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IASB project on the accounting model for regulatory assets and regulatory liabilities

Project Update

Objective

- 1 The objective of this session is to provide a project update to EFRAG TEG-CFSS members on the IASB project on the accounting model for regulatory assets and regulatory liabilities (the model). The update covers:
 - (a) Key messages identified so far on the model
 - (b) Status of the outreach on scope of the model
 - (c) Initial thoughts on the early-stage effects analysis of the model.
- 2 **Agenda paper 10-02** (background paper) outlines the IASB tentative decisions on the model and the views and concerns expressed so far by EFRAG TEG and EFRAG RRAWG members on the IASB tentative proposals.

Background

- 3 In July 2019, the IASB gave the Staff permission to start the balloting process for the publication of an exposure draft for the model. **The exposure draft is expected in October 2020.** We understand that the IASB Staff may ask the IASB at its meeting in July 2020 to extend the comment period from the initial suggested period of 120 days to 180 days.
- 4 The model, when finalised as an IFRS Standard, will replace IFRS 14 *Regulatory Deferral Accounts*, an interim Standard permitting different accounting approaches for rate regulation.
- 5 The model has been discussed with the EFRAG RRAWG at its meetings in October 2019 and on 19 June 2020. EFRAG TEG discussed the model at its meetings in November 2019 and a web-cast meeting in February 2020, respectively.
- 6 The EFRAG Board received a presentation from an IASB member on the model at its meeting in February 2020. The EFRAG Board was not asked to take any decisions. A key issue discussed was the actual perimeter of the entities impacted and whether this would finally be in line with the IASB's intention. Some believed that with the wording in the IASB tentative decisions only few large companies in the utility sector would be impacted, while others considered that the scope would be larger and impact entities outside that sector. This understanding needed to be confirmed through outreach to European national standard setters and other relevant organisations.

Key areas of the model

- 7 The model covers the following areas:
 - (a) Objective and general principle of the model
 - (b) Scope and definition of regulatory assets and regulatory liabilities
 - (c) Recognition (including regulatory boundary)
 - (d) Measurement of regulatory assets and regulatory liabilities (including accounting for target profit)
 - (e) Amendments to and interaction with IFRS Standards (IFRS 1, IFRS 3, IFRS 5, IAS 1, IAS 36)
 - (f) Presentation and disclosure requirements
 - (g) Transition

Objective of the model and general principle

- 8 The objective proposed in the model is that an entity should provide relevant information that faithfully represents how regulatory income and regulatory expense affect the entity's financial performance, and how regulatory assets and regulatory liabilities affect its financial position.
- 9 To meet this objective, the general principle of the model is that an entity shall **reflect the total allowed compensation for the goods or services supplied in a period**. The current working definition is that the total allowed compensation is:

The amount that an entity is entitled to charge customers, in the same or a different period, in exchange for the goods or services supplied in a specified period, in accordance with the regulatory agreement. This definition was confirmed in [agenda paper 9A](#) discussed by the IASB in March 2020.
- 10 The total allowed compensation will be specified in a regulatory agreement and includes the following elements:
 - (a) allowable expenses and chargeable income; and
 - (b) target profit (incl. margins on allowable expenses, regulatory returns, regulatory interest and performance incentives).
- 11 The total allowed compensation is key in the definition of regulatory assets and regulatory liabilities because the model recognises:
 - (a) A **regulatory asset** when total allowed compensation exceeds the amount already charged to customers under IFRS 15 *Revenue from Contracts with Customers*
 - (b) A **regulatory liability** when the allowed compensation is lower than the amount already charged to customers under IFRS 15.

Scope

- 12 To apply the general principle in paragraph 9 above, an entity will be required to recognise regulatory assets and regulatory liabilities. At its March 2020 meeting, the IASB confirmed that the focus would be on a type of rate regulation that meets certain criteria, which in turn gives rise to regulatory assets and regulatory liabilities.
- 13 The IASB has tentatively decided that the scope of the model would apply to:

*Regulatory assets and regulatory liabilities arise from a **regulatory agreement** (regulatory framework) between an entity and a regulator in which the agreement sets out the regulated rate that the entity can charge the customer for goods or*

services provided. The regulatory agreement should be binding on both the entity and the regulator.

