

Report of the EFRAG RRAWG Chairman – EFRAG RRAWG meetings held on 16 February, 4 March, and 11 March 2021

Overview of the EFRAG RRAWG discussions

- 1 The following agenda topics were discussed across the three RRAWG meetings:
 - (a) EFRAG's Initial Draft Comment Letter response, which included findings from the early-stage effects analysis;
 - (b) Alternative views on the scope of the proposed Standard;
 - (c) Illustrative Examples of the ED.
- 2 The EFRAG Secretariat also briefly presented EFRAG's plan for further outreach activities to be conducted in addition to the completed Early-stage effects analysis outreach. EFRAG RRAWG noted and had no comments on the outreach plan.

EFRAG Initial Draft Comment Letter

Question 1 – Objective and scope

- 3 EFRAG RRAWG suggested that EFRAG's position in the DCL should be less negative than the initial draft response and balanced between supporting the proposed Standard and expressing concerns regarding the scope and its application. EFRAG RRAWG acknowledged that the proposed Standard has delivered on its objective to provide relevant information about how regulatory items affected an entity's financial performance and its financial position.
- 4 Three EFRAG RRAWG members commented that the scope was clear and applying the scope definition to their regulatory agreements was straight forward and did not cause any difficulties. One of these members added that applying the scope did not result in any self-regulation being scoped in.
- 5 Another EFRAG RRAWG member, however, was concerned that the drafting of paragraph 8 of the ED might result in self-regulation being captured by the scope of the ED.
- 6 One EFRAG RRAWG member suggested that it was necessary to define the regulator to avoid difficulties with self-regulation activities being scoped into the ED. The member suggested that the regulator could be defined as the entity's counterparty in the regulatory agreement having authority for setting and enforcing the regulatory rights and obligations.
- 7 One EFRAG RRAWG member noted that the scope needed to be a more open definition as currently included in the ED. Two members, therefore, concluded that the scope definition was right and would be workable in practice.
- 8 One EFRAG RRAWG member suggested that the scope of the ED should cover circumstances where an entity can recover some or all of the total allowed compensation from third parties (i.e., government, insurance company etc.) instead of the customer. However, another member disagreed as compensation recovered by third parties was already accounted for under other IFRS Standards.

Question 2 – Regulatory assets and regulatory liabilities

- 9 EFRAG RRAWG supported the IASB proposals and agreed with the EFRAG's draft response regarding the definitions of regulatory assets and regulatory liabilities.

Question 3 – Total allowed compensation

- 10 The total allowed compensation is made up of recovery of allowable expenses, target profit (which consists of regulatory returns, profit margin and performance incentives), and regulatory interest income (expense) for the time lag for the recovery (fulfilment) of regulatory assets (liabilities). The proposed model excludes regulatory returns related to construction work in progress (CWIP). EFRAG RRAWG members supported the IASB proposals for the treatment of performance incentives but they questioned the exclusion of regulatory returns of CWIP while determining target profit. They considered that the proposed model's treatment of CWIP was not aligned to the requirements of IAS 16 *Property, Plant and Equipment*, which requires recognition of proceeds earned from assets not yet in use.
- 11 RRAWG members were concerned that the IASB proposal for CWIP treatment departs from both IAS 16 requirements and the period in which the regulatory agreement entitles an entity to include them in the regulated rates. In effect, it seems to be introducing a "third way" accounting approach.
- 12 A member questioned whether the proposed approach for CWIP would result in relevant information on performance when there is a high movement in the portfolio of assets under construction.
- 13 A member noted that some entities would have a remuneration based on CWIP and others would not. If the exception were in place, there would not be an easy way to compare the performance of those entities based on the total compensation, which was available in accordance with the regulatory agreement.
- 14 Some EFRAG RRAWG members noted that the delivery of goods or services involved a combination of various assets, rather than a single asset. In their view an entity would provide goods or services, even if one of the assets was being constructed. They also highlighted the operational challenges of keeping track of assets on a stand-alone basis rather than a portfolio level when considering the high volumes into assets under construction and thereafter into operations of some entities.
- 15 EFRAG RRAWG members proposed asking constituents about any implementation issues that they faced related to construction work in progress.

