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## **Regulatory Assets and Regulatory Liabilities Issues Paper**

### **Objective**

- 1 The objective of this paper is to obtain the views of EFRAG TEG-CFSS members on the proposals in the IASB Exposure Draft *ED/2021/1 Regulatory Assets and Regulatory Liabilities* ('the ED') and on the EFRAG's tentative responses in its draft comment letter ('the DCL'). In addition, EFRAG TEG-CFSS will be informed on the status of the EFRAG outreach activities.

### **Information for EFRAG TEG-CFSS**

- 2 The IASB will discuss the ED with the ASAF members on 28-29 June 2021. The focus of the ASAF discussion will be on the scope, total allowed compensation, measurement and interaction with other standards with a focus on the interaction with IFRIC 12 *Service Concession Arrangements*.
- 3 The IASB proposals on these four topics are presented in detail in the paper 12-03 provided for this session.
- 4 EFRAG positions on the four topics are presented in paragraphs 6 to 35 below. Included in these positions are three issues where two views were presented, and no conclusive position arrived at in the DCL. In addition to the ASAF-related questions, EFRAG would like to get the views from CFSS members on these three issues.
- 5 Paragraphs 36 to 38 have a summarised update on the outreach activities.

### **EFRAG DCL Position on the ASAF Session Topics**

#### *Scope*

- 6 EFRAG supports the IASB's overall objective to develop an accounting model for regulatory assets and regulatory liabilities. EFRAG agrees that the information provided by the proposed accounting model, together with information required by other IFRS Standards, would enable users of financial statements to understand how the financial performance and the financial position of a reporting entity is affected by its rate-regulated activities.
- 7 EFRAG's initial analysis including through the feedback from the early-stage effects analysis outreach to preparers (where most of the feedback was from the utilities sector), highlights that by and large, there is clarity on scope of the model within the utilities sector. However, EFRAG notes there are concerns from stakeholders outside of the utilities sector on the possible impact of the scope and unintended

consequences (i.e., entities unknowingly or unintendedly falling within the scope of the model).

- 8 While understanding the merits of a principles-based definition of the scope of the Standard that does not define a regulator, EFRAG is still assessing unintended consequences including the impact that may arise beyond the utilities sector.
- 9 The early-stage effects analysis also highlighted that some preparers were aware of rate adjustments related to concession arrangements where there was uncertainty on if these fell within the scope of the model instead of IFRIC 12. As noted in the section on interaction with other IFRS Standards, there is a need to further evaluate the interaction of the proposed model with IFRIC 12. Specifically, there is a need to obtain and assess fact patterns where it is not clear whether these fall within the scope of the proposed Standard or IFRIC 12.
- 10 EFRAG considers that more specific guidance and examples on what constitutes regulatory agreement would be helpful to appropriately identify activities within the scope of the proposed Standard. Furthermore, EFRAG considers that it would be helpful to describe the characteristics of a regulator to avoid unintended consequences including situations arising where structuring is done such that inter-company arrangements or self-regulation would fall within the scope of the proposed Standard.
- 11 However, EFRAG did not yet form a view and seeks stakeholders' feedback on the IASB proposal that the regulatory returns for CWIP, in cases where the regulatory agreement allows regulatory returns to be charged to customers during construction, are only included in profit or loss when the asset is in use. The first view is against the proposal based on its misalignment with regulator accounting, associated operational challenges, and cost-benefit considerations. The second view is in favour of the proposal based on the underlying conceptual reasoning and relevance of proposed information for some entities.
- 12 EFRAG agrees that an entity should not recognise any assets or liabilities created by a regulatory agreement other than regulatory assets and regulatory liabilities.

