EFRAG Secretariat: Isabel Batista, Ioana Kiss and Vincent Papa (AD)

IASB project - Regulatory Assets and Regulatory Liabilities

Regulatory assets and regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives

Objective

1 The purpose of this session is to ask EFRAG FR TEG members' views on the IASB tentative decisions taken in October 2022 on the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (the ED) on whether to recognise regulatory assets and regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives under IFRS.

Background

2 At its meeting in October 2022, the IASB agreed tentatively decided that the final Standard:

(a) provide guidance to help an entity determine whether its regulatory capital base (RAB) and assets recognised under IAS 16 *Property, Plant and Equipment* (IFRS PPE) have a direct relationship;

(b) retain the proposals for an entity to account for regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives if the entity has concluded that its regulatory capital base and its property, plant and equipment **have a direct relationship**; and

(c) require an entity that has concluded that its regulatory capital base and its property, plant and equipment have no direct relationship to provide disclosures to enable users of financial statements to understand the reasons for its conclusion.

3 In July 2022, EFRAG FR TEG discussed IASB staff alternatives on how to solve the concerns noted by respondents to the ED on differences between the regulatory recovery period and the assets' useful lives. At that meeting, EFRAG FR TEG members asked to re-discuss the topic once the IASB had decided on a way forward. The EFRAG Secretariat thinks that the IASB staff presentation (Agenda paper 06-02) explaining the differences in different regulatory regimes and the practical issues caused by some of these differences, will help EFRAG FR TEG members better understand the concerns regarding this topic and form a view as to whether the IASB decision is the right one.

4 This paper is partly based on the IASB staff analysis in IASB Staff paper 9b of the IASB meeting in October 2022.

Structure of this paper

5 This paper is structured as follows:

(a) Proposals in the ED

(b) Concerns on the ED proposals

(c) Feedback from IASB Consultative Group and EFRAG RRAWG

(d) IASB staff analysis and recommendations

(e) IASB tentative decisions in October 2022

(f) EFRAG RRAWG discussion on the IASB tentative decision

(g) EFRAG Secretariat analysis of the IASB tentative decision

6 This paper includes the following three Appendices:

(a) Appendix A – Summary of the main features present in cost-based schemes and incentive-based schemes.

(b) Appendix B - Numerical example that illustrates the difference between differences in measurement bases and differences in timing (this is Appendix A IASB Staff paper 9b of IASB meeting in October 2022).

(c) Appendix C - Possible disclosure requirements for entities that have concluded there is no direct relationship between their regulatory capital base and their property, plant and equipment (this is Appendix B IASB Staff paper 9b of the IASB meeting in October 2022).

Proposals in the ED

7 The ED defines allowable expense as:

> An expense, as defined in IFRS Standards, that a regulatory agreement entitles an entity to recover by adding an amount in determining a regulated rate.

8 Paragraph B4 of the ED says that that:

> If an expense is allowable under the terms of a regulatory agreement, that fact establishes that the expense relates to the supply of goods or services in some period. In applying this [draft] Standard, an entity shall treat that allowable expense as relating to the supply of goods or services in the period when the entity recognises the expense applying IFRS Standards. Thus, the amount that recovers that allowable expense forms part of total allowed compensation for goods or services supplied in that period. […]

9 Paragraph B6 of the ED says:

> If an entity consumes an asset over two or more reporting periods in which the entity supplies goods or services, and the cost of the asset is recoverable under the terms of a regulatory agreement, the entity shall allocate that cost in determining the total allowed compensation for the goods or services supplied in each of those periods. In making this allocation, an entity shall use the judgements and estimates it made in applying other IFRS Standards.

10 Paragraph B7 of the ED says:

> […] If a regulatory agreement allows an entity to recover the cost of an item of property, plant and equipment through the regulated rates charged to customers, the depreciation expense recognised in a period, by applying IAS 16, is an allowable expense and the amount that recovers that depreciation expense forms part of the total allowed compensation for goods or services supplied in the period. That is the case even if, under the terms of the regulatory agreement, the recovery of the depreciation expense occurs in a different period—for example, if the regulatory agreement uses a longer or shorter period of recovery than the asset's useful life.

11 Paragraph B8 of the ED says:

> In the example in paragraph B7, the remaining carrying amount of the item of plant depicts the cost of the unconsumed portion of that item. Amounts that recover this unconsumed portion will form part of the total allowed compensation for goods or services in the future as the entity recognises depreciation expense to depict the consumption of this portion.

12 Paragraph B9 of the ED says:

> Some regulatory agreements may require an entity to deduct specified income recognised by applying IFRS Standards in determining the regulated rate. This [draft] Standard refers to such income as chargeable income. For example, an entity may be required to deduct a gain on disposal of an item of plant in determining the regulated rate charged to customers in a future period. If a regulatory agreement treats income as chargeable, that fact establishes that this income relates to the supply of goods or services in some period. In applying this [draft] Standard, an entity shall treat the amount of that chargeable income as reducing the total allowed compensation for the goods or services supplied in the period in which the entity recognises the income by applying IFRS Standards.

13 The ED also contains some illustrative examples that highlight fact patterns in which a regulatory asset (regulatory liability) arises from differences between the regulatory recovery period and the IFRS depreciation period. Specifically:

(a) Illustrative example 2B – illustrates that a **regulatory asset** arises when the recovery period of the entity's regulatory capital base is longer than the asset's useful life.

