Focus areas and activities - preparatory work for endorsement advice

Regulatory assets and regulatory liabilities

Issues Paper

Background

1 The completion of the IASB's redeliberations on the 2021 Exposure Draft *Accounting for Regulatory Assets and Regulatory Liabilities* (ED) occurred in July 2024 and a final Standard is expected in H2 2025.

2 Correspondingly, starting from Q3 2024 until the issuance of the prospective Standard, the EFRAG Secretariat will primarily focus on the related preparatory work for endorsement advice (hereafter referred to as preparatory work) in order to kickstart the practicability and cost-benefit assessment of the prospective Standard. This will contribute to the timely completion of the endorsement work as expected by EFRAG's stakeholders.

3 The suggested preparatory work will be based on the tentative decisions made by the IASB during its redeliberations on the ED and the assessment undertaken will encompass the technical criteria set out in the EU regulation for the adoption of new standards.

Objective

4 This paper aims to get EFRAG FR TEG members' views on the appropriate areas of focus and activities to be undertaken during the preparatory work. This paper also includes an update on the ongoing targeted outreach by the EFRAG Secretariat on the direct (no direct) relationship concept.

5 The rest of this paper is structured as follows:

(a) Suggested focus areas

(b) Approach towards preparatory work for endorsement advice

(c) Update on EFRAG Secretariat's ongoing outreach on direct (no direct) relationship concept

Suggested focus areas

Focus areas derived from EFRAG RRAWG discussions

6 The suggested focus areas are informed by the RRAWG views along with the EFRAG FR TEG and the FRB views wherever these have been expressed on the IASB's tentative decisions (see agenda paper 10-02). The views expressed in the EFRAG comment letter to the 2021 ED were also considered. The suggested focus areas are those where concerns and contentious areas have been highlighted by the EFRAG technical bodies, considering other stakeholders including IASB ASAF members. We have also considered aspects of the requirements that are integral to the overall cost-benefit assessment (e.g., disclosures). The suggested focus areas discussed below are:

(a) Unit of account

(b) Total allowed compensation

(c) Direct (no direct) relationship concept

(d) Measurement – discounting applying minimum interest rate

(e) Disclosures

Unit of account

7 The IASB tentatively decided to clarify that the unit of account is the right or obligation arising from an individual difference in timing or from a group of differences in timing when the differences in timing included in that group would:

(a) be created by the same regulatory agreement;

(b) have similar expiry patterns; and

(c) be subject to similar risks.

8 Overall, members' feedback indicated there are still challenges in understanding the applicability of the unit of account concept. A question arose as to why a unit of account at an individual asset (liability) level is warranted. It could be argued that a unit of account at a higher level would create less problems with determining differences in timing (between RCB and PPE and operating expenses/income) and generally facilitate the recognition and measurement of regulatory assets (liabilities), than having it at a detailed level as proposed. Some argue that the proposed unit of account would likely create more costs than benefits for the entities. Some members considered the unit of account to be quite theoretical and asked for the IASB to consider providing examples.

Total allowed compensation

9 The ED specified in paragraph B2 the components of total allowed compensation (i.e. amounts that recover allowable expenses minus chargeable income, target profit and regulatory interest income and regulatory interest expense). Respondents to the consultation feedback noted that the proposed components fit well with the features of cost-based schemes. However, they expressed the concern that some regulatory agreements may include components that were not included in the ED because the regulatory scheme is not seeking to ensure the entity recovers its actual costs. Specifically, they noted that the proposed components do not work well with incentive-based schemes. Based on the feedback received, the IASB tentatively decided that in the prospective Standard, the application guidance will focus on helping entities to identify differences in timing and the most common differences in timing that could arise from various types of regulatory schemes rather than specifying the components of total allowed compensation

10 EFRAG RRAWG members noted that the IASB had responded well to the concerns of respondents and agreed with the decisions the IASB was taking on total allowed compensation and aligning the future requirements with the regulatory frameworks. EFRAG RRAWG members also agreed with a more principle-based approach to describe total allowed compensation which would work for entities that operate in incentive-based regulatory regimes.

