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IASB Project on Rate-regulated Activities Debriefing paper

Objective

- 1 The objective of this session is to provide an update on the accounting model for regulatory assets and regulatory liabilities being developed by the IASB (the accounting model). This paper provides background information on the IASB project on rate-regulated activities and a summary of the feedback received so far from the EFRAG Rate-regulated Working Group (EFRAG RRAWG) and EFRAG TEG.
- 2 A presentation on the project developments and the IASB tentative decisions to be included in the forthcoming exposure draft (expected in H2 2020) will be delivered by an IASB member.

Project history

- 3 Some entities are subject to regulations that say how much and when they can charge their customers for goods or services provided. Typical examples are the supply of water and electricity services, although there could be other activities subject to this type of regulation.
- 4 Entities reporting under IFRS tend not to recognise the effects of this rate regulation. In contrast US GAAP has specific guidance that requires entities to report such effects in its financial statements. Many argue that IFRS reporting entities report incomplete information about how rate regulation affects its underlying financial performance, financial position, and cash flows. This incomplete information hinders investors from comparing and understanding the effects of rate regulation across different countries and companies.
- 5 To respond to these concerns around incomplete information regarding regulatory balances, the IASB issued IFRS 14 *Regulatory Deferral Accounts* in January 2014 for entities adopting IFRS that would allow these entities to continue to use their local GAAP requirements for rate-regulated activities until the comprehensive project is completed. The intention was always to replace IFRS 14 with a comprehensive standard on regulatory assets and regulatory liabilities, once the IASB had a clearer understanding of the different types of rate regulation across IFRS reporting jurisdictions, and the type of rate regulation that created rights and obligations that should be considered for recognition as assets and liabilities.
- 6 In September 2014, the IASB published discussion paper *Reporting the Financial Effects of Rate Regulation* that explored the features of a type of regulation referred to as defined rate regulation and considered possible approaches about how to account for this type of regulation. In September 2019, the IASB concluded its discussions on the proposed accounting model for defined rate regulation.

Outline of the accounting model

- 7 The model will require entities subject to rate-regulated activities to provide information about their incremental rights to add amounts (regulatory assets), and incremental obligations to deduct amounts (regulatory liabilities), in determining the future rates to be charged to customers as a result of goods or services already supplied.
- 8 The accounting model will apply to activities subject to ‘defined rate regulation’, established through a formal regulatory framework that (i) is binding on both the entity and the regulator; (ii) defines a basis for setting the rate to be charged to the entity’s customers for goods or services; and (iii) gives rise to enforceable rights and obligations. It is therefore necessary that a tripartite relationship exists (regulator, entity and customer) for an activity to be within the scope of the RRA project.
- 9 The accounting model will supplement the information provided by applying IFRS 15 *Revenue from Contracts with Customers*, IFRIC 12 *Service Concession Arrangements* and IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, when applicable, before applying the model.
- 10 The purpose of the accounting model is to provide users of financial statements with clearer and more complete information about the financial performance, financial position, and prospects for future cash flows of companies operating activities subject to defined rate regulation.

Prior discussions with the EFRAG Rate-regulated Working Group

- 11 The EFRAG RRAWG met several times to discuss the development of the accounting model and provide feedback to the IASB. In October 2019, the RRAWG met to discuss the IASB’s tentative decisions on the accounting model and how it might be applied in practice. Appendix 1 in agenda paper 04-03 provides an extract of the Chairman’s report summarising the outcome of this meeting.
- 12 EFRAG RRAWG members welcomed the efforts of the IASB in developing an accounting model that would require entities subject to defined rate regulation to recognise regulatory assets and regulatory liabilities. Many European entities providing utility services have activities subject to this type of regulation, and there had been a long-standing request from the utility sector to address this topic.
- 13 However, there was a general concern from EFRAG RRAWG members that the model had become overly complex and difficult to understand and may result in application issues. The application issues related to (1) determining the boundary of the regulatory agreement, which was key to determine which regulatory balances should be recognised, (2) issues with measurement of regulatory assets and regulatory liabilities in particular the discounting proposals, and (3) the need for clarification around the interaction of the measurement requirements in the model with the impairment requirements under IAS 36 *Impairment of Assets*.
- 14 At least one RRAWG member thought that it would be useful to have guidance on the interaction with IFRIC 12 *Service Concession Arrangements* given the overlay nature of the model.