(b) Illustrative example 2C – illustrates a **regulatory liability** arises when the recovery period of the entity's regulatory capital base is shorter than the asset's useful life.

Concerns on the ED proposals

14 The concerns on the proposals arise mainly because of differences in regulation that exist between cost-based schemes and incentive-based schemes. Many respondents argue that the proposals work well for cost-based schemes but not for incentive-based schemes. In recent years, incentive-based based schemes have become more predominant in some jurisdictions.

(a) In cost-based regulatory schemes, the allowable expense for regulatory purposes will typically be the same as the IFRS expenses as the aim of the regulation is to allow entities to recover their costs.

(b) In incentive-based regulatory schemes, the allowable expense for regulatory purposes can differ from the entities' expenses recorded under IFRS. The objective of the regulation is generally to encourage the entity to be more efficient in providing regulated goods or services – the amount the entity can recover can therefore be less or more than its IFRS expenses. One of the key questions when applying the proposals is whether these differences give rise to regulatory assets and regulatory liabilities. A second question is whether an entity is able (in practical terms) to separately identify these differences.

15 Appendix A explains in more detail the differences between cost-based and incentive-based schemes. These differences will also be explained by the IASB staff in their presentation (Agenda paper 06-02).

Concerns raised in constituents' feedback to the ED

16 Many respondents (to the IASB and some to EFRAG) disagreed with the proposal for accounting for regulatory assets and regulatory liabilities when the recovery period of the regulatory capital base is longer or shorter than the assets' useful lives determined while applying IFRS.

17 The paragraphs below summarise the concerns reported in [IASB Staff paper 9b] of the IASB meeting in October 2022.

Preparers

18 Some respondents—mainly preparers in Europe and Asia-Oceania—said that the proposals are not aligned with incentive-based schemes. According to these respondents, these schemes set an 'allowed revenue' amount made up of different components. These respondents also said that an entity's regulatory capital base is not a regulatory asset register that can be linked or reconciled to the fixed asset register used for accounting purposes. There are several differences between the two sets of records such as:

(a) the asset classes in the regulatory capital base and corresponding recovery periods are different from the asset classes and useful lives in the accounting fixed asset register.

(b) the regulatory capital base is adjusted for inflation annually, whereas fixed assets are measured mainly at cost for accounting purposes.

(c) the regulatory capital base may include items that would not qualify for capitalisation under IAS 16 (for example, bonuses and penalties and operating expenditures). In addition, costs capitalised for accounting purposes may not have been included in the regulatory capital base (for example, contributed assets).

(d) the initial values of the regulatory capital base may have been set at entities' market values at the time these entities were privatised.

(e) fair value adjustments made to the accounting cost base due to business combinations may not have been included in the regulatory capital base.

19 Based on the information and feedback collected by the IASB staff since the ED was published, for entities subject to cost-based schemes there is generally a direct relationship between the regulatory capital base and an entity's property, plant and equipment and, ultimately, a relationship between the regulatory depreciation and the accounting depreciation.

20 However, for entities subject to incentive-based schemes with features similar to those in paragraph 18, the relationship between their RAB and IFRS PPE is **not as direct as for entities subject to cost-based schemes**. Consequently, the relationship between regulatory depreciation and accounting depreciation is also not as direct and result in **result in significant cost to apply the proposals**:

(a) To apply the proposals such entities would need to reconcile their regulatory capital base to their property, plant and equipment. Such a reconciliation would be subjective and require significant estimates. In some cases, a full reconciliation may be impracticable—for example, for those cases when the initial values of the regulatory capital base were set when the entity was privatised or when capital expenditures are added to the regulatory capital base as a lump sum or subsequent adjustments to that base are not broken down at an individual asset level

(b) Consequently, the IASB staff consider that for entities subject to incentive-based schemes, the cost of applying the proposals would be significant.

Users

21 Users that the IASB staff spoke to - mainly rating agencies and buy-side investors in Asia-Oceania and Europe—have said that the accounting for regulatory assets and regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives for entities subject to incentive-based schemes would:

(a) make the understanding of financial performance more difficult;

(b) not result in useful information. Users would not consider these regulatory assets and regulatory liabilities in their analyses; and

(c) affect entities' earnings before interest, tax, depreciation and amortisation (EBITDA), which is a measure considered in many covenants. This may require entities to renegotiate covenants with their creditors.

EFRAG Final Comment Letter

22 In its final comment letter, EFRAG noted that it was aware of situations where:

(a) The proposed requirements on total allowed compensation under paragraphs B3-B9 regarding allowable expenses will not reflect the economic substance of the regulatory agreement (e.g., recoverable costs (including depreciation) are based on regulatory accounting and not IFRS expenses).

(b) These requirements would result in regulatory assets and regulatory liabilities that are inconsistent with the IASB definitions of these terms (e.g., where the regulatory recovery period differs from the economic useful life and where a regulatory liability is recognised on deferral of regulatory returns on assets not yet in use).

23 As noted above in paragraph 22(b), some respondents disagreed with the recognition of regulatory assets and regulatory liabilities that arise from differences in shorter or longer recovery periods than the estimated useful economic life of the asset. These respondents noted that such differences do not give rise to regulatory assets and regulatory liabilities as defined in the ED. Rather these regulatory assets and regulatory liabilities are the result of a 'matching concept' and ignore the economic reality of regulatory agreements that allow for the recovery of asset costs over a different period than the useful economic life under IFRS.

