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Regulatory assets and regulatory liabilities Issues Paper

Objective

1 The purpose of this session is to seek EFRAG TEG/CFSS members' views on the recent IASB tentative decision on the scope and application of total allowed compensation in the expected final Standard. This input is sought in preparation for the ASAF discussion on 27 March 2023.

2 The tentative decisions addressed are:

(a) Scope - Interaction with IFRIC 12 *Service Concession Arrangements*;

(b) Total allowed compensation which includes:

(i) Proposed definition of allowable expense and benchmark expenses;

(ii) Regulatory assets and regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives;

(iii) Capitalised borrowing costs;

(iv) Inflation adjustment to the regulatory capital base; and

(v) Other items included in the regulatory capital base.

3 For each of the IASB tentative decisions discussed in this paper, the following content is provided:

(a) IASB tentative decision;

(b) Proposals in the Exposure Draft ('ED');

(c) Description and analysis of the issue; and

(d) Feedback received so far.

Scope - Interaction with IFRIC 12

IASB tentative decision (September 2022)

4 The IASB tentatively decided to:

(a) clarify the intended interaction between the proposed Standard and IFRIC 12 - that an entity would apply IFRIC 12 first and then apply the requirements of the proposed Standard to any remaining rights and obligations to determine if the entity has regulatory assets or regulatory liabilities; and

(b) include examples to illustrate that interaction, including:

(i) examples where the entity has a right to recover higher input costs incurred in a period in the regulated rates to be charged to customers in future periods;

   (ii) examples where the entity has a right to recover higher input costs incurred in a period in the regulated rates to be charged to customers in a future period, but the grantor guarantees to pay any shortfalls between the higher input costs incurred and the amounts recovered from the customers; and

(c) examples dealing with circumstances that are not expected to give rise to regulatory assets and regulatory liabilities.

Proposals in the ED

5 Paragraph B47 of the ED states that:

> IFRIC 12 applies to a public-to-private service concession arrangement if the grantor controls or regulates the price at which the operator must provide services, and if other specified conditions are met. Accordingly, some arrangements within the scope of IFRIC 12 *Service Concession Arrangements* may create regulatory assets or regulatory liabilities within the scope of this [draft] Standard. An entity shall account for those regulatory assets or regulatory liabilities separately from the assets and liabilities within the scope of IFRIC 12.

6 The proposed model supplements the information that an entity already provides applying IFRS Standards. This means that an entity would need to apply IFRIC 12 first and then, apply the requirements of the final Standard to any remaining rights and obligations to determine if the entity has regulatory assets or regulatory liabilities.

Description and analysis of the issue

7 Many respondents to the ED, including EFRAG. said that it is unclear how the proposals in the ED interact with IFRIC 12 and it would be useful for the IASB to develop examples in the final Standard that illustrate this interaction and help address the concerns raised when responding to the ED.

8 To address the concerns noted by respondents, the IASB staff developed examples that illustrated the interaction between IFRIC 12 and the model and sought feedback from stakeholders on these examples. The examples and feedback received were discussed with the IASB in its September 2022 meeting (agenda paper 9A)

Feedback received so far

EFRAG RRAWG (November 2022)

9 EFRAG RRAWG members agreed with the IASB's tentative decision and to include examples to illustrate the interaction between IFRIC 12 and the proposed model. The following additional comments were made:

(a) one member noted that it was useful to clarify that an entity should apply the requirements in IFRIC 12 first because IFRIC 12 is only an interpretation and not a full Standard. This clarification was important to avoid confusion related to the interaction of the model and IFRIC 12;

(b) two members suggested that the IASB further analyses examples of arrangements which currently affected the gas and electricity sector in Brazil. These arrangements were not currently regulated activities, however, it would be worth gathering additional information about their features as they could be extended in time.

EFRAG TEG and FRB (October 2022 and December 2022)

10 EFRAG TEG and EFRAG FRB generally welcomed the IASB tentative decision to clarity the interaction and include illustrative examples in the final Standard.

Question for EFRAG FR TEG/CFSS members

11 Do the IASB tentative decisions on Scope: Interaction with IFRIC 12 help address the concerns raised by stakeholders in your jurisdiction? Please explain.