Prior discussions with EFRAG TEG

- 15 EFRAG TEG discussed the accounting model at its meetings in November 2019 and in January 2020. Appendix 2 in agenda paper 04-03 provides an extract of the summary of decisions of both these meetings.

- 16 EFRAG TEG members considered that the current definition of defined rate regulation¹ may be too broad and include a wider range of activities than initially anticipated, which meant that industries other than the utility sector could be impacted. However, the extent of this potential impact, and its significance, is not known at this stage. The issue is that there were different ways of creating a binding agreement between a regulator and an entity, and the IASB proposals did not define ‘a regulator’ which left open for interpretation what types of binding regulatory agreements might be included within the scope of the model.
- 17 EFRAG TEG members considered that the definition of the regulator was important when determining whether certain activities were within the scope of the model. In previous discussions, EFRAG TEG members provided examples to the EFRAG Secretariat of some rate-regulated activities outside of the utility sector that could fall within the scope of the IASB project.
- 18 Regarding the application of the model, EFRAG TEG members shared similar concerns to those of EFRAG RRAWG members in paragraph 13 on the complexity around the recognition and measurement principles and the lack of clarity on the interaction of the model’s measurement principles (which were regulatory specific) with the impairment requirements in IAS 36. For example, the impairment effect of cash-generating units subject to defined rate regulation should be clarified to avoid unintended consequences such as potential ‘accounting impairments’ of these cash-generating units, which economically were not impaired.
- 19 Some EFRAG TEG members did not agree with providing an exception to the measurement principle in IFRS 3 *Business Combinations* for regulatory assets and regulatory liabilities on the basis that there were other assets recognised at fair value under IFRS 3 that were not traded on an active market. Other EFRAG TEG members agreed with the exception on the basis that it would avoid recognition of gains or losses in subsequent periods, that resulted from applying a different measurement bases for regulatory assets and regulatory liabilities in the period after acquisition.
- 20 Some EFRAG TEG members expressed concerns with the level of disclosure requirements and considered that entities might not have readily available the level of granular information required under the proposals. Furthermore, some EFRAG TEG members considered that entities might not have all the required information for full retrospective application and considered that a modified retrospective approach should be considered.

Next steps

- 21 The EFRAG Secretariat plans to undertake outreach activities with preparers and users of financial statements to better understand which activities subject to a binding regulatory agreement, outside of the utility sector, are likely to be impacted by the scope of the IASB project on rate-regulated activities.
- 22 Furthermore, the EFRAG Secretariat have asked members of the EFRAG RRAWG for real-life examples that would test the application of the accounting model to

¹ The IASB has tentatively decided that the scope of the project applies to defined rate regulation which is established through a formal regulatory framework that:

- (a) is binding on both the entity and the regulator; and
- (b) establishes a basis for setting the rate for specified goods or services that includes a rate-adjustment mechanism. That mechanism creates, and subsequently reverses, rights and obligations caused by the regulated rate in one period including amounts related to specified activities the entity carries out in a different period (referred to as timing differences).

better understand the concerns already identified regarding the recognition and measurement principles as well as any other issues on the model.

Questions for EFRAG Board

- 23 As this stage, does the EFRAG Board have any comments on the forthcoming IASB proposals on the accounting model for regulatory assets and regulatory liabilities?

Agenda Papers

- 24 In addition to this debriefing paper, agenda papers for this session are:
- (a) Agenda paper 09-02 – *IASB presentation* – has been provided for the session; and
 - (b) Agenda paper 04-03 – EFRAG RRAWG report and Summary of Discussions and Decisions following EFRAG TEG meeting in November 2019 and EFRAG TEG webcast meeting on 5 February 2020.