

REGULATORY ASSETS AND REGULATORY LIABILITIES

PRACTICAL IMPLICATIONS OF PROJECT SCOPE

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The publication of Briefings is part of EFRAG's strategy to stimulate debate within Europe and clarify the IASB discussions on *Regulatory Assets and Regulatory Liabilities*. The views expressed in this Briefing are those of the EFRAG Secretariat and have not been approved by either EFRAG TEG or the EFRAG Board. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Any views expressed in this Briefing are tentative and reflect the EFRAG Secretariat's understanding of how the proposals included in the IASB's exposure draft *Regulatory Assets and Regulatory Liabilities* might be applied.

Due to the nature of the Briefing, the EFRAG Secretariat has not included questions to constituents. However, constituents may express their views on the topic when responding to the EFRAG draft comment letter. EFRAG will develop its final views after considering the feedback received from its constituents.

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IASB's ED *Regulatory Assets and Regulatory Liabilities*

- ES1 Rate regulation determines when and how much total allowed compensation can be charged to customers for goods and services supplied in a period. In practice, differences in timing arise when the period in which total allowed compensation for goods or services is included in the regulated rates is different to the period in which those goods or services were supplied.
- ES2 Existing IFRS Standards do not permit a company to recognise a right to increase or obligation to decrease the regulated rates in the future for such differences in timing. Rate regulation can significantly affect a company's financial performance and financial position. However, users of financial statements do not get information about the effects of differences in timing on a company's financial statements and their assessment of the company's current and future performance often relies on alternative performance measures for the effects of rate regulation.
- ES3 On 28 January 2021, the IASB published the Exposure Draft *Regulatory Assets and Regulatory Liabilities* ('the ED'). The ED establishes accounting principles for reporting these differences in timing in a company's financial statements in order to provide relevant information which faithfully represents the effects of differences in timing on the company's financial performance and financial position. The ED has a comment period of 180 days and a comment deadline of 30 July 2021.
- ES4 Regulatory assets and regulatory liabilities are created by a regulatory agreement that determines the regulated rate in such a way that the part (some or all) of total allowed compensation for goods or services supplied in one period is charged to customers (both existing and future customers) in a different period. Any other rights or obligations created by the regulatory agreement should be accounted for under other IFRS Standards. As stated in paragraph 6 of the ED, a regulatory asset or regulatory liability can exist only if all the following conditions are met:
- the entity is a party to a regulatory agreement;
 - the regulatory agreement determines the regulated rate an entity charges for the goods or services it supplies to customers; and
 - part of the total allowed compensation for goods or services supplied in one period is charged to customers through the regulated rates for goods or services supplied in a different period (past or future).
- ES5 The proposed Standard is intended to supplement information an entity already provides by applying IFRS 15 *Revenue from Contracts with Customers* and other IFRS Standards and IFRS Interpretations such as IFRIC 12 *Service Concession Arrangements*. Therefore, an entity should not recognise any assets or liabilities created by a regulatory agreement other than regulatory assets and regulatory liabilities as defined by the ED. Other assets and liabilities, if any, would be recognised under other IFRS Standards.
- ES6 The ED proposes not to restrict the scope of the proposed requirements to apply only to regulatory agreements with a particular legal form or only to those enforced by a regulator with particular attributes. Instead, the ED proposes that an entity recognise all its regulatory assets and all its regulatory liabilities existing at the end of the reporting period.

