Control

96. IAS 38 focuses on the concept of control in the part of definition of asset. Paragraphs 13-17 provide guidance of applying the concept to various examples. It is what has long been the center of debates over whether the possible asset subject to rate regulation meets the definition of asset. It has been argued that the entity does not control the economic resource because regulations do not bind customers to buy goods from the entity and the entity therefore does not control the customers.

97. However, given that the DP/2013/1 attempts to clarify that a resource (asset) is different from the resulting inflows of economic benefits, the aforementioned argument could be seen as a result of confusion between a resource (asset) and inflows of economic benefits. In particular, paragraph 3.23 of DP/2013/1 defines control as follows: An entity controls an economic resource if it has the present ability to direct the use of the economic benefits that flow from it.

98. Also paragraph 3.27 implies that control over an economic resource is an ability to make the economic benefits arising from the resource flow to the entity, rather than an ability to ensure that the resource will generate economic benefits in all circumstances.

This concept has already been adopted in several intangible assets as follows:

Operator's right under a service concession arrangement - IFRIC 12

99. A right to charge users of the public service under IFRIC 12 is not an unconditional right to receive cash because the amounts are contingent on the extent that the public uses the service. IFRIC 12 does not require the operator control economic benefits driven by its right to charge users of the public service. Instead, for the entity to control the right, the economic benefits derived from the right must flow to the entity when users actually use the service. The IFRIC conclude that an unconditional right to receive future revenues from customers was not necessary for the operator to recognize an asset – the right to charge customers for the expected future usage of the infrastructure was sufficient.

100.

Established customer relationships

101. Another example is established customer relationships recognized in business combinations. An entity having the intangible assets is not able to force customers do business with the entity (control over economic benefits) but once the customers do, future cash flows flow to the entity.

102. As already noted during the deliberation of the 2009 ED, the key notion is that the entity has access to a resource and can limit others' access to that resource.

- ✓ Possible confusion arising from IAS 38

  Although DP/2013/1 clarifies the key notion above and the current IFRS already has the same concept in the case of IFRIC 12 and established customer relationships, IAS 38 somewhat has contributed to the confusion between control of economic benefits and economic resources. IAS 38.13-16 provides guidance on control notion and explicitly mention 'control over economic benefits' several times.

  We recommend that these paragraphs in IAS 38 also be amended in the same way as the clarification made in DP/2013/1.

- ✓ Enhancement to an existing intangible asset

  Assuming that the right to recover incurred costs under rate regulations is not separable from the existing rights, any costs to acquire the right to recover the incurred costs would constitute a subsequent expenditure to an existing right to operate the business. It would be very difficult to capitalize those expenditures under the current IAS 38 in this case, because IAS 38.30 explicitly states that only rarely will subsequent expenditures incurred after the initial recognition of an acquired intangible asset or after completion of an internally generated intangible asset be recognized in the carrying amount of an asset. The same paragraph further states that the nature of intangible assets is such that, in many cases, there are no additions to such an asset or replacements of part of it and that most subsequent expenditures are likely to maintain the expected future economic benefits embodied in an existing intangible asset rather than meet the definition of an intangible asset and the recognition criteria in IAS 38.

  However, in the case of the right to recover the incurred cost in rate regulated activities, it is not expenditure to maintain the expected future economic benefits. Rather, the future economic benefits have been increased by the regulator's guarantee of an increase of the future price that otherwise might not happen. It would not be appropriate to read and

interpret paragraph 30 of IAS 38 as prohibiting the rate regulated entity from capitalizing the subsequent expenditures.

Applying the current IAS 38 probably might or might not result in the subsequent expenditure being recognized in the carrying amount of the existing asset (if any). For clarification, we recommend deleting the statement that only rarely will subsequent expenditures be recognized in the carrying amount of an asset from the standard.

Measurement of Intangible Asset

103. If an entity has a deferred account due to higher actual costs than estimated the entity is allowed to charge higher rate in the future sales. According to paragraph 24 of *IAS 38, Intangible Assets*, an intangible asset shall be measured initially at cost. The acquisition cost of the deferred account is the costs that actually incurred. If an operation cycle is relatively short it is highly probable that the intangible assets will be amortized in the following period as expense.