11 Despite the support of EFRAG RRAWG members, this is a modification to the content of the ED. In addition, to apply the prospective standard, particularly given the proposed unit of account, it is essential that entities can identify the differences in timing arising from their regulatory agreements. Thus, we are of the view that it would be interesting to share with constituents the most common differences in timing identified by the IASB and determine whether they align with their assessment and learn how difficult it might be for entities to identify differences in timing (also referred to in the unit of account discussed below).

Direct (no direct) relationship concept

General

12 As part of the tentative decisions made by the IASB on the various aspects of total allowed compensation during the redeliberation phase, the IASB introduced the direct (no direct) relationship concept (i.e. this concept was not included in the ED). The inclusion of the concept aimed to:

(a) cater for the diverse regulatory schemes where the regulatory capital base (RCB) serves different purposes and bears little relationship with an entity's property, plant and equipment (PPE) ; and

(b) address respondents' concerns that, in some cases, it will be difficult and costly to identify differences in timing at a sufficient level of granularity (as required when determining the unit of account) and track the reversal of these differences in future periods.

13 Under the direct (no direct) relationship concept, regulatory assets and regulatory liabilities will be recognised for differences in timing between an entity's RCB and its PPE *only when* there is a direct relationship between the entity's RCB and its PPE. In other words, the IASB's tentative decision does not to permit recognition of regulatory assets and regulatory liabilities (on differences in timing arising between the two) for entities with no direct relationship between their RCB and their PPE.

14 EFRAG RRAWG members generally supported the relief provided by introducing the direct (no direct) relationship concept because the calculations necessary to identify differences in timing when there is no direct relationship between the regulatory capital base and property, plant and equipment would not be practical under some regulatory regimes. Members highlighted the importance of the indicators to help with the direct (no direct) relationship assessment. However, several EFRAG FR TEG members expressed concerns on the fact that the direct (no direct) assessment depends on the entity's ability to reconcile accounting balances with regulatory balances and therefore it may result in earnings management and put some pressure on auditors. Some constituents have also raised concerns about the complexities of the model and through outreach activities we have identified some cases where entities from the same jurisdiction and the same industry reach conclusions that may initially be seen as contradictory.

15 Thus, the EFRAG Secretariat considers it necessary to further test the practicability of applying the direct (no direct) relationship concept. The EFRAG Secretariat highlights that the introduction of this concept (which was not discussed in the ED) could raise concerns around comparability of information across entities within the scope of the prospective Standard. The EFRAG Secretariat also notes there are several IASB tentative decisions (e.g. IFRS 3 *Business Combinations* exception) where the introduction of the direct (no direct) relationship concept would have an impact on the comparability across reporting entities.

Capitalisation of borrowing costs

16 The IASB tentatively decided that when an entity's RCB and its PPE have a direct relationship and the entity capitalises its borrowing costs under IFRS:

(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.

17 Mixed views were expressed by EFRAG RRAWG members on the IASB's tentative decision with a few members preferring no action being done while one agreed to address the accounting mismatch. Concerns revolved mainly around costs, the additional complexity and the materiality of the issue.

Discounting – minimum interest rates

18 The IASB tentatively decided to retain the proposal that would require an entity to assess whether there is any indication that the regulatory interest rate for a regulatory asset might be insufficient to compensate the entity for the time value of money and for uncertainty in the future cash flows arising from the regulatory asset, and to use the minimum interest rate as the discount rate if it is higher than the regulatory interest rate. The IASB will provide guidance in the prospective Standard on the estimation of the minimum interest rate and clarify that when an entity performs the assessment on the minimum interest rate, it would not be required to calculate the minimum interest rate or carry out an exhaustive search for indications that the regulatory interest rate might be insufficient.

19 The EFRAG RRAWG discussed the minimum interest rate proposal before the IASB redeliberated the proposal and made the tentative decision. The purpose of the discussion was to help the IASB staff develop its recommendations to the IASB on the topic of discount rates.

20 All EFRAG RRAWG members that commented supported removing the above proposal as it added complexity, it was asymmetrical and there were no clear benefits from applying the proposal.

21 In the case that a regulatory interest rate is not specified in the regulatory agreement some members were of the view that an entity should not discount its regulatory assets and

regulatory liabilities. Conversely, some members considered that to be consistent with other IFRS Accounting Standards (e.g. IFRS 16 *Leases*), discounting should not depend on whether the regulatory agreement includes a regulatory interest rate.