Proposed definition of allowable expense and benchmark expenses

IASB tentative decision (October 2022)

12 The IASB tentatively decided that the final Standard:

(a) retain the proposed definition of allowable expense;

(b) clarify that a regulatory agreement may determine the amount that compensates an entity for an allowable expense using a basis different from the basis the entity uses to measure the expense in accordance with IFRS; and

(c) clarify the treatment of allowable expenses based on benchmarks and include examples to help entities identify differences in timing in those cases.

Proposals in the ED

13 Paragraph B3 of the ED defines allowable expense as (emphasis added):

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.

14 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 the total allowed compensation for goods or services supplied in that period. For example, if raw material costs are an allowable expense, the amount that recovers that allowable expense forms part of the total allowed compensation for goods or services supplied in the period when an entity consumes the raw materials and thus recognises that consumption as an expense applying IAS 2 *Inventories.*

Description and analysis of the issue

15 Several respondents to the ED, including EFRAG, expressed concerns with the definition of allowable expense in B3 and B4 and noted that:

(a) There are situations where the proposed requirements on total allowed compensation under paragraphs B3-B9 related to allowable expenses will not reflect the economic substance of the regulatory agreement (e.g., recoverable costs are based on regulatory accounting and not IFRS expenses). And where 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 life1 and where a regulatory liability is recognised on deferral of regulatory returns).

(b) It is unclear how expenses that are allowable based on benchmark figures from a peer group of companies should be treated. Therefore the IASB should further analyse whether the proposals can be applied in regulatory regimes where costs are based on sectoral averages or where recoverable costs are based on regulatory agreement and not IFRS expenses.

Feedback received so far

EFRAG RRAWG (November 2022)

16 RRAWG members were supportive of the IASB's tentative decision to incorporate benchmark expenses within the total allowed compensation per the regulatory agreement, rather than focus on compensation for entity-specific costs. This would align the requirements of the final Standard with the way some regulators in Europe determined regulated rates.

17 The following suggestions were made:

(a) One RRAWG member asked how enforceability would work when recoverable differences were subject to ex-post reviews (after the accounting period). One such example could be volume variances that could be subject to negotiation after the close of the accounting period. This happened in the airline sector. The IASB staff representative responded that this could be more of a measurement issue (which the IASB would redeliberate at a future meeting). In some cases, depending on existence uncertainty, it would also relate to recognition.

(b) One RRAWG member noted that given the application complexity of some of the proposals, it would be important for the IASB to create a Transition Reporting Group (TRG) as had been recommended in the EFRAG final comment letter to monitor and assist entities with application issues once the final Standard was published.

EFRAG TEG and FRB (December 2022 and January 2023)

18 EFRAG TEG and EFRAG FRB members supported the IASB’s tentative decision on allowable expense and benchmark expenses as it would help to clarify that allowable expenses are determined by reference to the regulatory agreement. The clarification would address the concerns noted by EFRAG and others when allowed expenses were based on benchmark or peer average expenses.

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

IASB tentative decision (October 2022)

19 the IASB 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 (PPE) have **no direct relationship** to provide disclosures to enable users of financial statements to understand the reasons for its conclusion.

Proposals in the ED

20 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.

21 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.

Description and analysis of the issue

22 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.

23 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.

24 These respondents - mainly preparers in Europe and Asia-Oceania - said that the proposals are not aligned with incentive-based schemes, which set an 'allowed revenue' amount made up of different components. In such regimes, 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. Identifying the individual differences in timing for compensation affected by the relationship between the regulatory capital base and PPE would be a costly and complex exercise. Some respondents considered that in some cases the differences in timing did not meet the definitions of a regulatory asset (regulatory liability).

Feedback received so far

EFRAG RRAWG

25 RRAWG members generally welcomed the IASB's tentative decision not to recognise regulatory assets and regulatory liabilities when a direct relationship between the regulatory capital base and IFRS PPE does not exist.

26 However, members noted that the indicators to help with the assessment of a direct relationship were very important. The indicators developed by the IASB staff and discussed with the IASB at the October 2022 meeting 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. Other comments and suggestions made were:

(a) 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.

(b) 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.

(c) 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.

(d) 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 relationship.

EFRAG TEG (January 2023)[1]

27 EFRAG FR TEG members supported the IASB's tentative decision to find a solution to the concerns reported by respondents. However, members made the following suggestions and noted areas for further clarification:

(a) It was highlighted that there would be significant judgement involved to identify a direct (no direct) relationship between the regulatory capital base and the IFRS property, plant and equipment (PPE). A member considered that it would be preferable for the IASB to develop factors rather than indicators to determine this relationship. The difference is that with ''factors'' an entity would need to comply, which was different to indicators. Therefore, making the decision based on factors would be clearer and more decisive.