*Total Allowed Compensation (No conclusive position in EFRAG DCL)*

- 13 EFRAG supports the proposed inclusion of the three components of target profit (profit margin, regulatory returns other than those related to assets not yet in use also referred to as construction work in progress – 'CWIP', and performance incentives) in the total allowed compensation, in the period when the regulatory agreement entitles an entity to add these components in determining a regulated rate for goods or services supplied in that period.
- 14 However, EFRAG did not yet form a view and seeks stakeholders' feedback on the IASB proposal that the regulatory returns for CWIP, in cases where the regulatory agreement allows regulatory returns to be charged to customers during construction, are only included in profit or loss when the asset is in use. The first view is against the proposal based on its misalignment with regulator accounting, associated operational challenges, and cost-benefit considerations. The second view is in favour of the proposal based on the underlying conceptual reasoning and relevance of proposed information for some entities.
- 15 **View 1 - against the proposal:** EFRAG notes concerns on the proposed treatment of CWIP regulatory returns in situations where the regulatory agreement allows regulatory returns to be charged to customers during construction. The proposal departs from the alignment of the accounting treatment with the regulatory treatment of regulatory returns. EFRAG also highlights the operational challenges of recognising regulatory returns related to construction work in progress only when the asset is in use. Assets are used on a portfolio rather than on an individual basis to generate revenue and it is difficult to attribute revenue to a single asset.

- 16 Furthermore, some entities have high volumes of initiated assets under construction and high volumes of these that become operational - it will be challenging for these entities to apply the proposed treatment of CWIP regulatory returns.
- 17 **View 2 - in favour of the proposal:** EFRAG acknowledges that the IASB proposal will reflect total allowed compensation when the underlying asset is being used to provide goods or services and being consumed (through depreciation) and this will result in a faithful representation of profit patterns particularly for entities that have material and long-duration CWIP. For such entities, if the regulatory returns were to be recognised as part of the total allowed compensation during construction, the profit would be misleadingly understated when the asset becomes operational.
- 18 Furthermore, EFRAG notes that the proposal will contribute to comparability across entities regardless of how regulatory return is structured within regulatory agreements.

*Measurement*

- 19 EFRAG supports the proposed cash-flow measurement technique because it is closely aligned to the cash inflows and outflows associated with regulatory assets and regulatory liabilities which are based on regulated rates (prices), and thus with the amounts an entity is entitled to receive or obliged to fulfil under the regulatory agreement.
- 20 EFRAG also agrees that an entity needs to consider all sources of uncertainty affecting the cash flow, including the credit risk that it bears when estimating the future cash flows arising from a regulatory asset. However, EFRAG recommends the IASB to provide guidance on how estimates of credit risk should be allocated to its individual regulatory assets.
- 21 EFRAG considers the requirements and guidance in the ED on the boundary of the regulatory agreement to be confusing and could be mixing up the entity's licence to operate with the enforceable rights and enforceable obligations arising from the regulatory agreement. In EFRAG's view, the boundary of the regulatory agreement should be determined based on an entity's enforceable rights and enforceable obligations under the regulatory agreement rather than being an accounting judgement. If an entity cannot recognise a regulatory asset or a regulatory liability because the approval of the regulator is still pending, and as a result the entity does not have an enforceable right or an enforceable obligation, then EFRAG considers that the guidance on the regulatory boundary should be included in the recognition part of the ED, and not in measurement.
- 22 EFRAG supports the proposal to require an entity to estimate future cash flows arising from each regulatory asset and regulatory liability recognised, using either the most likely amount or the expected value method, depending on which approach provides more relevant information.

*Discount Rate (No conclusive position in EFRAG DCL)*

- 23 EFRAG supports the proposal to require an entity to discount the estimated future cash flows to their present value in measuring regulatory assets and regulatory liabilities. In EFRAG's view, the concept of discounting is a fundamental part of general IFRS requirements where the effects of the time value of money are significant.
- 24 Like in IFRS 15, EFRAG recommends that the IASB consider introducing a practical expedient to exempt entities from discounting if the effects of discounting are not significant.
- 25 EFRAG disagrees with the proposal for different discounting approaches for regulatory assets and regulatory liabilities.