Objective and structure of this Briefing

- ES7 The objective of this Briefing is to stimulate debate on the outcome of the IASB's proposals on the scope of the proposed Standard and how the proposed requirements would affect entities which were not envisaged to be subject to the type of rate regulation described in the ED. It is intended to complement EFRAG's outreach and facilitate dialogue with stakeholders on [EFRAG's draft comment letter](#) (DCL) responses on the scope of the proposed Standard.
- ES8 The Briefing does not include questions posed to constituents in the EFRAG DCL. However, constituents may express their views on the examples in this document when responding to the DCL.
- ES9 This Briefing starts by providing background information in Chapter 1: *Background*.
- ES10 In Chapter 2: *Scope of the Project*, the EFRAG Secretariat analyses the scope of the IASB project as defined in the IASB's ED *Regulatory Assets and Regulatory Liabilities*.
- ES11 Finally, in Chapter 3: *Entities that may be Affected by the Proposals*, the EFRAG Secretariat considers the application of the IASB's proposals on scope applied to different fact patterns that are subject to regulated prices. The chapter illustrates how an assessment of eligibility to be within scope can be made to a selection of five fact patterns.
- ES12 The five facts patterns include examples identified by EFRAG TEG during the development of the IASB proposals. Chapter 3 also includes the analysis of a fact pattern related to arrangements/agreements in monopolistic industries and captures some of the sectors where some stakeholders have noted may unexpectedly fall within the scope of the proposed Standard (e.g., banking, insurance entities).
- ES13 These fact patterns are not an exhaustive representation of circumstances where questions of eligibility to be within the scope of the proposed Standard may arise. In its DCL, EFRAG is seeking input on examples of situations where entities will be affected by the proposals when they are not viewed as subject to rate regulation or examples of situations resulting in anomalous outcomes.

Impact of the IASB proposals when applied to different fact patterns

- ES14 As noted, in Chapter 3, EFRAG Secretariat assesses five different fact patterns against the scope of the proposed Standard as defined in the ED. EFRAG Secretariat observes that there are situations where entities with similar characteristics to those described in the scope of the proposed Standard might be affected by the IASB's proposals.
- ES15 EFRAG Secretariat notes that the existence of a regulatory agreement, which establishes the prices charged to customers for goods or services supplied and its enforceability, has an important role when determining whether an entity may be affected by the IASB proposals.
- ES16 In addition, there must be differences in timing between the period when the total allowed compensation for goods or services is included in the regulated rates and the period in which those goods or services are supplied. Finally, the right to increase or obligation to decrease the regulated rates in the future for such differences in timing must be enforceable.

CHAPTER 1: BACKGROUND

IASB's work on Rate-regulated Activities

- 1.1 In July 2009, the IASB published an Exposure Draft *Rate-regulated Activities* (2009 ED) to address concerns about how the impact of rate regulation should be reflected in the primary financial statements of companies. The ED proposed that regulatory assets or regulatory liabilities should be recognised only if an entity's activities are subject to "cost-of-service" rate regulation. The project was suspended in 2010 due to a diversity of views from respondents from different jurisdictions, and because it seemed unlikely the fundamental question on whether regulatory balances should be recognised could be answered within a reasonable timeframe.
- 1.2 Following an agenda consultation, in 2012, the IASB decided to restart the project on Rate-regulated Activities (RRA) and added a standard-level project to its agenda to understand the need for guidance and challenges related to differences between existing regulatory regimes.
- 1.3 In 2014, the IASB published a Discussion Paper *Reporting the Financial Effects of Rate Regulation* (2014 DP). The DP described the common features of various types of rate regulation and grouped the features that seemed most likely to give rise to rights and obligations that meet the definitions of an asset and a liability in the *Conceptual Framework*. The type of regulation containing those features was termed 'defined rate regulation'.
- 1.4 In January 2021, the IASB published a second exposure draft on the project. The ED *Regulatory Assets and Regulatory Liabilities* proposes an accounting model for regulatory assets and regulatory liabilities to supplement the information already provide by applying existing IFRS Standards. The main principle of the proposed model is that a company should reflect the total allowed compensation for goods or services supplied as part of its reported financial performance for the period in which it supplies those goods or services.

EFRAG's work on Rate-regulated Activities

- 1.5 EFRAG recognised the importance of having guidance on accounting for regulatory account balances and contributed to the development of the IASB project on rate-regulated activities by responding to the 2009 ED and 2014 DP. Furthermore, in response to the 2014 DP, EFRAG conducted outreach events.