The **regulated rate** is a transaction price that a regulatory agreement entitles an entity to charge customers in a period for goods or services supplied in the same period. The regulated rate is determined based on the **total allowed compensation** agreed between the entity and the regulator.

- 14 The IASB considers that the **feature that distinguishes** the type of rate regulation in the scope of the model from other forms of rate regulation is that the basis for setting the regulated rate gives rise to:
- (a) rights to add amounts to, and obligations to deduct amounts from, future rate(s) because of goods or services already supplied or because of amounts already charged to customers; and
 - (b) these rights and obligations arise because the basis for setting the rate establishes not only the amount of total allowed compensation for goods or services supplied in a period but also determines when (i.e. in which periods) that total allowed compensation is included in the rate(s) charged to customers.
- 15 In its tentative decisions the IASB did not define a regulator. However, the exposure draft might provide some indication of the types of regulatory agreements that would be included in the scope. However, the EFRAG Secretariat understands that the guidance will be high-level guidelines rather than overly prescriptive.

Definition of regulatory assets and liabilities

- 16 To apply the general principle in paragraph 9 above, an entity will be required to recognise regulatory assets and regulatory liabilities. Regulatory assets and regulatory liabilities will arise from a regulatory agreement between a regulator and an entity when the agreement creates enforceable rights and enforceable obligations. The IASB has not specifically defined a “regulator”.
- 17 The concept of total allowed compensation in paragraphs 9 and 10 above is used to help an entity in assessing when it would recognise and derecognise regulatory assets and regulatory liabilities and the amount of those assets and liabilities. The current tentative definitions of regulatory assets and regulatory liabilities are as follows:
- (a) **regulatory asset**—the present right to add an amount to the regulated rate(s) to be charged to customers in future periods because the **total allowed compensation** for the goods or services already supplied exceeds the amount already charged to customers.
 - (b) **regulatory liability**—the present obligation to deduct an amount from the regulated rate(s) to be charged to customers in future periods because the **total allowed compensation** for the goods or services already supplied is lower than the amount already charged to customers.
- 18 For a regulatory asset and a regulatory liability to exist, the right and/or the obligation must be an **enforceable present right and/or present obligation**.
- 19 As a result, an entity would recognise in its statement(s) of financial performance:
- (a) **regulatory income** if some or all of the total allowed compensation for the goods or services supplied in the current period will be included in revenue in future periods or was included in revenue in previous periods; and
 - (b) **regulatory expense** if the revenue recognised in the current period includes some (or all) of the total allowed compensation for goods or services that will be supplied in future periods, or that were supplied in previous periods.

- 20 The appendix to this paper provides an example, previously discussed by the IASB, of a regulatory asset and a regulatory liability.