Question 4 - Recognition

- 16 EFRAG RRAWG members supported the IASB proposals that an entity recognise all its regulatory assets and regulatory liabilities and agreed with EFRAG's draft response to this proposal.
- 17 EFRAG RRAWG members also supported the IASB proposal to apply a "more likely than not" recognition threshold when it is uncertain whether a regulatory asset or a regulatory liability exists. In their view, there were some occasions where it would be useful to have a "more likely than not" threshold included. For example, there could be situations where, although enforceable rights and obligations were in the regulatory agreement, aspects of the regulatory agreement were uncertain. Some judgement could be needed in terms of recognition, as the two were not mutually exclusive. Therefore, EFRAG RRAWG members did not agree with EFRAG's initial draft response which questioned whether a recognition threshold was needed.
- 18 It was agreed that EFRAG's draft response would be changed to support the proposal and to pose a question to constituents to provide examples of where situations of existence uncertainty arose in practice.
- 19 One member noted that the proposals should be clear as to whether other guidance would apply, especially when regulatory assets and regulatory liabilities would no longer be derecognised. Other EFRAG RRAWG members agreed and supported

the EFRAG initial draft response that further guidance should be provided in the body of the Standard regarding derecognition of regulatory assets and regulatory liabilities.

Question 5 - Measurement

- 20 EFRAG RRAWG members agreed with the EFRAG draft response to support the measurement proposals to apply a cash-flow-based measurement technique using updated estimated future cash-flows to reflect conditions at the reporting date.
- 21 However, EFRAG RRAWG members did not agree with the EFRAG initial draft response, which questioned the proposed treatment of credit risk when measuring regulatory assets. The initial response considered the proposed measurement requirements to be inconsistent with IFRS 15 *Revenue from Contracts with Customers* requirements whereby credit risk is considered before recognising revenue and through the impairment of receivables under IFRS 9 *Financial Instruments* requirements- rather than through the measurement of revenue. EFRAG RRAWG members supported the ED's proposal to reflect credit risk when measuring regulatory assets. In their view, the proposal was clear and relatively consistent with the outcome in IFRS 15. They did acknowledge that the proposal in the ED had a different focus to IFRS 15 because IFRS 9 would apply to receivables from customers whereas the ED proposed a standalone measurement basis.
- 22 EFRAG RRAWG noted that the issue was how to allocate the credit risk estimates to the individual regulatory assets. EFRAG RRAWG recommended that the IASB provided guidance on how to allocate amounts that would not be collectable to the different cashflow streams of the different regulatory assets.
- 23 EFRAG RRAWG members agreed with the EFRAG response that the proposed requirements related to the regulatory boundary were unclear.

Question 6 – Discount rate

- 24 One EFRAG RRAWG member highlighted that the definition of regulatory interest rate in Appendix A was inconsistent with the capital asset pricing model used in many regulatory agreements, which not only compensated an entity for time lag before regulatory assets (liabilities) are recovered (fulfilled) but also for business risk.
- 25 EFRAG RRAWG members did not support the proposal to determine a minimum adequate discount rate when the regulatory interest was considered insufficient and thus agreed with EFRAG's draft response. The proposal would be highly judgemental, subjective and likely result in lengthy discussions to justify whether the rate was sufficient.

Question 7 – Items affecting regulated rates only when related cash is paid or received

- 26 EFRAG RRAWG members agreed with the IASB proposals and the initial EFRAG draft response.
- 27 EFRAG RRAWG members raised concerns regarding items in OCI that would never be recycled to the statement of financial performance such as actuarial gains or losses. They questioned whether the ED was clear on in this aspect and whether it is the correct treatment for these items to remain in equity without being recycled. Therefore, EFRAG RRAWG suggested raising a question to constituents in this regard.

Question 8 – Presentation in the statement(s) of financial performance

- 28 The EFRAG RRAWG members agreed with the IASB proposals for the presentation in a single line item of the netted regulatory income and regulatory expenses and regulatory interest income and regulatory interest expenses.

- 29 The members, however, questioned whether the gross presentation of the regulatory assets and liabilities on the statement of financial position was useful for users and expressed concern regarding paragraph 71(b) of the ED which, in their view, could make offsetting balance sheet positions more complicated.
- 30 The EFRAG RRAWG members also questioned whether this paragraph 71(b) was needed at all, given the fact that there was already an enforceable right to offset the regulatory assets and liabilities as described in paragraph 71(a).
- 31 Members also referred to the conditions to offset in paragraph 42 of IAS 32 *Financial Instruments Presentation* being the existence of legally enforceable right and intent to settle on net basis and suggested that a similar underpinning principle could have been applied in this case.
- 32 Some members suggested to clarify that “the same future period” referred to in paragraph 71(b) can comprise more than one reporting period.