EFRAG Draft Comment Letter

- 1.6 In April 2021, EFRAG issued its draft comment letter (DCL) where it welcomes the IASB's ED and the IASB's efforts to address the accounting for regulatory assets and regulatory liabilities and provide investors with relevant information about a company's financial position and financial performance. EFRAG's DCL can be found [here](#). Comments on the EFRAG DCL are welcome by 28 July 2021.
- 1.7 To inform its response to the DCL, EFRAG obtained the input of the EFRAG Rate-regulated Activities Working Group (RRAWG) and conducted an early-stage effects analysis outreach to preparers and users of financial statements of rate-regulated entities based on survey questionnaires. The outreach to preparers included questions on the application of the scope of the proposed Standard.
- 1.8 If finalised as a new IFRS Standard, the proposed accounting model in the ED would replace IFRS 14 *Regulatory Deferral Accounts*. IFRS 14 which is an interim Standard and is not endorsed in Europe permits a variety of accounting approaches for reporting the effects of rate regulation.

CHAPTER 2: SCOPE OF THE PROJECT

In this chapter, the EFRAG Secretariat focuses its analysis on the scope of the proposed Standard. Specifically, the EFRAG Secretariat assesses whether rate-regulation gives rise to regulatory assets and regulatory liabilities that fall within the scope of the proposed Standard outlined in the IASB ED Regulatory Assets and Regulatory Liabilities.

The scope of the proposed Standard as described by the IASB

- 2.1 The ED proposes that an entity apply the proposed requirements to all its regulatory assets and all its regulatory liabilities.
- 2.2 As noted in ES4, regulatory assets and regulatory liabilities are created by a regulatory agreement that determines the regulated rate in such a way that part (some or all) of the total allowed compensation for goods or services supplied in one period is charged to customers in a different period.
- 2.3 The ED describes a regulatory agreement as a set of enforceable rights and obligations that determine a regulated rate to be applied in contracts with customers. The ED does not specify the form of the regulatory agreement, however, it states that practices for establishing regulatory agreements vary between jurisdictions and between industries and provides examples of forms that a regulatory agreement could take:
 - a) a contractual licensing agreement between an entity and a regulator;
 - b) a service concession arrangement; or
 - c) a set of rights and obligations specified by statute, legislation or regulation.
- 2.4 The ED also does not specify whether a particular type of body, such as a regulator, must exist to enforce compliance with the regulatory agreement, and what the characteristics of that body should be.
- 2.5 In the IASB's view, narrowing the scope of the proposed Standard to include only regulatory agreements subject to a regulator with particular characteristics would not lead to more useful information about the effects of regulatory assets and regulatory liabilities.
- 2.6 The ED does not specifically state that it does not apply to self-regulation. Typically, an entity cannot have enforceable rights and enforceable obligations with itself.

EFRAG preliminary comments on scope of the proposed Standard

- 2.7 EFRAG supports the overall objective of the ED and agrees that it would enable users to understand how the financial performance and the financial position of a reporting entity are affected by the differences in timing created by the rate regulation.
- 2.8 EFRAG acknowledges that there is clarity on the description of the scope of the proposed Standard within the ED. However, EFRAG is still assessing if there are possible unintended consequences (i.e., entities or arrangements unknowingly falling within the scope of the proposed Standard). These includes the impact of the scope criteria on arrangements which are not viewed as subject to rate regulation (see paragraph 65 of EFRAG's DCL).

- 2.9 EFRAG understands the merits of a broad and principles-based definition of scope. However, EFRAG considers and seeks constituents' feedback (paragraph 67 from EFRAG's DCL) on whether additional scope criteria might be helpful indicators when assessing whether an entity may be affected by the proposed Standard (e.g., limited competition within the sector, regulator committed to supporting the entity's financial viability through rate-setting process, and customers' having no ability to avoid price increases).
- 2.10 EFRAG notes that enforceable present rights and enforceable present obligations that the ED intends to cover in the scope can also arise from a regulatory framework that is enforceable by law, but where a regulatory agreement per se might not exist. EFRAG observes that the description of a regulatory agreement in the ED may be subject to interpretations of what exactly a regulatory agreement is. Therefore, EFRAG is consulting constituents (paragraph 66 of the EFRAG's DCL) on whether more specific guidance and examples on what constitutes a regulatory agreement would be helpful to appropriately identify the scope of the model.
- 2.11 EFRAG considers that a description of the characteristics of a regulator would be helpful to eliminate situations where price adjustment agreements akin to rate regulation may be affected by the proposed Standard.
- 2.12 Finally, EFRAG is seeking feedback from constituents on examples of anomalous outcomes that could arise from the application of the scope of the proposed Standard (paragraph 68 of EFRAG's DCL).

