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IASB project - Regulatory Assets and Regulatory Liabilities

Allowable expense and benchmark expenses

This paper is unchanged from Agenda paper 06-03 to EFRAG FR TEG's December 2022 meeting.

Objective

- 1 The purpose of this paper is to update and obtain EFRAG FR TEG members' views on the IASB tentative decisions on allowable expense and benchmark expenses made during its redeliberations after constituents' feedback to the IASB Exposure Draft *Regulatory Assets and Regulatory Liabilities* (the ED).
- 2 In October 2022, the IASB tentatively decided to provide guidance on how an entity should apply the proposed definition of allowable expense (including the treatment of benchmark expenses).

Structure of this paper

- 3 This paper is structured as follows:
 - (a) proposals in the ED
 - (b) concerns by respondents including EFRAG
 - (c) IASB tentative decisions in October 2022
 - (d) EFRAG RRAWG discussion in November 2022; and
 - (e) EFRAG Secretariat observations.
 - (f) Appendix (background only)- IASB discussion on features of different regulatory regimes.

Proposals in the ED

- 4 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.
- 5 Paragraph B4 of the ED says that that:

If an expense is allowable under the terms of a regulatory agreement, that fact establishes that the expense relates to the supply of goods or services in some period. In applying this [draft] Standard, an entity shall treat that allowable expense as relating to the supply of goods or services in the period when the entity

recognises the expense applying IFRS Standards. Thus, the amount that recovers that allowable expense forms part of total allowed compensation for goods or services supplied in that period. For example, if raw material costs are an allowable expense, the amount that recovers that allowable expense forms part of 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*.

- 6 The ED includes several illustrative examples that illustrate the fact patterns in which the regulatory agreements entitle an entity to recover expenses incurred when supplying goods or services (see Illustrative Examples 1, 7A and 7B). These illustrative examples show that regulatory assets or regulatory liabilities arise when part or all of the total allowed compensation for the goods or services supplied in a period is included in regulated rates charged in a different period.

Concerns raised by respondents including EFRAG

Allowable expense

- 7 As shown in the IASB staff analysis ([agenda paper 9a](#) of the October 2022 meeting), a few respondents (mainly from Europe and Asia-Oceania) expressed concerns or disagreed with the definition of allowable expense in the ED.
 - (a) These respondents said that regulatory agreements may use a basis different from IFRS for the measurement of allowable expenses. According to these respondents, determining allowable expenses by reference to the regulatory agreement rather than IFRS would better reflect the compensation to which entities are entitled. Determining allowable expenses based on IFRS would, according to these respondents, cause complexity for preparers and provide information that would be difficult for users of financial statements to understand.
 - (b) Some of these respondents referred to the differences that would arise between the regulatory and the accounting measurement bases as 'permanent differences'. These respondents did not think these differences should be accounted for as regulatory assets or regulatory liabilities as they do not represent enforceable present rights or enforceable present obligations to adjust the rates in the future. These respondents recommended the final Standard considers allowable expenses by reference to the regulatory agreement.
- 8 In its Final Comment Letter, EFRAG also expressed concerns with the definition of allowable expense and noted that:
 - (a) EFRAG is aware of 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) Therefore, EFRAG recommends that the IASB further analyses whether the requirements of paragraphs B3-B9 of the ED relating to allowable expenses can be applied across diverse regulatory regimes including those where costs

¹ This issue is discussed in more detail in Agenda paper 06-04 of today's session.

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are based on sectoral averages and where recoverable costs under the regulatory agreement are based on regulatory accounting and not IFRS expenses. And to thereafter clarify if and when these regulatory agreements are in scope.

Benchmark expenses

- 9 Per the IASB feedback, a few respondents—a preparer and a few national standard-setters in Europe—said it is unclear how expenses that are allowable based on benchmark figures from a peer group of companies should be treated. One of these respondents wondered what part of the compensation for expenses that is determined based on benchmark figures should be seen as compensation for allowable expenses and what part should be seen as an incentive.
- 10 In its Final Comment Letter, EFRAG recommended that the IASB further analyse whether the requirements of paragraphs B3-B9 can be applied across diverse regulatory regimes including those where costs are based on sectoral averages or where recoverable costs are based on regulatory agreement and not IFRS expenses.