24 Specifically, one respondent (IEAF - representing several EU utility companies) noted that

> *Misalignment between the regulatory recovery period and an asset's useful life does not result in any such adjustment under any known regulatory framework. Thus, **this proposal does not meet the Board's own definition of what a regulatory asset or regulatory liability is.** The outcome of the proposals is an alignment between income and related expenditure (as stated in paragraph BC235 of the ED).*
>
> *However, this ignores the economic reality of certain underlying regulatory agreements. Namely, entities are allowed to recover the costs of building an asset as they incur the expenditure and over a shorter or longer recovery period than the estimated useful economic life of the asset. There are no other requirements underpinning this right to recovery and the revenue that has been charged to customers is correct. Seeking to link the revenue to a future supply of goods or services thus distorts the economic reality.*
>
> *[…]. We would urge the Board to reconsider their proposals to align certain items of regulatory income and IFRS expenditure, so that IFRS financial statements do not stray away from reflecting the true economics of the*

pervasive underlying regulatory agreements, which are configured on an allowance-based model, not a cost-based model. Thus, the focus ought to be on recognising the revenue actually allowed by an underlying regulatory agreement for a given financial year, not when related costs according to IFRS were incurred.

25 The EFRAG Secretariat note that at least one other respondent (ASCG) expressed similar concerns to the ones of IEAF regarding the outcome of paragraphs B3-B9 of the ED.

26 In its Final Comment Letter, EFRAG recommended that the IASB further analyses whether the requirements of paragraphs B3-B9 of the ED relating to allowable expenses can be applied across diverse regulatory regimes including those where costs are based on sectoral averages and where recoverable costs under the regulatory agreement are based on regulatory accounting and not IFRS expenses. EFRAG asked that the IASB clarify if and when these regulatory agreements are in scope.

Feedback from IASB Consultative Group and EFRAG RRAWG

IASB Consultative Group feedback

27 In a March 2022 meeting, the IASB Consultative Group members confirmed the underlying causes of the disconnect between RAB and IFRS PPE as highlighted by the feedback to the ED. The user members highlighted that undercharged revenue is included in RAB in some instances in some jurisdictions (e.g. UK). They noted that some RAB amounts were initiated during the privatisation of some activities as a basis for determining revenue but had no connection to reported PPE (e.g., air traffic).

28 At this meeting, IASB staff proposed three possible courses of action

(a) Course of Action 1: Consider the relationship between regulatory and accounting depreciation (i.e., RA and RL recognition would occur depending on the linkage between recovery of allowable expense under the regulatory agreement and accounting depreciation) (see pages 14 to 16 of the IASB staff paper for a detailed description of this course of action including its pros and cons).

(b) Course of action 2: Overall calculation (i.e., making the regulatory asset register-RAB and accounting fixed asset register comparable) (see pages 17 to 18 of the IASB staff paper for a detailed description of this course of action including its pros and cons).

(c) Course of action 3: Confirm ED's proposals (see page 19 of the IASB staff paper for a detailed description of this course of action including its pros and cons).

29 Regarding the IASB staff proposed courses of action, the IASB Consultative Group members including user representatives mostly supported Course of Action 1 where reporting entities would recognise regulatory assets and regulatory liabilities if and only if: a) there is a direct relationship between the regulatory recoverable expense (regulatory depreciation) and the underlying IFRS expense (accounting depreciation expense); and b) there are differences between the regulatory pace and the assets' useful lives.

30 Under Course of Action 1, the IASB Consultative Group members proposed that even in the absence of recognition of regulatory assets and regulatory liabilities, either of the following disclosures should be in place

(a) A brief explanation of the (lack of a) relationship between the regulatory recoverable expense (regulatory depreciation) and the underlying IFRS expense (accounting depreciation expense).

(b) Disclose the RAB with information about the main reasons for the difference between RAB and PPE. A user expressed the need for disclosure of RAB determination and recovery pace across jurisdictions due to the variety of regulatory approaches to determining RAB.

(c) Qualitative and not quantitative information (i.e., no reconciliation) if there is no linkage between RAB and PPE.

31 There were several reservations expressed on Course of Action 2 that would entail making the RAB and accounting fixed asset register comparable**.** The discussion highlighted that even though, in some jurisdictions with cost-recovery schemes (Canada, Hong Kong, US), there is an alignment[1] of the RAB and accounting PPE, many members from other jurisdictions had reservations about the practicality, cost-benefit of reconciling RAB to the accounting PPE. A few members had concerns that Course of Action 2 would not capture the substance of the transaction (or certain components). Moreover, there would be questions on how to deal with components that were stripped out to make the different bases comparable.

EFRAG RRAWG feedback

32 EFRAG FR RRAWG members discussed the issue and the IASB staff proposed courses of action at its meeting in April 2022.

33 Most members raised similar concerns to those reported to the IASB and EFRAG and supported the approach (i.e., Course of action 1) to consider the relationship between regulatory and accounting depreciation in deciding whether the proposals should apply. Members supported Course of action 1 as it would be the only workable solution, is principle-based and caters for evolution in regulatory regimes, is consistent with the objective of the standard of ensuring alignment between regulatory and IFRS accounting, and due to concerns about the complexities associated with Course of action 2 (i.e., making RAB comparable to the IFRS PPE).