Potential bases for recognition and measurement of liabilities arising from rate-regulation

2009 ED

104. As explained above, the IASB published Exposure Draft "Rate-Regulated Activities" in 2009. The ED suggested that a rate-regulated entity should recognize an asset or a liability if the regulator permits the entity to recover specific previously incurred costs or required it to refund previously collected amounts and to earn a specified return on its regulated activities by adjusting the prices. This form of regulation is referred to as a "cost-of-service regulation." The ED defines a regulatory liability as "an entity's obligation to refund previously collected income and to pay a specified return by decreasing rates in future periods as a result of the actual or expected actions of its regulator[2]."

105. However, in 2010, the IASB decided not to proceed with the project for various reasons. Although the IASB did not make any technical conclusions regarding regulated activities, the analysis of IASB staff in September 2010 suggested that the regulatory liabilities do not meet

[2] Exposure Draft "Rate-Regulated Activities" Appendix A

the definition of a financial liability or a provision; therefore the liabilities should not be recognized. The analysis states that the reduction in a future cash inflow of economic benefits is a change in the value of a license, rather than a liability. The paper also includes a suggestion that only outflow of resources embodying economic benefits is a liability.

Financial liabilities

106. According to the IAS 32 Financial instruments: Presentation, a financial liability is defined as:

- a contractual obligation:
  - to deliver cash or another financial asset to another entity; or
  - to exchange financial assets or financial liability with another entity under condition that are potentially unfavourable to the entity; or
- a contract that will or may be settled in the entity's own equity instruments with certain criteria.

107. It can be argued that the future price decreases imposed by a regulator do not result in the entity being obligated to pay cash or other financial assets. Rather, the decrease in rates will result in a lower profit margin in the future, as a result of price regulation. Therefore, regulatory liability will not meet the definition of financial liability.

Provision

108. IAS 37 Provisions, Contingent Liabilities and Contingent Assets provides a detailed guidance regarding recognition of liabilities.

Provision, a liability of uncertain timing or amount, should be recognized when

- an entity has a present obligation (legal or constructive) as a result of a past event;
- it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- a reliable estimate can be made of the amount of the obligation.

109. According to the analysis of IASB staff in 2010, the regulatory liabilities do not meet the recognition criteria of provisions, as the existence of an obligation will be confirmed only by the occurrence or nonoccurrence of one or more uncertain future events not wholly within the control of the entity. Paragraph 19 of IAS 37 states that only present obligations arising from past events existing independently of an entity's future actions are recognized as provisions. If the entity can avoid the future expenditure by its future actions, it has no present obligation for that future expenditure and no provision is recognized. Also, the staff thought that IAS 37 does not consider whether the future contingent event that may occur in the future is highly probable of occurring.

110. Therefore, the obligation to decrease rates in future is not a provision, as the entity may decide not to sell the goods or services to avoid refund previously collected amounts in the form of decreased rates.

Conceptual Framework for Financial Reporting

111. Current IFRSs do not have specific guidance applicable to the regulatory liability. However, if the regulatory liability satisfies the general definition of a liability and recognition criteria, the entity may recognize a regulatory liability in its financial statements.

Definition of a liability

112. The IASB's Discussion Paper Conceptual Framework (2013) is proposing a new basis of recognizing a liability. The Discussion Paper defines a liability as below:

> 'a present obligation of the entity to transfer an economic resource as a result of past events.'

113. A rate-regulated entity's obligation to refund previously collected amounts over the actual cost shall be recognized as a liability when the obligation satisfies the proposed definition. In other words, if the obligation to refund a previously collected amount through lower sales price is a present obligation, the entity should recognize a liability.

114. There are three possible issues for a regulatory liability to satisfy the proposed definition as follows:

- What is the obligation of the entity?
- What is the past event that causes the obligation?
- Does the entity have a present obligation?

What is an obligation of the entity?