Question 9 - Disclosure

- 33 EFRAG RRAWG members supported the disclosure requirements noting that they are a complement/necessary cost for preparers to obtain the beneficial recognition and measurement requirements. One member noted the disclosures are helpful for assurance providers. It was noted that the proposed requirements are not prescriptive but require preparers to exercise judgment on the appropriate level of granularity.
- 34 However, some EFRAG RRAWG members expressed concerns that the proposed disclosure requirements are too detailed and would impose a burden to preparers. One EFRAG RRAWG member questioned the disclosure objective that seem oriented towards enabling users to verify/assure the determination of the reported amounts. The member questioned the usefulness of such information and suggested that the focus of disclosures should only be on information needed to assess performance of the entity.
- 35 Some members made the following comments/suggestions:
 - (a) to disclose only the main effects of the regulatory items which would have an impact on the financial statements. Disclosing the difference between budgeted and actual amounts would impose significant costs for preparers;
 - (b) in practice, the information required to be disclosed is only available after the reporting date;
 - (c) significant IT costs would be incurred to meet the disclosure proposals under the ED;
 - (d) entities have limited time to meet the specific disclosure objectives under the ED;
 - (e) for entities with a few regulatory agreements, it might be difficult to determine which agreement is more prominent in order to meet the requirements of paragraph 75 of the ED;
 - (f) significant judgement is required for identifying regulatory assets and regulatory liabilities;
 - (g) One member noted that classifying regulatory assets and regulatory liabilities in time bands under the requirements of paragraph 81 of the ED might be difficult to provide. It would be more useful to explain the mechanism for recovery/fulfilment of regulatory assets and regulatory liabilities under the regulatory regime. Another member commented that he was already providing a similar timetable for regulatory assets and liabilities and did not see a problem with the proposed requirement in the ED;

(h) disclosures required under paragraph 78(e) and 78(f) of the ED might not provide useful information.

- 36 A member proposed deleting the support expressed in the initial draft response for disclosing information about rights and obligations that did not meet the definitions of regulatory asset and regulatory liability. The member was opposed to having to explain why information was not disclosed. Another member suggested that this could be explained in accounting policies and another member noted that entities may have rights and obligations that they assumed should be regulatory assets and liabilities but fails to qualify for recognition. It was agreed to delete the support.
- 37 EFRAG RRAWG supported posing a question to constituents on which of the proposed disclosures should be prioritised.

Question 10 – Effective date and transition

- 38 The EFRAG RRAWG members supported the IASB proposals and agreed with the initial EFRAG draft response.

Question 11 – Other IFRS Standards

IAS 12 Income Taxes

- 39 The EFRAG RRAWG members agreed with the IASB proposals and initial EFRAG draft response.
- 40 One EFRAG RRAWG member noted that by including tax effects in the operating section, will affect the KPIs and, therefore, the disclosures would be useful.

IFRIC 12 Service Concession Arrangements

- 41 The EFRAG RRAWG members agreed with the initial EFRAG draft response and that the examples of more complex interactions, especially with the intangible assets model could be useful.
- 42 One EFRAG RRAWG member sought to clarify how the IASB proposals would work for intangible asset model where two performance obligations exist: to construct an asset and to provide the infrastructure. In this case, construction revenue is recognised over construction period whereas the infrastructure revenue is the revenue from the use and financing the infrastructure.
- 43 It was decided to ask constituents to provide examples of service concession arrangements falling under both models and where two different performance obligations exist, for example to construct an asset and to provide the infrastructure.

*IFRS 1 First-time Adoption of International Financial Reporting Standards and
IFRS 3 Business Combinations*

- 44 The EFRAG RRAWG members agreed with the IASB proposals. They suggested to add the questions to constituents on:
- (a) whether they agree with reclassification of goodwill-related regulatory balances to goodwill suggested in the proposed amendments to IFRS 1 as well as with the reclassification of measurement differences of regulatory assets and liabilities to goodwill suggested in the proposed amendments to IFRS 3 to the past business combinations; and
- (b) whether they consider that it would result in the correct depiction of the entity's financial performance when the goodwill-related revenues will be charged to customers but the related goodwill balances remain on the balance sheet.

IAS 36 Impairment of Assets

- 45 On the question of separation of the cash flows from regulatory assets and liabilities from the total cash flows of a CGU, the IASB staff explained that the regulatory

assets and liabilities can still be included in a CGU if the related cash flows cannot be separated. Any loss arising from impairment test will be allocated to the CGU.

- 46 The EFRAG RRAWG members suggested to remove the last sentence from the EFRAG response saying: "EFRAG highlights the practical challenges of such separation" because there was no evidence of such challenges.