(b) It was questioned whether under incentive-based regulatory regimes where there is no direct relationship, there would be any regulatory assets and regulatory liabilities to recognise. It was noted that many of the differences in timing that arose from differences between the regulatory capital base and the IFRS PPE would not result in the recognition of regulatory assets and regulatory liabilities if there was no direct relationship. For such cases, the IASB was considering disclosure requirements. It was also clarified that differences in timing that result in the recognition of regulatory assets and regulatory liabilities still occurred when there are volume variances and performance incentives among other areas.

(c) It was considered important to test the application of the direct (no direct) relationship as this was a new concept in the IASB tentative decisions that would have a significant impact on the outcome of the RRA accounting model.

[1] The EFRAG FRB will discuss this topic in May 2023, together with all other IASB tentative decisions on total allowed compensation.

Questions for EFRAG FR TEG/CFSS members

28 Do the IASB tentative decisions on the following topics relating to total allowed compensation help address the concerns raised by stakeholders in your jurisdiction:

(a) Proposed definition of allowable expense and benchmark expenses; and

(b) Regulatory assets and regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives.

Please explain.

Capitalised borrowing costs

IASB tentative decision (November 2022)

29 The IASB tentatively decided that when an entity's regulatory capital base and its property, plant and equipment have a direct relationship and the entity capitalises its borrowing costs:

(a) if the regulatory agreement provides the entity with both a debt and an equity return on an asset not yet available for use—to require the entity to reflect only those returns in excess of the entity's capitalised borrowing costs in the statement of financial performance during the construction period; and

(b) if the regulatory agreement provides the entity with only a debt return on such an asset—to prohibit the entity from reflecting the return in the statement of financial performance during the construction period.

30 All 11 IASB members agreed with these decisions.

Proposals in the ED

31 Paragraph B15 of the ED proposed that regulatory returns on an asset not yet available for use should form part of the total allowed compensation for goods or services supplied only once the asset is available for use. There is no accounting mismatch (depreciation of capitalised borrowing costs occurs when the asset is in operation). There would be a regulatory liability for the capitalised borrowing cost recognised during construction.

32 Feedback to the ED (including from EFRAG) disagreed with this proposal. Many respondents said regulatory returns compensate an entity for the services it provides during the construction period.

33 At its July 2022 meeting, the IASB tentatively decided that when an entity has an enforceable present right to regulatory returns, those returns should form part of the total allowed compensation for goods or services supplied during the construction period of an asset.

Description and analysis of the issue

34 For a direct relationship between an entity's regulatory capital base and its property, plant and equipment, when an entity capitalises the borrowing costs incurred during the construction of an asset, applying the July IASB's tentative decision in paragraph 33 above on regulatory returns could be viewed as creating an accounting mismatch and, in certain circumstances, result in the front-loading of profit during the construction period.

35 This is because:

(a) the debt return included within the regulatory returns would be reflected in profit or loss during the construction period—either as revenue under IFRS 15 (when regulatory returns are included in regulated rates as the asset is being

constructed) or as part of regulatory income related to the recognition of a regulatory asset (when regulatory returns are included in regulated rates only once the asset is operational).

(b) the capitalised borrowing costs would be recognised in profit or loss as part of depreciation expense only once the asset is operational (under IAS 23 *Borrowing Costs*).

36 Refer to some examples illustrating the accounting mismatch in the Appendix to this paper.

37 The issue occurs for the following situations:

(a) Regulatory returns are included in regulated rates charged during the operation period of an asset. Feedback from the ED indicated that these regulatory schemes are common in North America.

(b) Regulatory returns are included in regulated rates charged, and therefore in revenue recognised, during the construction of the assets.

38 The IASB Staff explored four approaches with its Consultative Group at its November 2022 meeting:

(a) Approach 1: No further action (i.e., allow the noted accounting mismatch);

(b) Approach 2: Deferring the entire debt return;

(c) Approach 3: Deferring part of regulatory return equal to capitalised borrowing cost; and

(d) Approach 4: Prohibiting capitalisation of borrowing costs.