115. To recognize a liability, an entity should have an obligation. The DP explains that an "obligation to transfer an economic resource" may result in an entity paying cash or other assets, granting a right to use an asset, rendering services or standing ready to make a payment on the occurrence of a future event that is outside the entity's control.[3]

116. Under the rate-regulation, if a regulated entity makes sales in a certain period at a higher price than allowable cost, then the entity will have to decrease sales price the following period. The obligation of the entity is not to refund the over-collected amount to customers, but to decrease future sales price.

117. According to the above paragraphs, it may seem that the obligation of the entity may not constitute an "obligation to transfer an economic resource", as the entity does not directly transfer cash or other assets to the customer or government. Rather, the entity has to transfer goods or services at a lower amount than the price the entity would charge without rate-regulation.

118. However, the rate-regulation will make an obligation when considering the pricing mechanism. For example, the regulated entity collected 10,000 through sales last year. This collected amount is 1,000 larger than the entity's allowable cost actually incurred in the period. According to the related regulation, the entity has to refund the over-collected amount of 1,000 next year, through price adjustment. The entity and the regulator expect that the allowable cost of the following year will be 12,000. The regulator required the entity to collect 11,000 through sale, as the entity collected 1,000 in the previous year.

119. If the entity was not rate-regulated, the entity will set a price to collect 12,000. The amount of 1,000 the entity is not allowed to collect will be an obligation of unfavorable transaction, compared to the entity without rate-regulation.

120. It may be not clear under *Conceptual Framework*, whether the unfavorable transaction will constitute an obligation. There are other standards that require recognition of a liability, when the obligation of the entity is to transact in an unfavorable terms. For example, the definition

[3] Discussion Paper Conceptual Framework for Financial Reporting Paragraph 3.36

of a financial liability in IAS 32 includes "a contract to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity." According to the above definition, a derivative liability will be recognized when the entity has an obligation to purchase an instrument at a higher price or, to sell an instrument at a lower price.

121. IAS 37 also requires an entity to recognize a provision for an onerous contract. Although the IFRSs generally do not require recognizing an executory contract, IAS 37 requires that if an entity has a contract that is onerous, the present obligation under the contract shall be recognised and measured as a provision.

122. From these examples, we can regard the obligation to decrease future price as an obligation to transfer an economic resource. Therefore, the regulated entity has an obligation of setting a lower price than the expected costs and margin, to refund the previously over-collected amount to the customers.

What is the past event that causes the obligation?

123. To satisfy the definition of a liability under the DP, the present obligation of a regulated entity must have arisen from a past event. The regulated entity's obligation has arisen when the entity provided goods or services at a higher price in the previous period.

124. Some may think that the event that makes the obligation is future sales transaction, rather than the sales in the past. If this transaction is considered from an individual transaction basis, the entity's obligation from past sales transaction would not be identified. For example, if a new customer begins to purchase from a regulated entity, there are no past event(s) that cause the entity's obligation, even though the customer will buy the goods or services at the lower price.

125. However, the obligation of a regulated entity needs to be analyzed at the collective customer level, rather than individual customer. The amount the entity should refund through the decreased price is determined from sales transactions already incurred in the previous period to the whole customer group. The obligation is to refund that total amount back to the customers rather than to the individual customer.

126. Considering the linkage between the amount received in the previous period and the obligated amount, we can conclude that the obligation to refund the previously collected amount through future sales price has arisen from the sales transaction in the previous period.

Does the entity have a present obligation?

127. As discussed above, the objection of recognizing the regulatory assets were mainly based on the fact that the entity does not control the inflow of economic resources. For regulatory liabilities, it can be argued that the entity does not have a present obligation if the entity can avoid the obligation.

128. The obligation of a regulated entity is fulfilled when customers buy goods or services in the future. For example, if the sales price of a regulated entity was higher than the actual incurred cost, the entity should refund a part of the collected amount through price regulation. The entity might avoid the obligation, for example when it ceases to operate. (It depends on the regulations.)

