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Regulatory assets and regulatory liabilities

The direct (indirect) relationship concept

Cover Note

This paper is the same as Agenda Paper 05-01 of the EFRAG FR TEG meeting of 20 December 2023. The session in December 2023 was cancelled.

Objective

1 The purpose of this session is to discuss the responses to an IASB staff survey on the direct (no direct) relationship concept. This concept will form a key part of the forthcoming IFRS Standard on the accounting for regulatory assets and regulatory liabilities.

Background of the direct (no direct) relationship

2 The direct (indirect) relationship concept was introduced by the IASB in 2022 in response to concerns about operational difficulties to apply the proposals in the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (ED) when an entity's property, plant and equipment (PPE) did not align with the regulatory capital base (RCB). This concept is central to the IASB's tentative decisions taken since October 2022 on total allowed compensation and more generally the accounting for regulatory assets and regulatory liabilities.

3 The IASB tentatively decided that entities that operate in a regulatory environment where there is no direct relationship between the RCB and its PPE will in many instances not recognise regulatory assets and regulatory liabilities. This decision was confirmed by the IASB at its meeting in September 2023.

4 During 2023, EFRAG FR TEG and FRB have discussed the IASB tentative decisions in which the IASB has used the direct (no direct) relationship concept which impact the following

(a) the accounting for regulatory assets and regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives;

(b) the accounting for regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs to construct that asset; and

(c) the accounting for allowable expenses or performance incentives included in an entity's regulatory capital base.

Key discussion points for the session

5 The presentation focuses mainly on the survey results from European companies which include their assessment of whether they have a direct (no direct) relationship between the RCB and their PPE and the principal factor supporting their assessment.

6 This same presentation was discussed with the EFRAG RRAWG on 30 November 2023. A summary of the discussion is provided in the Appendix.

Agenda Papers

7 In addition to this cover note, the following papers are provided for this session:

(a) agenda paper 05-02 – Survey results on direct (no direct) relationship concept

(b) Agenda paper 05-03 - The IASB staff report on findings from the survey on direct (indirect) relationship concept - **background paper**.

Appendix

Summary of discussion from EFRAG RRAWG on survey results

1 Most members generally continued to support the relief provided by introducing the direct (no direct) relationship concept because the calculations necessary to compute regulatory assets and liabilities would not be practical under some regulatory regimes faced by companies. However, one member noted that the initial objective of the IASB project had been to recognise amounts that were legally enforceable resulting from regulated activities and now the concept of no direct relationship presented an 'exit route' for entities to not recognise regulatory assets and regulatory liabilities.

2 The members supporting the model noted the gap between the regulatory treatment of RCB and IFRS accounting for PPE was wide and there was no mandatory reconciliation at the granular level required to be able to determine whether there were timing differences at individual asset level necessary for the recognition of regulatory assets and regulatory liabilities. This view was also supported by one member from the UK on the basis that it was challenging to reconcile the RCB for UK entities against fixed assets.

3 One member noted that with hybrid arrangements it could be difficult to conclude whether the relationship was direct or not direct. However, the view of this member was that the indicators proposed by the IASB were helpful. A conclusion on the relationship would have to be made and it was not possible to be both. Another member asked if there could be a different outcome of the same regulation depending on which indicator was used. The view of this member was that the IASB's indicators were useful but questioned whether they would be sufficient.

4 The observer from the UKEB also shed light on concerns that are in place in the UK. Some differences in timing would be recognised as regulatory assets and regulatory liabilities by entities with a direct relationship but not by those without a direct relationship. In the UK, regulatory regimes had no direct relationship and UKEB needed to ascertain what that meant for unrecognised regulatory assets and regulatory liabilities and how material these are. There was a concern that not reflecting regulatory assets and regulatory liabilities would fail to reflect the economics and result in a lack of comparability.

5 Illustratively, the observer from the UKEB provided an example of a company that had US-based regulatory operations and UK-based regulatory operations. There was a question of whether that would mean that the entity would recognise more regulatory assets and liabilities for the US company but less for the UK and whether that was a fair economic reflection. The observer's view was that just because agreements differed did not mean that one set of agreements ought to have fewer differences in timing being recognised. The differences needed to be understood, whether and how they should be recognised rather than simply concluding that there were no adjustments without a direct relationship. This observer considered that the IASB was potentially creating a situation where non-direct entities would recognise fewer regulatory assets or liabilities than entities outside of the UK (like Canada and the US). That would impact comparability.