39 Pages 10 and 11 of IASB Staff paper 9B show that a few members supported either approach 1 or 2 while one member supported approach 3. In addition, a few members disagreed with approach 4. Some affirmed that the problem arises when there is a direct relationship. One member considered IAS 23 to be an old Standard that could be amended for unforeseen circumstances.

40 Based on the feedback received at its Consultative Group meeting, the IASB Staff analysed further Approaches 2 to 4 in IASB Staff paper 9A discussed at the IASB meeting in November 2022. The IASB tentative decisions consider the case where an entity receives regulatory returns that consist of both an equity and a debt return and the case when an entity receives regulatory returns that only consists of a debt return. In the first case (returns = equity + debt returns), the IASB's tentative decision would be aligned with approach 3. In the second case (returns = debt return), the IASB's tentative decision would be aligned with approach 2.

Feedback received so far

EFRAG RRAWG (February 2023)

41 EFRAG RRAWG discussed the IASB's tentative decisions regarding the accounting for regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs to construct that asset.

42 Mixed views were expressed on the IASB's tentative decision with a few members preferring no further action while one agreed to address the accounting mismatch. Concerns revolved around the additional complexity, materiality of the issue, and perceived inconsistency with the regulatory agreement's approach. Detailed comments are as follows:

(a) For those that indicated that they preferred no action to be taken (i.e. make no amendments to address the noted accounting P&L mismatch due to the borrowing costs being recognised as part of regulatory income (P&L) in a period whereas the capitalised borrowing costs are only recognised in P&L

afterwards), reasons provided include that the tentative decisions would be costly to make sure that there is no accounting mismatch; the amendment would result in excess complexity and questions on whether the issue was material.

(b) One member preferred to address the accounting mismatch for a direct relationship by deferring part of the regulatory return equal to capitalised borrowing costs (consistent with the IASB's tentative decisions).

43 One member indicated that their company has a non-direct relationship between the regulatory capital base and its PPE and they invoice returns on construction work in progress during the construction period. In this situation, there would also be this accounting mismatch because the revenue would include the total amount charged to customers but they apply IAS 23. This member suggested disclosing information if material. This member did not agree with amending IAS 23 because the rate-regulated activities model is a supplementary model and the underlying model should not change.

44 Another member indicated that the Standard should take into consideration what the regulation stipulates on the total allowed compensation. Therefore, for situations whereby the regulated return is included in the regulated rate in the operation phase, this member did not agree with recognising a regulatory asset. The IASB Staff responded that the recognition of a regulatory asset is linked to if goods or services are supplied during construction rather than the period when the regulator includes the returns in the rates charged. The proposed model is consistent with accrual accounting and the treatment of regulatory returns is consistent with the treatment of performance bonuses.

45 This member also indicated that for situations whereby the regulated return is included in the regulated rate in the construction phase, she was not comfortable with recognising a liability as this is contradictory with the July IASB tentative decisions (i.e., regulatory returns that are included in IFRS 15 revenue during construction should not result in timing differences).

46 Another member indicated that there are two types of mismatches: the accounting mismatch as revenue is only recognised in construction and not when assets are in use; and an economic mismatch because of the revenue recognised and the capitalisation of the borrowing costs. This member indicated his company decided not to capitalise their borrowing costs so as not to recognise a regulatory liability.

47 Another member recalled two situations whereby the regulated return is included in the regulated rate in the operation phase: one whereby the construction work in progress is being maintained on an existing network compared to another situation whereby there is a creation of a new asset. For the latter situation, it would be risky to recognise a regulatory asset as the entity may not be sure if it will be successful. Therefore, this member preferred to have criteria to make a distinction between these two situations. A member added that it would also be complicated and complex to measure if the entity earns in the operation period. This member wanted to understand the cash impact of the cash flows being received. The IASB Staff responded that for a new asset being developed, the regulator may set different rules. The entity would need to assess enforceable rights.

Inflation adjustment to the regulatory capital base

IASB tentative decision (December 2022)

48 The IASB tentatively decided that the final Accounting Standard specify that an entity is neither required nor permitted to recognise as a regulatory asset, inflation adjustments to the regulatory capital base.

49 All 12 IASB members agreed with this decision.

Proposals in the ED

50 Paragraph B13 of the Exposure Draft says that an entity's regulatory capital base might include property, plant and equipment measured on a basis that is different from the basis required by IFRS Accounting Standards. For example, the regulatory capital base may include an inflation adjustment.