- 26 EFRAG is concerned by the complexity of the proposal, particularly regarding the minimum rate. EFRAG considers that the IASB should better clarify the purpose of discounting and has not formed a view at this stage and seeks constituents' feedback on how regulatory assets and regulatory liabilities should be discounted. There are two possible views:
- 27 **View 1: Use the regulatory interest rate for regulatory assets and regulatory liabilities.** The regulatory interest rate is negotiated with the regulator and considered objective by users. Supporters of this view disagree with the proposed application of a minimum adequate rate as the discount rate for regulatory assets when the regulatory interest rate provided for a regulatory asset is insufficient. What matters ought to be the discount rate agreed with the regulator, as this represents the rate the entity is entitled to recover (fulfil) when measuring its regulatory assets and regulatory liabilities. Therefore, the application of a minimum adequate rate would not be relevant information for users to understand regulatory assets and regulatory liabilities.
- 28 **View 2: Discounting of regulatory assets and regulatory liabilities should follow the general discounting principles in IFRS Standards** because the objective of discounting is to appropriately reflect the effects of the time value of money. The regulatory interest rate might have a different objective. In cases where there is a significant financing component and the regulatory interest rate differs from the market rate, an entity should apply the requirements in IFRS 15 and use the prevailing interest rates in the relevant market.

*Interaction with other IFRS Standards*

- 29 EFRAG generally agrees with the IASB proposals addressing the interaction with other IFRS Standards. however, EFRAG has suggests for further clarification on the interaction with the Standards noted below.
- 30 **IAS 12 Income Taxes:** EFRAG suggests the IASB specifies that these tax cash flows should form part of regulatory income and regulatory expense and should be presented in the 'regulatory income minus regulatory expense' line item.
- 31 **IFRIC 12 Service Concession Arrangements:** EFRAG suggests the IASB provides more guidance, (including illustrative examples) on the model's interaction with IFRIC 12 requirements given the supplementary nature of the IASB model.
- 32 **IFRS 3 Business Combinations (No conclusive position in EFRAG DCL):** EFRAG is seeking views of constituents on the proposed exception from the recognition and measurement requirements of IFRS 3 for regulatory assets (or liabilities) acquired in a business combination. Applying this exception, the regulatory assets and liabilities will be measured at modified historical cost, rather than at fair value.
- 33 As part of its assessment, EFRAG is seeking stakeholders' views on the recognition and fair value measurement of the regulatory assets and liabilities at acquisition, as required by IFRS 3, and on the application of an adjusted discount interest rate for discounting (similar to IFRS 9 provisions) during subsequent measurement.
- 34 **IFRS 1 First-Time Adoption of International Financial Reporting Standards:** EFRAG also questions whether the reclassification of goodwill-related regulatory balances to goodwill suggested in the proposed amendments to IFRS 1 for the first-time adopters would result in the correct depiction of the entity financial performance when the goodwill-related revenues will be charged to customers but the related goodwill balances remain on the balance sheet.
- 35 **IAS 36 Impairment of Assets:** EFRAG suggests the IASB to provide further guidance how the interaction with a CGU that included regulatory assets would work in practice, in respect of separating the cash flows from regulatory assets from the total cash flows generated by a CGU for impairment test purposes.

### Update on Outreach Activities

- 36 From May to early June 2021, EFRAG has participated in several calls with audit firm representatives, a preparers' organisation, and a working group of the national standard setters ('NSS'). EFRAG also participated in an OIC-IASB-EFRAG joint outreach event for Italian stakeholders. A recurrent point of discussion across the outreach meetings has been the proposed treatment of regulatory returns for CWIP, where elaborating comments on the determination, underlying incentives and economic purpose of these returns have been provided. Other points of discussion have been the scope, cost recognition, and the interaction between the proposed Standard and IFRIC 12, IFRS 15 *Revenue from Contracts with Customers* and other IFRS Standards.
- 37 To facilitate the outreach and help stimulate debate on the ED proposals, in early June, the EFRAG Secretariat published a [Briefing Practical Implications on the Project Scope](#).
- 38 During June – July 2021, EFRAG is planning to continue its outreach activities with the NSS' working groups, the preparers' organisation, and with regulators where possible. Furthermore, EFRAG is organising an outreach event with users, and will extend the effects analysis that was conducted for users and preparers before the issuance of the DCL. EFRAG will also participate at the European Accounting Association workshop for academics. These outreach activities will be conducted until the end of July 2021 and the feedback received will be incorporated into the EFRAG's final comment letter.