Summary of key messages expressed so far on the model

- 21 The discussions so far with EFRAG RRAWG and EFRAG TEG have identified the following key messages on the scope and application of the model. This is a summary of the more detailed messages included in paper 10-02 (background paper).
- (a) **Scope** - EFRAG TEG members considered that the scope may be too broad and include a wider range of regulatory agreements than initially anticipated (e.g. regulatory agreements of entities other than entities operating in the utility sector could be impacted). The EFRAG RRA project team is currently undertaking outreach with national standard setters to understand whether the proposed scope is clear and whether it is likely to include any activities or items that would not have expected to be included and vice versa (likely to exclude any activities or items that constituents would have expected to be included).
 - (b) **General comment on the model** - The model had become overly complex and difficult to understand and may result in application issues.
 - (c) **Enforceable rights and obligations** - EFRAG TEG and EFRAG RRAWG agreed that the rights and obligations must be enforceable to result in the recognition of assets and liabilities. Some EFRAG TEG members questioned whether regulatory assets and regulatory liabilities met the definitions of assets and liabilities in the IASB's *Conceptual Framework for Financial Reporting* (Conceptual Framework). In contrast, most (all) members of the EFRAG RRAWG agree that regulatory assets and regulatory liabilities meet the Conceptual Framework definitions.
 - (d) **Recognition** - EFRAG TEG and EFRAG RRAWG members generally supported the IASB's tentative decision on the recognition criteria of the accounting model. However, some members (EFRAG TEG and EFRAG RRAWG) did not see a need for a recognition threshold if an entity had enforceable rights and enforceable obligations that arose from the regulatory agreement and had assessed that such rights and obligations were in the scope of the model.
 - (e) **Boundary of regulatory agreement** - EFRAG TEG and EFRAG RRAWG found the IASB's tentative decision on the boundary of the regulatory agreement confusing. Like EFRAG RRAWG, EFRAG TEG had difficulties with understanding how in practice an entity would determine the boundary of a regulatory agreement and why it was important to make this assessment. EFRAG TEG suggested that boundary should be determined based on the regulatory legal framework. EFRAG TEG shared the views expressed by the EFRAG RRAWG that the tentative guidance on determining the boundary was mixing the entity's licence to operate with the regulatory agreement. They suggested that the boundary be tested in practice using more complex examples provided by the EFRAG RRAWG, preferably when combined with concession agreements accounted for under IFRIC 12 *Service Concession Arrangements*.
 - (f) **Measurement** – EFRAG TEG and EFRAG RRAWG members generally agreed with the proposed adjusted historical cost measurement principle. Some EFRAG TEG and EFRAG RRAWG members suggested that the model should not resort to the requirements in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* when accounting for changes in estimated cash flows but rather provide guidance in the model for defined rate regulation.

Some EFRAG RRAWG members suggested that further guidance was needed with respect to the application of the measurement exception for regulatory assets and regulatory liabilities that relate to expenses or income included in the regulatory rate when cash is paid or received.

- (g) **Discounting** - Some EFRAG TEG members disagreed with the discounting approach. Some EFRAG RRAWG members commented that the concept of discounting when measuring regulatory items was not very relevant to those items as the amounts to be recognised as regulatory assets and regulatory liabilities were initially negotiated with the regulator, as this negotiation factored in discounting. Some EFRAG RRAWG members added that discounting would be complex because, like with IAS 12 *Income Taxes*, an entity would need to track the timing differences and the periods in which they originate (reverse).

Most (if not all) EFRAG TEG and EFRAG RRAWG members disagreed with the IASB tentative decision that when the regulatory interest rate is inadequate to compensate the entity for the time value of money and uncertainty inherent in the cash flows, the entity should determine a minimum adequate rate to use as the discount rate. The EFRAG RRAWG members pointed out that the regulatory agreement does not use the concept of a minimum adequate rate and introducing such a rate in the model would be a highly subjective and complex exercise for preparers. In addition, EFRAG RRAWG members expressed views that the application of a minimum adequate rate would not bring value to users to understand regulatory assets and regulatory liabilities.

The EFRAG RRAWG members that supported discounting said that it should be based on the regulatory discount rate.