51 Illustrative example 7C.2 accompanying the Exposure Draft illustrates that if a regulatory agreement adjusts the regulatory capital base in the current period for inflation, giving an entity the right to add an inflation adjustment in the regulated rates to be charged to customers in future periods, that right would not meet the definition of a regulatory asset. This is because, according to the Exposure Draft, that right is not a right to recover the total allowed compensation for goods or services already supplied to customers.

Description and analysis of the issue

52 Two regulatory approaches are typically used to compensate entities for inflation on the regulatory capital base:

(a) nominal approach—under this approach entities receive a regulatory return that is computed by multiplying a nominal regulatory capital base by a return rate that includes inflation (that is, a nominal return rate). A regulatory capital base that stays constant in nominal terms effectively loses its underlying value by inflation each year with the nominal return rate aiming to compensate entities for that loss.

(b) real approach—under this approach entities receive a regulatory return that is computed by multiplying a regulatory capital base that is adjusted by inflation—so that it holds its value over time—by a return rate that does not include inflation (that is, a real return rate).

53 Both regulatory approaches are present value-neutral, that is, the present value of the future cash flows[2] that an entity receives from the nominal approach and real approach is the same.

54 When considering which approach to use, regulators consider different factors. For example, regulators may use the nominal approach if their priority is to improve an entity's ability to finance its investments. Regulators may use the real approach if their priority is to maintain stable regulated rates for customers over time.

55 The IASB Staff have observed that the nominal approach is more commonly used by cost-based schemes and the real approach is more commonly used by incentive-based schemes.

56 The question is whether - the inflation adjustment to the regulatory capital base gives rise to a regulatory asset or not.

57 The IASB Staff discussed this topic with its Consultative Group and there were two views as follows:

Reason supporting view	Type of supporters
View 1: the inflation adjustment to the regulatory capital base gives rise to a regulatory asset	
• The inflation adjustment to the regulatory capital base relates to compensation for goods or services that the entity has already supplied and consequently, it is compensation to which the entity is already entitled.	Mainly a few preparers from Africa and Europe, representatives from an accounting firm, and a credit analyst and an equity

[2] The future cash flows relating to the regulatory capital base are the compensation for depreciation of that base and the regulatory return on that base.

• Accounting for a regulatory asset would result in entities that are subject to the real approach reporting a similar financial performance to that of entities subject to the nominal approach.	analyst who both cover the utility sector in Europe.
View 2: the inflation adjustment to the regulatory capital base does not give rise to a regulatory asset	
• The inflation adjustment to the regulatory capital base will result in a higher amount of regulatory depreciation that the regulator will include when determining the allowed revenue to which an entity is entitled for a specified period. The entity would have an enforceable present right to recover only the allowed revenue amount for a specified period and not the remainder of the regulatory capital base at a given point in time. • The inflation adjustment to the regulatory capital base should be seen as a mechanism to adjust the measurement of the regulatory capital base so that it holds its value over time rather than an item that gives rise to a regulatory asset. • Accounting for the inflation adjustment as a regulatory asset could be seen as being equivalent to changing the measurement basis of property, plant and equipment from cost to current value (if an entity applies the cost model in IAS 16). • It is unclear why the final Standard would only account for the inflation adjustment as a regulatory asset, when other differences between the regulatory capital base and an entity's property, plant and equipment—could be viewed as giving rise to regulatory assets and regulatory liabilities—are not considered. • It will be onerous and very judgemental for an entity to demonstrate that it has an enforceable present right to the inflation adjustment to the regulatory capital base.	Mainly from accounting firms based in Europe.

Feedback received so far

EFRAG RRAWG (February 2023)

58 EFRAG RRAWG discussed the IASB's tentative decisions on inflation adjustments to an entity's regulatory capital base.

59 Members were, in general, in agreement with the IASB's tentative decision not to recognise a regulatory asset for inflation adjustments to the regulatory capital base. One member did not agree with the IASB's tentative decisions indicating that he was not convinced by the argument that it will be too costly to track inflation adjustments. This member indicated that based on the IASB's tentative decisions, example 7C.2 of the Exposure Draft would need to be rephrased.

60 One member confirmed that they apply a real return approach (incentive-based scheme). While another member was more familiar with the nominal approach.