EFRAG's view on what constitutes a regulatory agreement

- 2.13 EFRAG considers the description of a regulatory agreement to be important to ensure the appropriate application of the proposed Standard by entities.
- 2.14 EFRAG notes that the enforceable present rights and enforceable present obligations that the ED intends to cover in the scope of the proposed Standard can also arise from a regulatory framework that is enforceable by law, but where a regulatory agreement per se might not exist.
- 2.15 EFRAG suggests that more specific guidance and examples on what constitutes a regulatory agreement would be helpful to appropriately identify arrangements within the scope of the proposed Standard.

EFRAG's view on description of a regulator

- 2.16 The IASB's ED does not require that a particular type of body, such as a regulator, must exist to enforce compliance with the regulatory agreement, and what the characteristics of that body should be.
- 2.17 EFRAG notes that the principles-based definition of the scope of the proposed Standard does not necessitate the definition of a regulator. EFRAG acknowledges that a regulator is not a criterion for an entity to be within the scope of the proposed Standard. However, EFRAG is consulting constituents (paragraph 67 of EFRAG's DCL) on whether defining some of the regulator's characteristics would be helpful to determine whether certain entities may be affected by the proposed Standard. And whether it would help limit unintended consequences such as broader application than intended and inclusion in scope of price adjustment agreements that are similar to rate regulation.

- 2.18 In EFRAG's view, specifying that the regulator is an independent body would be important to avoid structuring opportunities, such as situations where entities could set up a related party to be the 'regulator' in order to be eligible to apply the proposed accounting model and recognise regulatory assets and/or regulatory liabilities. Similarly, there is the possibility of new contracts being written by entities for purposes of falling within the proposed scope.

CHAPTER 3: AGREEMENTS THAT MAY BE AFFECTED BY THE PROPOSALS

In this chapter, the EFRAG Secretariat focuses on the application of the IASB's proposals on scope. The EFRAG Secretariat assesses the outcome of the IASB's proposals when applied to different fact patterns which characteristics might meet the scope criteria as defined in the IASB's ED. The purpose of the assessment is to identify any situations where the proposed requirements for scope will affect entities that are not subject to rate regulation.

Assessing the outcome of the IASB proposals when applied to different fact patterns

- 3.1 In this chapter, the EFRAG Secretariat assesses how the IASB's proposals on scope will be applied to different facts patterns that exist within a rate-regulated environment.
- 3.2 Entities that would be affected by the proposals would be subject to rate regulation that determines:
 - a) how much total allowed compensation entities are entitled to charge customers for goods or services supplied in a period; and
 - b) when the entities can include the total allowed compensation in the regulated rates charged.
- 3.3 EFRAG Secretariat observes that price regulation within the utilities sector such as the supply of water, gas and electricity may be affected by the proposals. In other situations, the application of the proposals on scope might be more complex, for example, price adjustment agreements that share similar characteristics to rate regulation and could potentially fall within the scope of the proposed Standard.
- 3.4 Furthermore, EFRAG Secretariat notes that price regulation per se is not a sole criterion for an entity to be within the scope of the proposed Standard but all of the features listed in paragraph ES4 (and paragraph 6 of the ED) should be met.
- 3.5 In the section below, the EFRAG Secretariat assesses a selection of five fact patterns that might meet the proposed scope requirements of the IASB's ED even though might not be viewed as being subject to rate regulation. The fact patterns include examples identified by EFRAG TEG during the development of the IASB proposals. It also includes the analysis of a fact pattern related to arrangements/agreements in monopolistic industries and captures some of the sectors where some stakeholders have noted may unexpectedly fall within the scope of the proposed Standard (e.g., banking, insurance). These fact patterns are not an exhaustive representation of circumstances where questions of eligibility to be within the scope of the proposed Standard may arise.
- 3.6 The EFRAG Secretariat has assessed each of the described fact patterns below against the necessary elements included in the scope definition of the ED (paragraph 6 of the ED). Those elements are:
 - a) an entity is a **party to a regulatory agreement**;
 - b) the **regulatory agreement determines the regulated rate** the entity charges for goods and services it supplies; and

- c) there are **differences in timing** between the period in which the total allowed compensation for goods and services is charged to customers and the period in which these goods and services are supplied to customers.