- (h) **Accounting for regulatory returns on CWIP** - EFRAG RRAWG members had mixed views regarding the IASB's tentative decision that regulatory returns on a construction work-in-progress (CWIP) base included in the **regulated rates charged to customers during the construction period form part** of total allowed compensation only during the period when the asset is in operation and is being used to supply goods or services. Some EFRAG RRAWG members noted that it is not uncommon to recognise revenue over the construction period. Those that did have that view referred to the amendment in IAS 16 *Property, Plant and Equipment* where sales revenue can be recognised before an asset is ready for its intended use. However, some RRAWG members noted that tracking CWIP will be very burdensome. CWIP was not necessarily tracked in such detail for regulatory purposes. Other RRAWG questioned whether this proposal was aligned with the requirements for CWIP under IFRIC 12. (This issue has not been discussed with EFRAG TEG).
- (i) **Accounting for performance incentives** - EFRAG RRAWG members generally supported the IASB proposals on the treatment of performance incentives in the model. Suggestion was made to improve the wording with respect to defining the performance incentives period for construction-related performance incentives as the period to evaluate the performance of construction. (This issue has not been discussed with EFRAG TEG).
- (j) **Presentation** - EFRAG TEG members expressed split views with respect to the presentation of regulatory expenses and regulatory income in profit or loss and the OCI. Some EFRAG RRAWG members thought that the IASB proposal created complexity.

EFRAG RRAWG members were also divided as to whether regulatory interest income and regulatory interest expense should be included within the regulatory income or regulatory expense line item immediately below the

revenue line item. Some members supported the IASB presentation approach as it gives clearer performance of regulatory assets and regulatory liabilities. Other members were of the view that regulatory interest expense and regulatory interest income belong to the financing category and should be presented as such.

- (k) **Interaction with IFRS Standards** - EFRAG TEG members had mixed views on the exception to the measurement principle in **IFRS 3 Business Combinations** for regulatory assets and regulatory liabilities acquired in a business combination. Some EFRAG TEG members agreed with the exemption. Other EFRAG TEG members did not agree with the exception on the basis that there are other assets that do not trade in an active market. EFRAG RRAWG members agreed with the exception.

EFRAG TEG and EFRAG RRAWG members thought that the IASB needed to further consider the interaction between **IFRS 5 Non-current Assets held for sale and Discontinued Operations** and **IAS 36 Impairment of Assets** 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. A similar point was made for assets that had been acquired in a business combination and were used to provide regulatory goods or services.

EFRAG TEG and EFRAG RRAWG members noted that it would be necessary 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. A question was also raised for cases when an entity has a hybrid model under IFRIC 12.

- (l) **Disclosure requirements** - Some EFRAG TEG and many EFRAG RRAWG members expressed concerns with the level of detailed disclosure requirements and considered that entities might not have readily available the level of granular information required under the proposals. EFRAG RRAWG members generally agreed that the materiality principle will need to be applied to narrow down the disclosure requirements under the model.
- (m) **Transition requirements** - EFRAG TEG members generally agreed with the transition requirements of the model. However, they suggested that the IASB should also consider a modified retrospective approach to simplify the transition requirements of the model for regulatory assets and regulatory liabilities similar to the approach in IFRS 15. EFRAG RRAWG agreed that a modified approach should be explored by the IASB. EFRAG TEG members noted that the transition requirements will have an impact on the impairment test of the CGU under IAS 36, therefore additional guidance was required. EFRAG RRAWG noted the same concern.

Some EFRAG RRAWG members questioned why goodwill-related regulatory assets should be derecognised to goodwill under the model and not allocated to other assets.

Status of the outreach on scope of the model

- 22 The EFRAG RRA project team is currently undertaking outreach with European national standard setters to understand whether the proposed scope is clear and whether it is likely to include any activities or items that would not have expected to be included and vice versa (likely to exclude any activities or items that constituents would have expected to be included).

- 23 At this stage, feedback received so far from EFRAG TEG and EFRAG RRAWG members indicates that the sectors likely to be impacted by the scope are some or all of the utility sector (gas, electricity and water), transport sector (such as airports, railways and some public transport services), and perhaps the real estate sector (when they are providing goods or services that fall under the scope of the model).
- 24 EFRAG Secretariat has contacted some European national standard setters to assist in establishing contacts with entities which would be interested in testing the scope of the model for regulatory assets and regulatory liabilities. Currently, interest to participate in the scope outreach has been expressed by the French standard setter (ANC), the German standard setter (DRSC), the Spanish standard setter (ICAC), the Portuguese standard setter (CNC) and the Polish standard setter (PASC).
- 25 At present, the EFRAG Secretariat would like to create a list of field test participants willing to test the IASB proposals on the scope as soon as the exposure draft on the model for regulatory assets and regulatory liabilities is published in October 2020. The final wording of the scope description and other proposed requirements, including an understanding of the application guidance and accompanying illustrated examples, could potentially affect the scope and application of the model. The IASB Staff has informed us that they are currently refining the wording and developing application guidance on specific areas to be included in the exposure draft. The EFRAG Secretariat consider that it may be possible to undertake the work on scope together with the effects analysis discussed in the paragraphs below.