61 One member questioned whether all incentive-based schemes apply a real return and the IASB Staff responded that it was not necessary that all incentive-based schemes have a real return. Based on what the IASB Staff have seen, cost-based schemes applying a nominal return and incentive-based schemes applying a real return were coincidental rather than a reflection of the features of the scheme.

62 In response to a member's question for clarification on whether the IASB Staff's recommendations were only for inflation adjustments linked to the regulatory asset base and not to other inflation adjustments, the IASB Staff confirmed that the tentative decisions relate only to inflation adjustments linked to the regulatory asset base. The IASB Staff indicated that the tentative decisions do not deal with other inflation adjustments that may be included in regulated rates. Also, the tentative decisions are for both a direct and non-direct relationship between an entity's regulatory capital base and its PPE.

Total allowed compensation - Other items included in the regulatory capital base

IASB tentative decision

63 In December 2022, the IASB tentatively decided that the final Standard specify that:

(a) An entity is required to recognise a regulatory asset or a regulatory liability relating to an allowable expense or performance incentive included in its regulatory capital base when:

(i) the entity's regulatory capital base and its property, plant and equipment (PPE) have a direct relationship; and

(ii) the entity has an enforceable present right (obligation) to add (deduct) the allowable expense or performance incentive to (from) future regulated rates.

(b) An entity is neither required nor permitted to recognise a regulatory asset or a regulatory liability relating to an allowable expense or performance incentive included in its regulatory capital base when the entity's regulatory capital base and its property, plant and equipment have no direct relationship.

64 All 12 IASB members agreed with this decision.

65 The IASB's tentative decisions on other items, including performance incentives, included in the regulatory capital base are consistent with its previous decision to apply the direct (no direct) relationship concept when accounting for regulatory assets and regulatory liabilities. This relationship is discussed in agenda paper 08-04 for this meeting.

Proposals in the ED

66 The ED defines a regulatory asset (regulatory liability) as:

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. 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. This is 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.

67 The ED proposed that an entity recognise all its regulatory assets and regulatory liabilities. If an entity is uncertain whether a regulatory asset or regulatory liability exists, an entity should recognise that regulatory asset or regulatory liability if it is more likely than not that it exists.

68 Paragraph B17 discusses performance incentives and says:

> Amounts relating to a performance incentive form part of or reduce the total allowed compensation for goods or services supplied in the period in which the entity's performance gives rise to the incentive. To determine what that period is, the entity shall consider the regulatory agreement's terms relating to the performance incentive, together with other facts and circumstances.

69 In some jurisdictions, the regulator adds (deducts) the performance incentives to (from) the regulatory capital base when determining how an entity will recover (fulfil) a performance incentive. In other jurisdictions, regulators might require an entity to recover a performance incentive in the rates of the current period

Description and analysis of the issue

70 The way that regulators allow entities to recover an item of expense or a performance incentive can differ across jurisdictions. For example, in some cases, an entity may expense an item whereas the regulator may require the entity to add that item to its regulatory capital base so that the entity recovers the item in future regulated rates. Similarly, some regulators require entities to add (or deduct) performance incentives to (from) the regulatory capital base. In such cases, the performance incentive is recovered (fulfilled) as the regulatory capital base is depreciated - that is, over time. Other regulators might require an entity to recover (fulfil) a performance incentive in the rates of the current period.

71 The issue is whether other items of allowable expenses or performance incentives included in an entity's regulatory capital base give rise to regulatory assets (regulatory liabilities).

72 The IASB staff considered the following two aspects when analysing the issue:

- (a) Does the allowable expense or performance incentive give rise to a regulatory asset (regulatory liability)?
- (b) The costs and benefits of recognising the regulatory asset (regulatory liability), particularly, when there is no direct relationship between the regulatory capital base and the entity's PPE.

Does a regulatory asset (regulatory liability) arise?

73 In its analysis, the IASB staff concluded that an allowable expense or a performance incentive added to (deducted from) the regulatory capital base would give rise to a regulatory asset (regulatory liability) if an entity has an enforceable present right (obligation) to add these amounts to (deduct these amounts from) regulated rates charged in the future.

74 However, the IASB staff also noted that for an entity to recognise a regulatory asset (regulatory liability), the entity would need to be able to identify and track the movement of these expense/performance incentives items within the regulatory capital base through to the rates charges to customers. The entity would also need to be able to estimate the amount and timing of future cash flows arising from that regulatory asset (regulatory liability) to be able to measure that regulatory asset (regulatory liability).