129. The DP Conceptual Framework has guidance regarding the meaning of present obligation, when the obligation is conditional on the occurrence of the entity's future actions. The DP suggested three views:

- View 1: a present obligation must have arisen from past events and be strictly uncondition al
- View 2: a present obligation must have arisen from past events and be practically uncondi tional
- View 3: a present obligation must have arisen from past events but may be conditional on the entity's future actions

<u>View 1</u>

130. Under View 1, as long as the entity could avoid the transfer of resources through its future actions, it does not have a present obligation. In other words, if an entity must take a series of actions before it has an unconditional obligation, no liability exists until it has taken all of the actions.[4] According to this view, the regulated entity does not have a present obligation. The entity may decide not to continue the operation, and then the entity does not have an obligation to refund a certain amount to customers.

<u>View 2</u>

[4] Discussion Paper *Conceptual Framework for Financial Reporting*, Paragraph 3.75

131. Under View 2, even though the entity may avoid the obligation in theory, if it is not practical, then the entity has a present obligation. The assessment of whether an entity has the practical ability to avoid any remaining conditions would require judgement.[5]

132. According to this view, the regulated entity may have an obligation to decrease rates, to the extent that the entity does not have a practical ability to cease to operate. Although it depends on the entities' decision to cease operation in the future, it may be less practical for a regulated entity. Generally, government or regulator grants license to the regulated entity, and the entity may not decide to cease operation based on the license.

133. The DP includes many scenarios applying the three views above. There are scenarios that the entity is able to avoid the obligation through leaving the market or curtailing the operation. The analysis of the DP suggests that the assumption of leaving the market or curtailing the operation is not practical in most cases.

134. Considering the characteristic of the regulated operation and the analysis in the DP, it would not be practical to assume that the regulated entity may stop operation to avoid the obligation to decrease rates, and therefore the entity has a present obligation.

<u>View 3</u>

135. The last view is that the past event is sufficient to create a present obligation. Under this view, it is not necessary for the obligation to be unconditional. An obligation arises when the entity receives a resource or conducts an activity, in exchange for which another party will be able to demand a transfer of resources if the entity meets further conditions.

136. As soon as the entity has received the resource or conducted the activity, it no longer has complete discretion to avoid a future transfer. The future transfer may be conditional on the entity's future actions but the obligation has arisen from past events and so is a present obligation.[6]

137. According to View 3, the entity has a liability if it will be required to exchange economic resources with another party on more onerous terms than would have been required without

[5] Discussion Paper *Conceptual Framework for Financial Reporting*, Paragraph 3.79
[6] Discussion Paper *Conceptual Framework for Financial Reporting*, Paragraph 3.85

the past receipt or activity.[7] Therefore, the regulated entity's obligation to decrease rates is a present obligation under View 3.

Executory contracts

138. It can be argued that the regulated entity's future unfavorable transaction should not be recognized as this is an executory contract. The DP also suggests that the executory contracts are not recognized as an asset or liability. According to the DP, the executory contracts generally are not recognized as the measurement of the contract would be zero.

139. The regulated entity's obligation is different from executory contracts, as the measurement would not be zero. The regulated entity already received a part of the consideration that should be received when future sales take place. The DP states that a liability can be viewed as having arisen from past events if the amount of the liability will be determined by reference to benefits received by the entity before the end of the reporting period.[8]

Conclusion

140. Among the above three views, the IASB could not reach a preliminary view, although it rejected View 1[9]. According to View 2 and View 3, the regulated entity's obligation could be considered as a present obligation. The DP provides a possible ground to recognize regulatory liabilities.

Recognition criteria

141. The DP states that an entity should recognise all its assets and liabilities. However, a particular standard may require an entity not to recognize an asset or a liability, if the recognition of an asset or a liability would provide users of financial statements with information that is neither relevant nor faithful:

[7] Discussion Paper *Conceptual Framework for Financial Reporting*, Paragraph 3.86
[8] Discussion Paper *Conceptual Framework for Financial Reporting*, Paragraph 3.66
[9] Discussion Paper *Conceptual Framework for Financial Reporting*, Paragraph 3.96

142. The DP includes some example guidance that recognition might not provide relevant information.

- if the range of possible outcomes is extremely wide and the likelihood of each outcome is exceptionally difficult to estimate
- if an asset (or a liability) exists, but there is only a low probability that an inflow (or outflow) of economic benefits will result
- if identifying the resource or obligation is unusually difficult
- if measuring a resource or obligation requires unusually difficult or exceptionally subjective
- if recognising an asset is not necessary to meet the objective of financial reporting

143. As discussed above, the regulatory liability would satisfy the definition of a liability. Unless the recognition of a regulatory liability leads to providing information not relevant or not faithful, the regulatory liability should be recognized.