Question 12 – Likely effects of the proposals

- 47 EFRAG RRAWG members agreed with the proposals of the IASB and the initial EFRAG draft response. EFRAG RRAWG members also noted the increase in estimates and judgements brought about by the proposals in the ED, specifically with regards to the recognition and measurement of performance incentives.

Alternative views on the scope of the ED

- 48 Paragraphs AV7-AV9 of the Basis for Conclusions accompanying the ED explain the alternative view taken by an IASB member on the proposed scope of the proposed Standard as defined in paragraphs 3-6 of the ED.
- 49 Under the ED's proposals, regulatory assets and regulatory liabilities can only exist, if an entity is a party to a regulatory agreement which determines the regulated rate to be charged to customers when part of the total allowed compensation for goods and services supplied in one period is charged to customers in a different period.
- 50 As noted in AV8, the right to increase prices for supplying goods or services outside the scope of the proposed Standard is not recognised separately from a brand name or license, and those intangible assets are not recognised unless they were acquired.
- 51 Under the alternative view, the IASB member agreed with the ED proposal that the existence of a regulatory agreement that regulates rates for supplying specified goods or services is a necessary scope criterion, however, it was not a sufficient criterion (i.e., this criterion is not sufficient to differentiate the right that warrants recognition of an asset for future rate increases). In the IASB member's view, it was also necessary for the performance of the entity's activities to be regulated that:
- (a) competition in the sector is limited; and
 - (b) the regulator is committed to support the financial viability of the entity through the rate-setting process.
- 52 EFRAG RRAWG discussed the alternative view expressed by the IASB member regarding the definition of scope in the ED. Members did not support the alternative view to introduce additional factors to consider when determining whether an entity was within the scope of the project. The following comments were made:
- (a) the proposed additional factors would unduly narrow the scope definition;
 - (b) limited competition was not a necessary criterion to define the scope and it would make the assessment on scope more difficult;
 - (c) financial viability criterion was already embedded in the rate-setting mechanism and uncertainty on financial viability should be incorporated into the measurement;
 - (d) the additional factors would increase complexity and subjectivity of judgement on scope;
 - (e) for incentive-based regulatory agreements which are the majority of European ones and which aim to push out inefficient actors, the proposed definition of scope in the ED was sufficient;

- (f) there is a preference for principles-based requirements and there is a risk of introducing rules with the additional criteria.
 - (g) on the alternative view that the scope does not sufficiently differentiate regulatory assets from other enforceable rights, and that, if the proposed Standard was applied by analogy, it might lead to the recognition of other enforceable rights and obligation- a member noted that it should be borne in mind that the proposed model was a supplementary model.
- 53 EFRAG RRAWG agreed that a question should be posed to constituents on the alternative view in particular whether they were aware of anomalous outcomes that could arise from the proposed Standard (e.g., recognition of currently excluded enforceable rights and obligations).

Illustrative Examples of the ED

Example 1 - Input cost and quantity variances

- 54 EFRAG RRAWG observed that the fact pattern in Example 1 could be better introduced by aligning the presentation of the input data for the two reporting periods included in the example.

Example 2A - Quantity variances affecting recovery of an item of plant

- 55 EFRAG RRAWG commented that Examples 2A, 2B and 2C should clearly explain which element(s) of the target profit was(were) illustrated in the example. Furthermore, members found it useful for Example 2A to consider the effects of the regulatory interest rate which compensates the regulated entity for the time value of money and uncertainty in the amount and timing of the future cash flows.
- 56 EFRAG RRAWG members agreed with EFRAG Secretariat's recommendation that the definition of a target profit in Appendix A of the ED be expanded to include the application guidance in paragraph 11 of the ED which details the three main elements of the target profit, namely: profit margin on allowable expense; regulatory returns and performance incentives.
- 57 Finally, EFRAG RRAWG members suggested to include an illustrative example on performance incentives and to explain their practical implications.

Example 2B - Recovery period longer than an asset's useful life

- 58 EFRAG RRAWG did not express any concerns regarding Example 2B.

Example 2C - Recovery period shorter than an asset's useful life

- 59 EFRAG RRAWG supported EFRAG Secretariat's recommendation to re-word the final sentence of IE42 to clarify that the fulfilment of the regulatory liability (CU200) in Year 5 is referring to reduced future cash flows from customers, and it is reversing the recognised revenue having exceeded the total allowed compensation in Year 1 to Year 4.