75 In regulatory regimes where an entity's regulatory capital base has a direct relationship with its PPE, the regulatory and accounting requirements are closely aligned, the tracking of items that are included (deducted) from the regulatory capital base and IFRS is straightforward. However, in regimes where there is no direct relationship, the IASB staff considered that the cost-benefit analysis was an important consideration.

Costs and benefits analysis

76 The IASB staff consider that in regulatory regimes where there is a direct relationship between the regulatory capital base and the entity's PPE:

(a) it is common for regulators to include items of allowable expense in entities' regulatory capital base. However, it would be uncommon for regulators to include performance incentives in the entities' regulatory capital base.

(b) it is feasible for an entity to track allowable expenses or performance incentives and follow up the corresponding recovery (fulfilment) through regulated rates charged.

77 In regimes where there is no direct relationship between the regulatory capital base and the entity's PPE, the IASB staff has learned through post-ED discussions including members of the IASB Consultative Group that:

(a) the regulatory capital base may include items of expense. In those schemes, entities do not reconcile their regulatory capital base with their fixed asset register and differences, which will include items of expense, are not tracked.

(b) some regulators include performance incentives in the regulatory capital base. However, the IASB staff's understanding is that this may not be very common and when performance incentives are included in the regulatory capital base they generally relate to bonuses and are not significant. This is because regulators would generally prefer penalties (that can be an element of performance incentives) to be deducted from regulated rates charged to customers in the next period(s) rather than over time through the depreciation of the regulatory capital base.

78 **For no direct relationship regimes,** the IASB staff consider that it would be difficult and costly for entities to track the movement of individual items of allowable expense or performance incentives included in the regulatory capital base. Consequently, the IASB staff concluded that the costs of recognising regulatory assets or regulatory liabilities in such cases would outweigh the benefits. For this reason, the IASB staff recommended to the IASB that entities subject to schemes where there is no direct relationship between the regulatory capital base and the entities' property plant and equipment should not recognise regulatory assets (regulatory liabilities) arising from allowable expenses or performance incentives included in their regulatory capital base.

79 As explained in agenda paper 08-03 for this meeting, the IASB staff recommendation to the IASB is consistent with the recommendations and IASB tentative decisions made on other expense items that are affected by the relationship between the regulatory capital base and PPE.

Feedback received so far

EFRAG RRAWG (February 2023)

80 EFRAG RRAWG members considered the IASB's tentative decisions on other items included in the regulatory capital base including performance incentives.

81 One member referred to a 2021 IFRIC agenda decision on the accounting treatment of costs relating to Software as a Service (SaaS) arrangements, as an example of other items that could be included in the regulatory capital base. This member supported the IASB's tentative decision not to require an entity to recognise regulatory assets (regulatory liabilities) if there was no direct relationship. This was because they did not track differences in timing for these items and it would be complicated if they would be required to do so. This member highlighted that performance incentives were not added to the regulatory capital base.

82 Other members welcomed the IASB tentative decision for the reasons already mentioned and noted that performance incentives were generally not added to the regulatory capital base. One member said that in some cases performance incentives could be part of the regulatory capital base.

83 Members generally supported the IASB tentative decision which was consistent with the use and application of the direct (no direct) concept for other differences in timing that are affected by the relationship between an entity's regulatory capital base and its PPE.

Questions for EFRAG FR TEG/CFSS members

84 Do the IASB tentative decisions on the following topics relating total allowed compensation help address the concerns raised by stakeholders in your jurisdiction:

(a) Capitalised borrowing costs;

(b) Inflation adjustment to the regulatory capital base; and

(c) Other items included in the regulatory capital base.

Please explain.

Appendix: IASB Staff examples illustrating the issue on capitalised borrowing costs

Example A - Regulatory returns are included in regulated rates charged during the operation period of an asset

1 An entity invests CU1,000 of capital to construct an asset in year 1.

2 The regulatory agreement allows the entity to accumulate regulatory returns during the construction period (year 1) and to include those returns in regulated rates during the operation period (years 2–6). The regulatory agreement applies a return rate of 8% to the capital invested, comprising a return for equity of 5% and a return for debt of 3%. Therefore, the entity accumulates regulatory returns of CU80 (8% x CU1,000) in year 1 and recovers regulatory returns of CU16 in each of the years 2–6 (CU80 / 5 years). The entity concludes that it has an enforceable present right to these regulatory returns during the construction period.