34 It was noted that Course of action 2 would be complex and would not address the range of concerns related to total allowed compensation (e.g., does not address inflation related to the regulatory asset base). A member supported Course of action 1 but suggested that disclosures should be restricted to those that are qualitative due to the noted difficulties in reconciling RAB to IFRS PPE. A user member elaborated on why quantitative disclosures could be useful observing that in her analysis primacy is accorded to future cash flows over profit or loss portrayal that may depict non-cash items under the ED's proposals. Also, it would be helpful to have quantitative disclosures that help users to understand how the regulator recovery of allowable expense may differ from accounting depreciation.

IASB staff analysis and recommendations

35 This section is based on the IASB Staff paper 9b of the IASB meeting in October 2022.

[1] A Consultative Group preparer member highlighted that in Canada where there are 100+utility companies within the scope of the proposed Standard, they regularly disclose the reconciliation of differences between RAB and accounting PPE under IFRS 14.

36 Given the concerns raised by entities and other constituents (including users) that operated in incentive-based schemes the IASB staff consider that:

(a) for entities subject to schemes with features similar to those in paragraph 18, the cost of applying the proposals would be significant and would outweigh the benefits of accounting for any regulatory assets and regulatory liabilities arising from differences between the recovery pace of the regulatory capital base and the assets' useful lives.

(b) accounting for regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives is more complex when the regulator measures the regulatory capital base using a measurement basis that is different from that used by the entity for IFRS Accounting. The IASB staff example in Appendix B of this paper illustrates this situation.

37 Consequently, in October 2022, the IASB staff recommended to the IASB that the **proposals in the ED should only apply** when an entity's regulatory capital base **has a direct relationship** with its property, plant or equipment. This recommendation would:

(a) mean that entities with no direct relationship between their regulatory capital base and their property, plant and equipment would not be required to account for regulatory assets or regulatory liabilities arising from differences between the regulatory recovery pace and assets' useful live; and

(b) require that the final Standard provides guidance to help entities determine when such a direct relationship does not exist.

38 If an entity determines the recoverable amount of a cash-generating unit that includes regulatory assets and regulatory liabilities, not accounting for regulatory assets or regulatory liabilities arising from differences between the regulatory capital base and property, plant and equipment could affect whether an impairment is recognised. The IASB staff plan to discuss this matter with the IASB at a future meeting.

39 As part of this guidance, the IASB staff consider that the final Standard **could state that a direct relationship may not exist when**:

(a) the regulatory depreciation included in regulated rates charged does not aim to compensate an entity for its accounting depreciation—that is, the determination of the regulatory depreciation is not based on the entity's accounting depreciation;

(b) factors other than the useful life of the assets (for example, the duration of the bonds an entity uses to finance its operations) have a significant effect on the determination of the regulatory depreciation; and

(c) the regulator does not require the entity to track differences between the regulatory and accounting requirements nor does the regulator require the entity to reconcile its regulatory capital base and its property, plant and equipment.

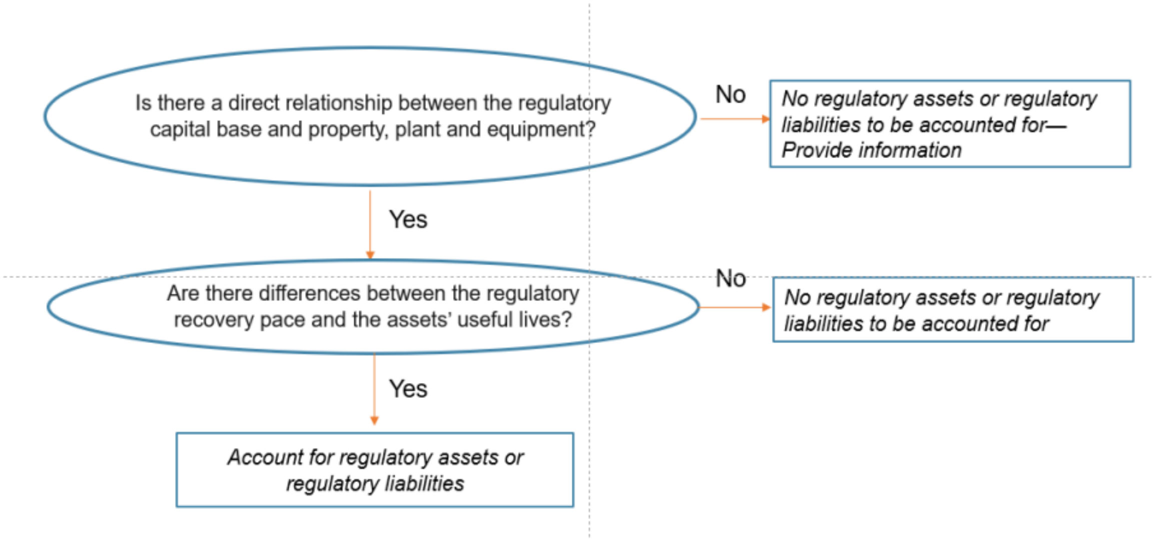
40 If an entity concludes its regulatory capital base does not have a direct relationship with its property, plant and equipment, the entity would:

(a) not account for any regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives.