Fact patterns that may be affected by the proposals

Fact Pattern 1: Pricing mechanism agreement between a water Cooperative and its customers

Fact pattern

- 3.7 A Cooperative provides water to its members who are also its owners. The members of the Cooperative are obliged to purchase water from the Cooperative and are not allowed to purchase water from a different water supplier as long as they are members of the cooperative.
- 3.8 The articles of association of the Cooperative establish a pricing mechanism that determines the price of water supplied to its members.
- 3.9 The pricing mechanism often reflects the overall objective that the cooperative's profit margin, which on average should be nil or relatively low based on a specific cost formula. When setting the water prices, the cooperative is not under the supervision of a regulator, although the objective is to ensure that it provides water services at a reasonable price to its members.

EFRAG Secretariat's assessment

- 3.10 EFRAG Secretariat considers that the articles of association of the Cooperative can be interpreted as a type of a regulatory agreement (paragraph 8(c) of the ED refers to a set of rights and obligations specified by statute) which regulates the selling price for water supplied to members of the Cooperative.
- 3.11 Depending on the articles of association, EFRAG Secretariat assesses that it is possible that differences in timing are created when the supply of water to members of the Cooperative in a particular period is charged to customer as part of the total allowed compensation in a different period. If the right to increase or obligation to decrease the prices in the future due to these differences in timing are enforceable by law, this type of Cooperatives can be affected by the proposed requirements of the ED.
- 3.12 EFRAG Secretariat notes that for a regulatory asset to exist, it is necessary that an entity would have supplied goods or services. And for a regulatory liability to exist, it is necessary that the entity would have already included in revenue amounts for goods or services to be supplied in the future.

Fact Pattern 2: Concession agreement between a municipality and its school cafeteria

Fact pattern

- 3.13 A Municipality owns and runs a school cafeteria. The Municipality outsources the operation of the school cafeteria to a commercial operator (Operator). The activities of the operator are based on a service agreement with the Municipality.
- 3.14 Under the service agreement the Operator is reimbursed by the Municipality:

- a) based on targeted per-unit cost to produce and serve the meals plus a pre-determined profit margin less revenue received from the sale of the meals; and
 - b) for the cost and profit margin for free meals delivered to students who are not able to pay the target price.
- 3.15 The Operator of the school cafeteria offers meals to students at reduced (subsidised) prices considered affordable for the students. The prices are based on a target price per meal established by Municipality A and is less than the per-unit cost to produce and serve the meal. The targeted per-unit cost of the meal is based on an estimated number of meals and is calculated based on a minimum occupancy of the school and not on a minimum number of meals served.
- 3.16 If the Operator sells the estimated number of meals or more, it will fully recover its period costs. However, if occupancy is below the guaranteed minimum, the reimbursements will be reduced proportionally. The Operator receives its reimbursements monthly, however, because the reimbursements are based on historic data, subject to audit and reviewed every 3 years, it is possible that the operator may face situations where the period costs will be reimbursed after the end of the review period.

EFRAG Secretariat's assessment

- 3.17 The EFRAG Secretariat considers that the service agreement with the Municipality can be perceived as equivalent to a regulatory agreement that sets the price (cost-per-unit plus profit margin) for customers.
- 3.18 Based on facts and circumstances, there are differences in timing when the provision of goods by the canteen in one period is charged to customers as part of the total allowed compensation in a different period. If the right to increase or obligation to decrease the prices in the future due to these differences in timing are enforceable, then the arrangement would fall within the scope of the proposed Standard. EFRAG Secretariat notes that for a regulatory asset to exist, it is necessary that an entity would have already supplied goods or services. And for a regulatory liability to exist, it is necessary that the entity would have already included in revenue amounts for goods or services to be supplied in the future.
- 3.19 The EFRAG Secretariat observes that the described fact pattern could also contain elements that are within the scope of existing IFRS Standards.