3 The entity incurs borrowing costs in constructing the asset amounting to CU35, with an implicit rate of 3.5% (CU35 / CU1,000). Applying IAS 23, the entity capitalises those borrowing costs as part of the cost of the asset. The entity reflects capitalised borrowing costs of CU7 in profit or loss as part of depreciation expense in each of the years 2–6 (CU35 / 5 years).

4 The regulatory agreement requires the entity to reconcile its regulatory capital base to its property, plant and equipment. The entity applies the same measurement basis and depreciation pace to the assets within its regulatory capital base and to its property, plant and equipment. The entity determines that there is a direct relationship between its regulatory capital base and its property, plant and equipment.

5 Considering the July IASB tentative decisions, the below table shows the entity's statement of financial performance and statement of financial position for years 1–6:

Table 1A—Applying the IASB's tentative decision to Example A
(Regulatory returns are included in regulated rates during the operation period) *In CU*

Statement of financial performance	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	TOTAL
Revenue (*)	—	216	216	216	216	216	1,080
Regulatory income / (regulatory expense)	80	(16)	(16)	(16)	(16)	(16)	—
Depreciation expense	—	(207)	(207)	(207)	(207)	(207)	(1,035)
Profit/(loss)	**80**	**(7)**	**(7)**	**(7)**	**(7)**	**(7)**	**45**

Statement of financial position	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Property, plant and equipment	1,035	828	621	414	207	—
Regulatory asset	80	64	48	32	16	—
Cash	(1,035)	(819)	(603)	(387)	(171)	45
Net assets	**80**	**73**	**66**	**59**	**52**	**45**

(*): Revenue for years 2–6 only includes the amount that recovers the depreciation expense of the asset excluding the capitalised borrowing costs (CU1,000 or CU200 yearly) and the regulatory returns accumulated during the construction period (CU80 or CU16 yearly).

6 This example shows that the regulatory returns that compensate the entity for borrowing costs (CU35) are recognised as part of regulatory income in profit or loss in year 1. However, because the borrowing costs are capitalised, they are only recognised as an expense in profit or loss as the property, plant and equipment is depreciated over years 2–6 (CU7 yearly). This arguably results in an accounting mismatch and front-loading of profit referred to above. It could also be argued that during the construction period the net asset position of the entity is overstated by CU35 and the overstated amount is only reversed over the operation period.

Example B - Regulatory returns being included in regulated rates charged, and therefore in revenue recognised, during the construction of the assets

7 Example B is the same as Example A, except that the regulatory agreement allows the entity to include the regulatory returns in regulated rates during the construction period. The IASB Staff observed from feedback on the Exposure Draft that this example may not be common. In Example B, no differences in timing would arise from those regulatory returns.

8 Considering the July IASB's tentative decision, the table below shows the entity's statement of financial performance and statement of financial position for years 1–6:

Table 1B—Applying the IASB's tentative decision to Example B
(Regulatory returns are included in regulated rates during the construction period) *In CU*

Statement of financial performance	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	TOTAL
Revenue (*)	80	200	200	200	200	200	1,080
Regulatory income / (regulatory expense)	—	—	—	—	—	—	—
Depreciation expense	—	(207)	(207)	(207)	(207)	(207)	(1,035)
Profit/(loss)	**80**	**(7)**	**(7)**	**(7)**	**(7)**	**(7)**	**45**

Statement of financial position	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Property, plant and equipment	1,035	828	621	414	207	—
Regulatory asset / (regulatory liability)	—	—	—	—	—	—
Cash	(955)	(755)	(555)	(355)	(155)	45
Net assets	**80**	**73**	**66**	**59**	**52**	**45**

(*): Revenue for year 1 only includes the regulatory returns (CU80) and revenue for years 2–6 only includes the amount that recovers depreciation expense of the asset excluding the capitalised borrowing costs (CU1,000 or CU200 yearly).

9 This example shows that the regulatory returns that compensate the entity for borrowing costs (CU35) are recognised as part of revenue in profit or loss in year 1. However, because the borrowing costs are capitalised, they are only recognised as an expense in profit or loss as the property, plant and equipment is depreciated over years 2–6 (CU7 yearly). This arguably results in an accounting mismatch and front-loading of profit referred to above. It could also be argued that during the construction period the net asset position of the entity is overstated by CU35 and the overstated amount is only reversed over the operation period.