(b) disclose additional information. The objective of that additional information would be to enable users of financial statements to understand why the entity has concluded there is no direct relationship between its regulatory capital base and its property, plant and equipment. This information is intended to help users understand the different regulatory schemes to which entities are subject and to help them compare the financial position and financial performance of different regulated entities.

41 Appendix C of this paper illustrates possible disclosure requirements proposed by the IASB staff that support this disclosure objective. The IASB staff will discuss specific disclosure requirements with the IASB at a future meeting.

42 The following flowchart illustrates the IASB staff recommendations:



IASB tentative decisions in October 2022

43 At its meeting in October 2022, the IASB agreed with the IASB staff recommendations and tentatively decided that the final Standard:

(a) provide guidance to help an entity determine whether its regulatory capital base and its property, plant and equipment have a direct relationship;

(b) retain the proposals for an entity to account for regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives if the entity has concluded that its regulatory capital base and its property, plant and equipment have a **direct relationship**; and

(c) require an entity that has concluded that its regulatory capital base and its property, plant and equipment have no direct relationship to provide disclosures to enable users of financial statements to understand the reasons for its conclusion.

44 In the discussion, the IASB Board members noted that cost-based and incentive-based schemes were the extreme poles and that entities subject to hybrid schemes would also need to apply the guidance. Consequently, the guidance will need to be operational for entities subject to a variety of schemes. The guidance should help entities apply judgment to determine whether their RAB has a direct relationship with their IFRS PPE. Entities conclusion on this matter is not an accounting policy choice but is derived from a determination that may require judgement. An IASB member emphasised the need to verify user information needs when drafting the accompanying disclosure requirements.

45 As mentioned above in the IASB staff analysis (see paragraph 38 and paragraph 41), the IASB staff will discuss (a) possible impairment implications of not

accounting for regulatory assets or regulatory liabilities arising from differences between the regulatory capital base and property, plant and equipment and (b) possible disclosure requirements in such cases.

EFRAG RRAWG discussion on IASB tentative decision[2]

46 At the November 2022 RRAWG meeting, some RRAWG members welcomed the IASB's tentative decision not to recognise regulatory assets and regulatory liabilities when a direct link between the RAB and IFRS PPE does not exist. However, these members noted that the indicators to help with the assessment of a direct relationship were very important. The indicators developed by the IASB staff were a good starting point, but further work was needed to understand the different regulatory schemes and assess whether there were ''grey areas'' for which further guidance might be needed.

47 One EFRAG RRAWG member noted that assessing whether there is a direct relationship between RAB and IFRS PPE would be highly judgemental and difficult to audit. This member also believed that the IASB tentative decision would leave out many entities and thus not meet the general objective of the project which was to account for regulatory assets and regulatory liabilities that met the recognition criteria.

48 There was some support for the IASB staff's proposed possible disclosures for when an entity concludes that there is no direct relationship between the RAB and IFRS PPE. Disclosures would become important given the level of judgement to assess whether a direct relationship existed. However, one member commented that entities might find it difficult to provide quantitative disclosures as the information may not be readily available.

49 One RRAWG member considered that a link would generally exist for recovery of depreciation expense – it was more a question of the period of recovery – which under the ED was considered a difference in timing and gave rise to a regulatory asset or a regulator liability. The difficulty noted in the UK might be a question of whether an entity maintained a fixed asset register and tracked the differences between the regulatory accounts and IFRS. It was understood that in the UK such tracking was not done and thus it was difficult to identify which differences would be differences in timing as defined by the RRA accounting model. Other members representing EC entities noted that granular tracking of differences in timing could be an issue and questioned whether a regulator asset or a regulatory liability should be recognised in such cases.

50 One RRAWG member (UK) explained that in the UK water regulation was based on providing an entity with a revenue stream which was not linked to an entity's IFRS PPE value. The difficulty in identifying differences in timing was therefore broader than depreciation expense and would involve other differences. This member said that the IASB staff proposed indicators set out in the paper did a good job of identifying a direct link.

51 The IASB representative explained that the IASB would be discussing other differences in timing between the RAB and IFRS PPE at future meetings. In November 2022, the IASB will be discussing borrowing costs and in December 2022 the IASB is expected to discuss inflation adjustments.

[2] Extract from the Report of the Chairman of the EFRAG RRAWG meeting 8 November 2022

EFRAG Secretariat analysis of the IASB tentative decision

52 We agree that the IASB tentative decision will provid53e practical relief to entities that have difficulty in identifying differences between the regulatory recovery period and the assets' useful lives under IFRS and conclude that there is no direct relationship between the RAB and IFRS PPE.

53 We also agree that the IASB tentative decision will indirectly address the concerns of some respondents that disagreed with the recognition of a regulatory asset and a regulatory liability due to differences between the regulatory recovery period and the assets' useful lives under IFRS. We say ''indirectly'' because the reason for the disagreement was not because a direct relationship did not exist, but rather that a regulatory asset or a regulatory liability does not exist in these cases.

54 However, we consider that there are broader implications of the IASB decision on depreciation as the disconnect between RAB and PPE can arise from other factors (inflation, borrowing costs). The IASB might need to extend this direct relationship principle to these other factors. This may therefore result in many companies that are within the scope of the final Standard, not recognising regulatory assets and regulatory liabilities that meet the definitions in the ED and thus question whether the objectives of the ED are being met.