Initial thoughts on effects analysis/field tests on the model

- 26 The effects analysis/field testing is intended to help EFRAG and its constituents understand the potential impact, expected benefits and costs of the proposed approach on the accounting for regulatory assets and regulatory liabilities. The effects analysis/field tests will be targeted at preparers and users of financial statements.
- 27 The IASB proposals will affect entities that have regulatory assets and regulatory liabilities as defined by the IASB in its project on rate-regulated activities. Some European IFRS reporting entities do not currently recognise regulatory assets and regulatory liabilities. Other European entities might already recognise regulatory assets and regulatory liabilities in their IFRS financial statements. These entities would have developed an accounting policy under IAS 8 that explains why they recognise regulatory assets and/or regulatory liabilities.
- 28 The EFRAG project team discussed an initial plan to conduct an effect analysis of the IASB proposals prior to publication of the exposure draft, with the EFRAG RRAWG on 19 June 2020. The benefit of this approach is to kick-start the likely effects work at an early stage and substantiate the comments in the EFRAG draft comment letter with inputs on the expected impacts. It was agreed that the effect analysis could be conducted using a questionnaire and would cover both scope and application issues. This work could be undertaken jointly (partly) with the outreach/field-test work discussed in paragraph 25. Other than gathering feedback through the questionnaire, we think it would be useful to undertake individual/group field tests with a select group of preparers to test the operationality of the forthcoming proposals. This allows for a deeper analysis of the issues.
- 29 In November 2018, the AcSB (Canadian Accounting Standard Setters Board) published a research paper on rate-regulated activities titled Exploring the decision-usefulness of financial information that reflects the economics of rate-regulated activities (the AcSB research paper can be found [here](#)). The research paper explored the decision-usefulness of financial information that reflects the economics of rate-regulated activities by assessing data taken from the practical experiences of users of the financial statements of entities with such rate-regulated activities.

The EFRAG protect team will examine to what extent this research is useful for EFRAG's work on assessing the costs and benefits of the model.

Next steps

- 30 As discussed in paragraphs 22 to 24 the EFRAG project team will continue to work with EFRAG CFSS members to better understand the impacts of the scope of the model.
- 31 The EFRAG project team will also develop a questionnaire to undertake work on the effects' analysis. We plan to present a draft questionnaire to EFRAG TEG at the 2/3 September 2020 meeting. At that same meeting will also present an issues paper outlining the key messages to be included in the initial EFRAG draft comment letter. The key messages will reflect the views and concerns expressed during previous discussions of the model by EFRAG TEG and EFRAG RRAWG members. We will seek assistance from EFRAG CFSS to help find suitable candidates to participate in the field test and effects analysis.

Questions for EFRAG TEG/CFSS members

- 32 Are you monitoring this project and/or do you consider that it is an important change for entities for your jurisdiction?
- 33 At this stage, do you have any comments on the developments of the model and the proposed extended consultation period of 180 days (should the IASB agree with the IASB staff recommendation which will be presented at the July 2020 IASB meeting)? If you do not agree, please explain.
- 34 Do you have any comments or suggestions on next steps in paragraphs 30 and 31?
- 35 Do EFRAG TEG and EFRAG CFSS members have any comments/ suggestions on the outreach approach undertaken by EFRAG Secretariat in paragraphs 22 to 25?
- 36 Can EFRAG CFSS members assist in expanding the possible list of entities to take part in the field test on the scope and application of the model for regulatory assets and regulatory liabilities (both utility sectors and outside – e.g. airports and railways)?
- 37 Do EFRAG TEG and EFRAG CFSS members have any comments on the initial thoughts of the effects analysis/field tests provided in paragraphs 26 - 28?