Example 3 - Regulatory returns on an asset not yet available for use

- 60 EFRAG RRAWG members highlighted the fact that an entity has fulfilled its obligation when it is constructing an asset (as the provision of goods or services involved a combination of assets, rather than a single asset). Therefore, EFRAG RRAWG members questioned why there is no matching in terms of recognising some of the revenue during the construction phase as opposed to deferring the recognition of revenue to the operation phase.
- 61 EFRAG RRAWG also noted that an example demonstrating the mismatch between recognising the revenue during the construction phase and those that are not, would be helpful.

- 62 It was also noted that a table explaining the composition of the regulatory return could be helpful.
- 63 EFRAG RRAWG members found it difficult to compare the example with the boundaries of the regulation and asked for a clearer explanation of paragraph IE 51 (c).
- 64 The IASB representative explained that the driver for recognition of regulatory returns for assets under construction was different to the accounting for performance incentives and penalties, including those related to assets under construction, which was based on performance, rather than the delivery of goods or services. The IASB had opted for consistent accounting for performance incentives and bonuses regarding of whether the asset to which the performance incentive or bonus related was under construction.
- 65 The IASB representative also explained that the reversal of the regulatory return of CU80 was based on the recovery period, rather than the useful life of the asset. EFRAG RRAWG members suggested that this be made clearer in the example as well as the body of the exposure draft. In the example, the regulatory period was the same as the useful life. The IASB representative agreed that clarification might be helpful as in cases where the regulatory period went beyond the regulatory boundary there might be a need for remeasurement if outside the boundary.

Example 4 - Items affecting regulated rates only when related cash is paid or received

- 66 EFRAG RRAWG members had no comments on example 4 and did not disagree with the EFRAG Secretariat recommendation to provide an additional example illustrating the application of the proposals when the liability would be accounted for under IFRS 1.

Example 5 - Uneven regulatory interest rate

- 67 EFRAG RRAWG members did not have comments on example 5.

Example 6A - Pre-funding of an asset by customers

- 68 EFRAG RRAWG members did not have comments on example 6A.

Example 6B - Pre-funding of an asset indirectly by customers

- 69 EFRAG RRAWG members agreed with the EFRAG Secretariat analysis and questioned whether the example was consistent with the proposals that was based on recovery and settlement from the customer. It was important that the guidance in the exposure draft better explained whether recovery or settlement could be indirectly by a third party on behalf of customers. As it was, the exposure draft seemed to suggest something different.
- 70 There was also a question of whether recovery or settlement needed to be stated in the regulatory agreement. The IASB representative noted that in cases when the entity recovers from a third party on behalf of its customers, the regulatory agreement would not allow for a double recovery and thus such amounts would not be part of total allowed compensation recovered through the rates.

Example 7A - Examples of circumstances that give rise to regulatory assets

- 71 EFRAG RRAWG supported EFRAG Secretariat's view that examples on regulatory items arising from the interaction of the intangible asset model in IFRIC 12 and the proposals of the ED would be useful to better understand the proposals of the model.
- 72 Additionally, the performance bonus and the items recovered only when cash is paid/received could also be included in the list of illustrative examples.

- 73 One EFRAG RRAWG member raised a question of whether the net interest on the net defined benefit liability was the regulatory interest rate or the service cost. The IASB staff explained that it was the replica of the regulatory interest rate on the regulatory liability.

Example 7B - Examples of circumstances that give rise to regulatory liabilities

- 74 EFRAG RRAWG agreed that the list of illustrative examples could be expanded to include regulatory liability created based on a penalty or other items recovered only when cash is paid/received.

Example 7C - Examples of circumstances that give rise to neither regulatory assets nor regulatory liabilities

- 75 EFRAG RRAWG agreed that it would be useful to have a numerical example based on the fact pattern described in example 7C.4, especially if this case is common in practice. Under example 7C.4, a regulated entity which is part of a group of entities purchases an asset from unregulated entity within the same group. While the unregulated entity recognised an intercompany gain on the sale of the asset in its financial statements, the regulated entity under the requirements of the regulatory agreement includes the full cost of the asset in the regulatory capital base without eliminating the intercompany gain. Consequently, the regulated entity recovers the full cost of the asset through the regulated rate charged to customers.

Other

- 76 EFRAG RRAWG members also noted that a more detailed example of disclosure should be helpful especially in terms on total allowed compensation.
- 77 One EFRAG RRAWG member suggested that it would be useful to have a transition resource group (TRG) set up for the rate-regulated activities project similar to the implementation of IFRS 15 and IFRS 17.

Question for EFRAG TEG

- 78 Does EFRAG TEG have any comments on this report?