55 Below are our observations and concerns on the implications of this IASB tentative decision:

(a) As pointed out by some EFRAG RRAWG members, a link would generally exist for recovery of depreciation expense – it is more about the period of recovery (for regulatory purposes can be longer or shorter - particularly in incentive-based regulatory regimes) and the amount that is recovered in accordance with the regulatory agreement in each period could be different to IFRS depreciation expense for that period. **The question is therefore whether this difference in timing gives rise to a regulatory asset[3] or a regulatory liability[4] as defined by the ED.**

(b) Several respondents to the IASB (including EFRAG) did not agree that a regulatory asset or a regulatory liability exists when recovery periods for allowable expense and depreciation IFRS expense are different. In their view, there are no other requirements per the regulatory agreement, that underpin this right or timing of recovery. What is recognised under IFRS 15 *Revenue from Contracts with Customers* represents the amount that the entity is entitled to for goods or services provided in that period. To present IFRS information that implies the contrary, does not provide useful information to investors. The regulatory agreement does not provide a right to add or obligation to deduct any amount in future periods for goods or services already supplied.

[3] A regulatory asset is an enforceable present right, created by a regulatory agreement, to add an amount in determining a regulated rate to be charged to customers in future periods because part of the total allowed compensation for goods or services already supplied will be included in revenue in the future.'

[4] A regulatory liability is an enforceable present obligation, created by a regulatory agreement, to deduct an amount in determining a regulated rate to be charged to customers in future periods because the revenue already recognised includes an amount that will provide part of the total allowed compensation for goods or services to be supplied in the future.'

(c) As pointed out by some EFRAG RRAWG members, even though the IASB tentative decision relates to differences in regulatory and accounting depreciation, the issue of whether there is a direct relationship between RAB and IFRS PPE does not only pertain to depreciation but ought to also involve differences such as borrowing costs, inflation adjustments, indexation etc. Some of these other differences (other than depreciation) might give rise to regulatory assets and regulatory liabilities as defined in the ED.

(d) Based on our current understanding, we question whether the principle of the 'existence of a direct relationship between RAB and IFRS PPE' is the right solution to solve the concerns on this issue. **We consider that the real issue might be more about the existence of an enforceable right (obligation) under the regulatory agreement and whether a regulatory asset or a regulatory liability exists in situations where differences between the regulatory recovery period and the assets' useful lives under IFRS.**

56 However, we also acknowledge that some EFRAG RRAWG members (and respondents to the IASB ED) indicated that it is difficult to reconcile the RAB and IFRS PPE (see paragraphs 18 to 20) and consequently it would be difficult to separately identify each difference in timing between the RAB and IFRS PPE, including depreciation differences**. In effect, this is a broader issue than only depreciation differences and will have other implications on the application of the model.**

57 Overall, we consider that there are two key concerns on differences between RAB and IFRS PPE, including depreciation.

(a) The first concern is that in some cases differences between the regulatory recovery period and the assets' useful lives under IFRS do not give rise to a regulatory asset or a regulatory liability as defined in the ED.

(b) The second concern is that some entities that operate in incentive-based regimes and have features similar to those in paragraph 18 are unable to separately identify differences between RAB and IFRS PPE.

58 In our view, the IASB tentative decision is not specifically addressing the first concern in paragraph 57(a). However, it will address the broader concern in paragraph 57(b). Given the broader implications of the IASB tentative decision, we consider it could be useful for the IASB staff to conduct further outreach to better understand the extent to which companies cannot separately identify differences between RAB and IFRS PPE and what the implications of this might be on the overall proposed accounting model.

Questions to the EFRAG FR TEG members

59 What are your views on the IASB staff's initial proposed indicators to identify a ''direct relationship'' in paragraph 39?

60 What are your views on the IASB tentative decisions in paragraph 43? Please explain why you agree or disagree.

61 Do you share the observations and concerns (some) of the EFRAG Secretariat in paragraph 55?

62 Do you share the observations/suggestions of the EFRAG Secretariat in paragraphs 56 to 58?

63 At this stage, do you have any comments on the IASB staff's proposed disclosures (for when an entity concludes that there is no direct relationship between its regulatory capital base and its property, plant and equipment) in Appendix C?

Appendix A - Features of cost-based and incentive-based schemes

1 The paragraphs below provide a summary of the features of cost-based and incentive-based schemes.

2 These paragraphs are an extract from [IASB Staff paper 9b]() of the IASB meeting in October 2022.

Cost-based schemes

3 Cost-based schemes generally contain the following features:

(a) The componentisation of assets recorded for regulatory purposes is broadly aligned with that used for accounting purposes. Any differences in componentisation are tracked separately.

(b) The measurement basis and capitalisation policies used for regulatory purposes are broadly aligned with those used for accounting purposes with any differences tracked separately.

(c) Depreciation rates used for regulatory purposes are broadly aligned with those used for accounting purposes, with regulators requiring depreciation rates that are different from those used for accounting if necessary to meet a public interest objective.