IASB tentative decisions in October 2022

- 11 The IASB discussed the feedback received on the definition of allowable expense and an IASB staff analysis of the issues and staff recommendations. The IASB staff analysis can be found in paragraphs 14-22 (allowable expense) and paragraphs 23-29 (benchmark expenses) of [agenda paper 9a](#) IASB October 2022 meeting.
- 12 The IASB staff noted that most respondents did not comment on the proposed definition of allowable expense and only a few had concerns. The IASB staff stated that if benchmark expenses occur at the same time as charges to customers, there are no timing differences. However, timing differences can arise if the efficiency gain or loss is passed onto the customers through the rates charged at a future period.
- 13 In response to the concerns highlighted in the feedback on the ED, **IASB tentatively decided** that the final Standard:
 - (a) retain the proposed definition of allowable expense (i.e., paragraph B4 of the ED);
 - (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.
- 14 In the IASB discussions that preceded its tentative decisions, an IASB member asked the IASB staff to further clarify with stakeholders that there were no permanent timing differences that can arise. There was also a debate on whether an update of the definition was needed in light of the issues that arose with the definition in the ED and a board expressed concern about resolving the issue through clarification guidance instead of amending the definition. However, other board members acknowledged the concern about the definition but considered that finding an alternative definition that is neither too detailed nor exempt from misinterpretation is hard to attain, and a combination of the definition in the ED and the clarifying application guidance should address the issues raised.

EFRAG RRAWG discussion in November 2022

- 15 EFRAG RRAWG welcomed the IASB tentative decisions to clarify but not to amend the proposed definition in the ED of allowable expense and clarify how to deal with situations when allowable expense was based on benchmark (peer) expenditure rather than an entity's own expenses. This decision would address the concerns reported by the RRAWG members in previous discussions and included in the EFRAG Final Comment letter, without restricting the scope of the final Standard.

EFRAG Secretariat observations

- 16 As noted by EFRAG RRAWG members, the EFRAG Secretariat considers that the IASB tentative decision will help to clarify that allowable expenses are determined by reference to the regulatory agreement.
- 17 In our view, this clarification might help to solve the concern expressed by several respondents including EFRAG in its Final Comment letter in (see paragraph 8(a) of this paper) and which relates to the issue discussed in agenda paper 06-04 for today's session on differences between the regulatory recovery period and the useful life of an asset.
- 18 The EFRAG Secretariat considers that the concept of sectoral averages is similar to benchmark expenses and used in jurisdictions (particularly for incentive-based regimes) where the regulated rates and recoverable expenses under the regulatory agreement are based on sector average costs, rather than an entity's own costs. The IASB's tentative decision aims at providing clarification and supporting guidance to address the concerns of constituents that operate in these or similar jurisdictions and expressed in EFRAG's Final Comment Letter (see paragraph 8(b))

Questions to the EFRAG FR TEG members

- 19 Do you agree with the IASB tentative in paragraph 13 (i.e., retain the definition of allowable expense and provide clarifying guidance and examples? If not, please explain.

APPENDIX- BACKGROUND INFORMATION

IASB May 2022 Discussion- Features of different regulatory schemes

1. In May 2022, the IASB received a presentation from IASB staff on the features of different regulatory schemes (see [IASB staff presentation- May agenda paper 9A](#)). Page 15 of the presentation highlights there is a continuum in types of schemes ranging from cost-based to incentive-based and the majority of schemes tend to be hybrid schemes. Incentive-based schemes are common in certain jurisdictions (e.g., Germany, Netherlands and the UK). The presentation also highlighted the limitations of applying the ED proposals to incentive-based schemes (see pages 27 and 28 of the IASB agenda paper). For instance, the recoverability of costs plays a less important role in incentive-based schemes than in cost-based schemes. Consequently, any direct link between regulatory compensation and allowable expenses may be limited to some passthrough costs. For these schemes, it is more challenging to ascertain whether there are timing differences that give rise to regulatory assets and regulatory liabilities.
2. Following the IASB staff presentation on the different features of regulatory schemes, a Board member questioned the appropriateness of the characterisation of differences between regulatory recovery pace and the assets' useful lives as non-cash differences in timing. The Board member pointed out that even in cases where the regulatory depreciation and the accounting depreciation are disconnected, the regulatory depreciation that is charged to customers allows the entity to some extent the recovery of the accounting depreciation. Hence, these would be implicit rather than explicit differences in timing.
3. Several board members acknowledged that the outreach had brought to light new information including the challenges related to incentive-based schemes. The Board members made comments supporting the retention of the ED principles and for these to be applied in a manner that considers the features of different regulatory schemes.
4. A Board member questioned whether the main takeaway was that there was greater existence and measurement uncertainty associated with incentive-based schemes. The IASB staff clarified that the differences between cost-based and incentive-based schemes arise due to differences in contractual terms, which may translate to entities subject to these schemes having different regulatory assets and regulatory liabilities. The Board member then observed that the task is to identify where differences in timing exist based on the principles of the ED rather than developing a model that is tailored for incentive-based schemes. The Board member underscored the role of disclosures in providing information about the features of incentive-based schemes. In other words, it is not about bringing all aspects of regulatory reporting into the accounting model.