Fact Pattern 3: Arrangements/agreements in a monopolistic environment

Fact pattern

- 3.20 In some jurisdictions, there is only a single provider of particular services (service arrangements) such as insurance, healthcare, banking. The natural monopolistic environment does not allow for more market participants to be active in these locations. Therefore, the prices (rates) of such services are determined by regulation in order to protect the customer from paying excessive prices because of lack of competition.

EFRAG Secretariat's assessment

- 3.21 Such type of service arrangements could be within the scope of the proposed Standard because the regulation establishes a cost-of-service type of regulatory rate. This regulatory rate is adjusted to account for differences in timing arising because the period when the services are supplied is different from the period in which some or all of the total allowed compensation is charged to customers. If the right to increase or obligation to decrease the prices in the future due to these differences in timing are enforceable, the EFRAG Secretariat assesses that these service arrangements could be within the scope of the proposed Standard.
- 3.22 The EFRAG Secretariat notes that for a regulatory asset to exist, it is also necessary that an entity would have already supplied goods or services. And for a regulatory liability to exist, it is necessary that the entity would have already included in revenue amounts for goods or services to be supplied in the future.

Fact Pattern 4: Settlement by third parties on behalf of the customer

Fact pattern

- 3.23 In some jurisdictions, there are agreements under which if the customer is not able to pay the regulated rate for the supply of goods and services then the obligation will be settled/ recovered by a third party (a regulator, a government agency, a contractor etc.).

EFRAG Secretariat's assessment

- 3.24 Applying the proposed requirements in the ED, such arrangements can be considered to meet the definition of a regulatory agreement that established the regulated rate charged to customers. Furthermore, there need to be differences in timing between the period in which goods and services were supplied and the period when some or all of the total allowed compensation was charged to customers. To be in the scope of the proposed Standard, the right to increase or obligation to decrease the prices in the future due to these differences in timing need to be legally enforceable.
- 3.25 The EFRAG Secretariat notes that for a regulatory asset to exist, it is also necessary that an entity would have already supplied goods or services. And for a regulatory liability to exist, it is necessary that the entity would have already included in revenue amounts for goods or services to be supplied in the future.
- 3.26 The EFRAG Secretariat observes that for the arrangement to fall within the scope of the proposed Standard, it is important that the customer is charged for the supplied goods or services through the regulated rate regardless of which party actually pays for these goods and services. This observation is in line with the analysis provided in illustrative example 6B of the proposed Standard.

Fact Pattern 5: Transfer pricing agreement between a Parent company and its subsidiary

Fact pattern

- 3.27 A subsidiary of a Parent company sells its products to its customers at prices determined by the Parent company. The selling prices to the customers are based on a cost-plus formula included in a transfer pricing agreement between the Parent company and its subsidiary. In this way, the Parent company guarantees a level of profitability to its subsidiary.

- 3.28 The Parent company and its subsidiary prepare their financial statements in accordance with IFRS Standards.

EFRAG Secretariat's assessment

- 3.29 The EFRAG Secretariat assesses the fact pattern from the perspective of the separate financial statements of a subsidiary. This fact pattern has not been analysed from the perspective of the Parent company.
- 3.30 In the EFRAG Secretariat's view, if the transfer pricing agreement (between the Parent company and its subsidiary) is enforceable, it can be interpreted as a form of regulatory agreement which sets the prices (rates) charged to the customers of the subsidiary.
- 3.31 Depending on the facts and circumstances, the EFRAG Secretariat assesses that if the transfer pricing agreement creates differences in timing between the provision of goods and services and the inclusion of some or all of the total allowed compensation for goods and services supplied in the revenue recognised. And if the right to increase or obligation to decrease the prices in the future due to the differences in timing are enforceable, it is possible that such agreements could fall within the scope of the proposed Standard.



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