Incentive-based schemes

4 The following features of incentive-based schemes make the regulatory capital base different from an entity's property, plant and equipment:

(a) componentisation of the regulatory capital base—the regulatory capital base may not consist exclusively of capital expenditures but may also include operating expenditures, performance incentives and other movements in working capital. For example, the IASB staff explain that regulatory schemes in the electricity sector in a few jurisdictions in Europe determine the regulatory capital base as a percentage of an entity's total expenditures. As a result, for entities subject to these schemes, the link between their regulatory capital base and their property, plant and equipment is less direct. In other schemes, the regulatory capital base may be split into asset classes that are different from those used for accounting purposes. In addition, in some cases:

(i) the movements of the regulatory capital base—mainly amounts of capital expenditure and regulatory depreciation—may be based on forecasts made for a period. In such cases, regulatory agreements may adjust that base to reflect actual amounts. Both the forecasted amounts of capital expenditure and the adjustments are lump sum amounts and would not be broken down by individual assets.

(ii) the regulatory capital base may include assets that are being constructed (construction work in progress). In these cases, regulatory agreements may not distinguish construction work in progress from assets in operation, with regulatory depreciation calculated so as to recover both assets that are in operation and assets that are being constructed. Because of this, regulatory depreciation may start on a different date from accounting depreciation. For example, the depreciation of regulatory capex may start when there is a cash outflow, not when the asset is placed in service.

(iii) regulators disallow amounts of capital expenditure on efficiency and prudency grounds. When they do this, the amounts disallowed would not be broken down at an asset level making it difficult to reconcile the regulatory capital base to the entity's property plant and equipment.

(iv) different treatment of disposals. Disposals may be deducted from the regulatory capital base using the sales proceeds, not based on the assets' net book values.

(b) measurement of the regulatory capital base—the regulatory capital base may be measured using measurement bases other than historical cost (for example, replacement cost). In addition, regulators may index the regulatory capital base to reflect inflation.

(c) depreciation rate of the regulatory capital base—this may differ from the assets' useful lives.

5 Entities subject to incentive-based schemes recover the regulatory capital base by including regulatory depreciation in the regulated rates charged. The main component of the regulatory capital base will be, in most cases, capital expenditures. Because of this, there will be a relationship between the regulatory capital base and an entity's property, plant and equipment and, ultimately, a relationship between the regulatory depreciation and the accounting depreciation.

6 However, for entities subject to incentive-based schemes with features similar to those in the paragraph above, the relationship between their regulatory capital base and their property, plant and equipment is not as direct as for entities subject to cost-based schemes. Consequently, the relationship between regulatory depreciation and accounting depreciation is also not as direct. To apply the proposals such entities would need to reconcile their regulatory capital base to their property, plant and equipment. Such a reconciliation would be subjective and require significant estimates. In some cases, a full reconciliation may be impracticable—for example, for those cases when the initial values of the regulatory capital base were set when the entity was privatised or when capital expenditures are added to the regulatory capital base as a lump sum or subsequent adjustments to that base are not broken down at an individual asset level.

Appendix B – Example of different measurement basis

1 This appendix reproduces Appendix A of [IASB Staff paper 9b] of the IASB meeting in October 2022 and provides an example that illustrates the case when a regulator measures the regulatory capital base using a measurement basis that is different from that used by the entity when measuring its assets applying IFRS.

2 The purpose of the example is to illustrate the difference between differences in timing and differences in measurement bases. Assume an entity builds an asset during year 1 and starts to use it to supply goods or services on 1 January year 2.

3 The cost of the asset is CU1,000. Applying IFRS Accounting Standards, it has a useful life of four years.

4 Table 1 shows the IFRS carrying amount of the asset and accounting depreciation for years 2 to 5.

Table 1—IFRS carrying amount of the asset					
In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Opening balance	-	1,000	750	500	250
Additions	1,000	-	-	-	-
Depreciation expense	-	(250)	(250)	(250)	(250)
Closing balance	**1,000**	**750**	**500**	**250**	**-**

5 The regulator measures this asset at replacement cost and allows the entity to recover the asset over five years, from years 2 to 6.[5] The main driver of the replacement cost computed by the regulator is the value of a specific price index at the end of the year. Table 2 shows the regulatory carrying amount of the asset and the regulatory depreciation for years 2 to 6:[6]

Table 2–Regulatory carrying amount and regulatory depreciation							
In CU	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**TOTAL**
Replacement cost end of year	1,040	1,060	1,120	1,140	1,160	1,160	
Regulatory depreciation	-	212	236	236	244	232	1,160
Regulatory roll-forward							
Opening balance	-	1,040	848	672	456	232	
Additions	1,000	-	-	-	-	-	
Replacement cost change	40	20	60	20	20	-	

6 The total allowed compensation for this asset over years 2 to 6 is CU1,160.11 Table 3 shows the entity's statement of financial performance before the recognition of differences in timing:[7]

[5] The example assumes there is no change in the replacement cost of the asset during year 6.

[6] The regulatory depreciation for each period is calculated as the difference between the cumulative depreciation for the period and the cumulative depreciation for the previous period. For example, the cumulative depreciation for year 3 is: CU1,120 x (2/5) = 448 and the cumulative depreciation for year 2 is: CU1,060 x (1/5) = 212. Consequently, the regulatory depreciation for year 3 is: CU448 – CU212 = CU236

[7] To simplify, the example ignores the effect of any regulatory return on the asset.