Appendix – Example of regulatory asset and regulatory liability

Regulatory asset – recovery period is longer than an asset’s useful life

- 39 One example of a regulatory asset would be when the regulatory agreement specifies that the recovery period of an asset under IAS 16 *Property, Plant and Equipment* (PPE) is **longer** than the asset’s useful life for IFRS reporting purposes. Consider the following example:

Fact pattern

- 40 Entity A acquires an item of PPE with a cost of CU 1.000 and a useful life of 4 years. Entity A recognises depreciation under IAS 16 on a straight-line basis. The regulatory agreement specifies that the cost of the PPE will be added to the regulatory asset base (RAB) for recovery in the rates charged to customers over a period of 5 years.

Application of the model

- 41 Applying the model, the total allowed compensation of CU1.000 representing the allowable expenses incurred in supplying the goods or services, which relate to the consumption of the item of PPE. This consumption is reflected in the IFRS accounts by recognising depreciation of CU250 per year for years 1-4. Under the regulatory agreement the total allowed compensation would be recovered by charging customers CU 200 per year for 5 Years.

In CU	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Allowable expenses – depreciation under IAS 16	250	250	250	250		1.000
Total allowed compensation	250	250	250	250		1000
Amounts charged to charges	200	200	200	200	200	1000
Difference	50	50	50	50	(200)	-

- 42 The total allowed compensation for the goods and services provided supplied in years 1-4 **exceeds the amount charged to customers in those years**. In other words, Entity A has charged its customers less than it was entitled to. Applying the model, Entity A recognises a regulatory asset of CU 50 in Year 1. Assuming all stays the same, Entity A also recognises an additional regulatory asset of CU 50 in each of years 2-4.
- 43 The **regulatory asset of CU 50 in each of the years 1-4 represents Entity A’s right to add an increasing amount** when determining the regulated rate in future periods **for goods or services already delivered**. The accumulated regulatory asset of CU200 will be de-recognised in Year 5.

Regulatory liability - recovery period is shorter than an asset’s useful life

- 44 An example of a regulatory liability would be when the regulatory agreement specifies that the recovery period of an asset under IAS 16 is **shorter** than the asset’s useful life for IFRS reporting purposes.

Fact pattern

- 45 Assume the same fact pattern as in the example above, except that the item of PPE has a useful life of 5 years. It is depreciated on a straight-line basis for IFRS purposes. The regulatory agreement states that the cost of the PPE of CU1.000 can be added to the RAB (total allowed compensation) and recovered over a period of 4 Years.

Application of the model

- 46 Applying the model, Entity A would recognise depreciation of CU200 per year for Years 1-5. Under the regulatory agreement the total allowed compensation of CU 1.000 would be recovered over 4 years by charging customers CU 250 per year.

In CU	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Allowable expenses – depreciation under IAS 16	200	200	200	200	200	1.000
Total allowed compensation	200	200	200	200	200	1.000
Amounts charged to charges	250	250	250	250	-	1.000
Difference	(50)	(50)	(50)	(50)	200	-

- 47 The amounts charged to customers in years 1-4 exceed the total allowed compensation for the goods or services supplied in those years. Applying the model, Entity A recognises a regulatory liability of CU50 in Year 1. Assuming all stays the same, Entity A will recognise an additional regulatory liability of CU 50 in each of Years 2-4.
- 48 The regulatory liability of CU 50 in each of the years 1-4 represents Entity A's obligation to deduct an increasing amount when determining the regulated rate to be charged to customers in future periods. The accumulated regulatory liability of CU200 will be de-recognised in Year 5.