144. Recognizing all of entity's assets and liabilities in financial statements will generally provide relevant information. Especially, recognizing regulated liabilities on financial statements would not impair relevance or faithfulness.

145. In many cases, the rate-regulated activities are the main operation of the regulated entity. Representing the economic effect of the rate-regulation on its financial statements will improve the financial information by being more relevant and faithful.

146. Therefore, the recognizing the regulatory liabilities on the financial statements will better provide the users of financial statements with faithful and relevant information. The entity would have to recognize regulatory liabilities according to the DP *Conceptual Framework*.

Measurement of regulatory liabilities

2009 ED

147. The 2009 ED suggested that on initial recognition and at the end of each subsequent reporting period, an entity shall measure a regulatory asset or regulatory liability at its expected present value.

148. When measuring the asset or liability, the entity shall reflect the following elements in the measurement of the expected present value:

- an estimate of the future cash flows that will arise in a range of possible outcomes.
- an estimate of the probability of each outcome occurring.
- the time value of money, represented by the current market risk-free rate of interest.
- the price for bearing the uncertainty inherent in the regulatory asset or regulatory liability.

Expected present value approach is based on the assessment that it reflects the entity's expectations of future cash flows more faithfully.

Conceptual Framework

149. The Discussion Paper Conceptual Framework includes guidance that can be used when determining a measurement approach. The DP suggests three categories of measurement:

- cost-based measurements
- current market prices including fair value
- other cash-flow-based measurements

The preliminary view in the DP is that the selection of a measurement for a particular liability should depend on how the entity will settle or fulfill that liability.

150. Cost-based measurements are widely used in measuring liabilities. The cost of a liability refers to cash received or the fair value of other consideration received at the time that a liability is incurred. Cost of a regulatory liability will be determined by the previously collected amount over the allowable costs, and the regulator requires the entity to refund in the future.

151. Cash-flow-based measurement is not used frequently as a measurement basis of an asset or a liability; this measurement approach is used for impairment, net realizable value, deferred tax assets and liabilities.

152. According to the DP, cash-flow-based measurements are used when

- cost or a current market price does not provide sufficiently relevant information;
- there is no cost or proceeds for the item being measured; or
- a current market price is too difficult or too costly to obtain.[10]

153. Fair value is the most frequently used current value measurement in existing IFRSs. However, current market prices (including fair value) would not be appropriate to measure a regulatory liability. This category is appropriate when the liability can be traded in market. The regulatory liability cannot be traded in market because of the regulation.

154. To suggest the appropriate measurement approach for a regulatory liability, how the entity will settle that liability should be considered. The regulatory liability will be settled though future sales transaction, by putting a lower price than a price without regulation, for a specified period. Though the form of settlement is exchanging the goods or services at a lower price, the settlement method will have a similar effect to settling the obligation with cash.

155. Although it depends on the regulation, the amount that will be settled would be close to the cost of the liability. In other words, the cost provides sufficiently relevant information about future cash flows of a regulatory liability.

156. However, the amount can be influenced by the volume of sales. Generally, the entity and the regulator use estimates of the sales volume to determine the amount of refund per unit. If the actual sales volume does not reach the estimated sales volume, the settlement amount will be less than the cost of the liability. This uncertainty should be included in the measurement of liability, to fairly represent future cash flows from the regulated liability.

157. In conclusion, the regulated liability will be measured initially at cost. The cost of regulated liability generally is the same as cash-flow based measurement. However, if the estimate of future cash flow changes over time, the entity will have to update the estimated cash flow.

[10] Discussion Paper *Conceptual Framework for Financial Reporting*, Paragraph 6.52