Table 3–Statement of financial performance (without differences in timing)						
In CU	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**TOTAL**
Revenue	212	236	236	244	232	1,160
Depreciation expense	(250)	(250)	(250)	(250)	-	(1,000)
Profit or loss	**(38)**	**(14)**	**(14)**	**(6)**	**232**	**160**

7 Table 3 shows the cumulative difference in measurement bases of CU160—that is, the difference between the regulatory compensation the entity is allowed to include in regulated rates measured at replacement cost (CU1,160) and the measurement of the asset at cost (CU1,000). That difference is not a difference in timing. Because the regulator allows the recovery of the asset over five years, the difference of CU160 is included in regulated rates charged during years 2–6.

8 However, a difference in timing—a regulatory asset—does arise because the regulatory compensation is included in regulated rates charged over a period (5 years) that is longer than the useful life of the asset (4 years). An entity applying the model could compute such a difference in timing by deducting from the actual revenue amounts the revenue the entity would have obtained had the regulatory depreciation been calculated to recover the asset over four years, that is years 2–5:[8]

Table 4–Computation of the regulatory asset						
In CU	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**TOTAL**
Revenue (Table 3)	212	236	236	244	232	1,160
Recalculated revenue using 4 years	265	295	295	305	-	1,160
Difference in timing	(53)	(59)	(59)	(61)	232	-
Regulatory asset	**53**	**112**	**171**	**232**	**-**	**-**

9 Table 5 shows the entity's statement of financial performance, including the effect of accounting for the regulatory asset:

Table 5–Statement of financial performance (including regulatory asset)						
In CU	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**	**TOTAL**
Revenue	212	236	236	244	232	1,160
Reg income/(Reg expense)	53	59	59	61	(232)	-
Depreciation expense	(250)	(250)	(250)	(250)	-	(1,000)
Profit or loss	**15**	**45**	**45**	**55**	**-**	**160**

10 The profit or loss shown in the statement of financial performance in Table 5 reflects the effect of the difference between the measurement basis used for the regulatory capital base and that used applying IFRS Accounting Standards. The difference in measurement basis can also be seen as follows:

[8] The regulatory depreciation for each of the four years is calculated using the same methodology as that described in footnote 10.

Table 6–Difference in measurement bases included in profit or loss					
In CU	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**TOTAL**
Actual revenue over 4 years	265	295	295	305	1,160
Depreciation expense	(250)	(250)	(250)	(250)	(1,000)
Difference	**15**	**45**	**45**	**55**	**160**

11 The example makes a few significant simplifications:

(a) the regulatory capital base consists of one asset that is recovered over five years—entities' regulatory capital base may consist of a large volume of assets that are recovered over much longer periods;

(b) the entity can estimate the changes in the replacement cost of the asset throughout the life of the asset and those estimations match the actual changes in value. Differences between estimated and actual replacement cost would affect the amount of the regulatory depreciation and the amount of the differences in timing;

(c) the asset is not sold and is not subject to any other changes, such as upgrades. In reality, assets may be subject to changes that would affect the regulatory compensation. These changes would need to be tracked so that they are reflected in the related difference in timing. These simplifications above make it easy to check that any resulting profit or loss amounts (Table 5) accurately reflect differences in the measurement bases (Table 6). However, in practice, the situation is often much more complicated making it very difficult for entities to trace the resulting profit or loss amounts to differences in measurement bases.

Appendix C - Possible disclosure requirements

1 This appendix reproduces Appendix B of IASB Staff paper 9b of the IASB meeting in October 2022 and illustrates possible disclosure requirements for when an entity concludes that there is no direct relationship between its regulatory capital base and its property, plant and equipment.

2 The objective of the disclosures would be to enable users of financial statements to understand why the entity has concluded there is no direct relationship between its regulatory capital base and its property, plant and equipment. This information is intended to help users understand the different regulatory schemes to which entities are subject and to help them compare the financial position and financial performance of different regulated entities.

3 To comply with the objective in paragraph B2 of the ED, an entity could be required to disclose the main reasons why it has concluded that its regulatory capital base does not have a direct relationship with its property, plant and equipment—and hence, there is no direct relationship between regulatory depreciation and accounting depreciation. This could include:

(a) a description of the items forming part of the regulatory capital base, with an explanation of the main differences between the regulatory capital base and the property, plant and equipment; and

(b) information that compares the recovery period of the regulatory capital base with the assets' useful lives, including a description of the main factors considered in determining the regulatory recovery period that are not considered in the determination of the useful lives.

4 The IASB staff is also considering other disclosures that could help users understand the financial statement effects of changes in an entity's regulatory capital base. These disclosures could include:

(a) a reconciliation of the opening to closing regulatory capital base. An entity could accompany the reconciliation with information that would enable users to understand how changes in the entity's regulatory capital base affect the entity's financial statements (for example, the impact of the regulatory depreciation in the movement of the regulatory capital base on the revenue line etc);

(b) changes in the componentisation and measurement basis of an entity's regulatory capital base and the effects of these changes on the determination of the regulated rates in the current and/or future periods; and

(c) changes in the regulatory recovery pace during the period and, if so, the underlying reasons for the change and the effects of the change on the regulatory capital base and the determination of the regulated rates in the current and/or future periods.

5 The IASB staff plans to bring this matter to the IASB when discussing disclosures at a future meeting.