22 After the IASB made its tentative decisions on the minimum interest rate, one EFRAG RRAWG member supported the decision on a conceptual basis. Another member questioned how frequently an entity would have to apply these proposals in practice. It was suggested that this matter would be considered during the EFRAG's preparatory work for endorsement advice.

Disclosures

23 The IASB made some tentative decisions on the disclosures proposed in the ED (see paragraph C39 of agenda paper 10-02) and on new disclosures (see paragraph C40 of agenda paper 10-02).

24 Several EFRAG RRAWG members were supportive of the proposed disclosures in the ED and the main changes made to the proposals stemming from the IASB's redeliberations. The overall disclosure objectives were deemed reasonable, and the newly added disclosures were considered useful. However, some members considered the proposed disclosures were too detailed/prescriptive and it would be an issue to explain them at consolidation level in situations when the reporting entity had several regulatory agreements in different jurisdictions.

25 Though many RRAWG either supported or did not object to the IASB's tentative decisions on disclosures, we have included disclosures as an area for focus in the endorsement work. This is because (a) in its final comment letter, EFRAG had called for a balanced approach to disclosures and an outreach to users in light of some concerns expressed by some preparers about the too-detailed nature of the disclosures in the ED; (b) via the tentative decision, additional disclosures have been proposed in light of the introduction of the direct (indirect) relationship concept and these were not subject to EFRAG's outreach to preparers and users during the outreach on the ED (i.e., via the early-stage analysis surveys to preparers and users); and c) assessing the overall disclosure package is a core part of assessing the cost-benefit of the prospective Standard.

Other areas raised by other standard setters

26 The EFRAG Secretariat has identified the following incremental areas that were contentious for other national standard setters:

Inflation adjustments included in the RCB:

27 The IASB tentatively decided that the Standard specifies that an entity is neither required nor permitted to recognise as a regulatory asset inflation adjustment to the regulatory capital base.

28 ASAF members expressed at the March 2023 ASAF meeting mixed views about the IASB's tentative decision that an entity should not recognise as a regulatory asset the inflation adjustment to the regulatory capital base.

29 The ANC and ASBJ representatives suggested that the IASB should permit an entity whose RCB has a direct relationship with its PPE to account for inflation adjustments to the RCB as a regulatory asset.

30 The PAFA and GLASS representatives queried the impact of the tentative decision in jurisdictions where inflation is currently high.

31 The UKEB member expressed concern about the potential effect of inflation on the regulatory capital base and said it is important the IASB investigate the accounting implications. The UKEB is concerned that the IASB's tentative decision does not reflect the underlying economics of those entities that do not have a direct relationship between PPE and RCB.

32 EFRAG RRAWG 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 would be too costly to track inflation adjustments.

33 On this topic, the EFRAG Secretariat plans to have a further discussion with the RRAWG in November 2024 where we will present the concerns raised by other standard setters so that the RRAWG can re-evaluate whether this tentative decision raises any concerns on European Stakeholders. We are of the view that a second discussion could be useful because there may be some arguments put forward by other standard-setters that were not considered by the EFRAG RRAWG at its February 2023 meeting and because the EFRAG RRAWG has a better understanding of the prospective Standard since the redeliberation phase is completed.

Approach towards preparatory work for endorsement advice

34 The EFRAG Secretariat is of the view that additional work should be performed to assess the impact of the main areas identified and discussed above (i.e. unit of account, total

allowed compensation, direct (no direct) relationship concept, discounting–minimum interest rates and disclosures) on affected entities. The following are the suggested steps:

(a) As a first step, we propose to prepare an online **questionnaire initially addressed to preparers** outlining the IASB's tentative decisions and the identified areas of concern discussed above. We will ask preparers for input on the practicability of applying these decisions.

(b) Depending on the survey responses and prevalence of issues, a **targeted outreach (via interviews) or other activities (e.g., roundtables)** might be necessary to further flesh out the practicability and cost-benefit considerations.

(c) Parallel to the activities suggested above, we propose to undertake **a review of the financial statements of some entities in the scope of the prospective standard** to understand what entities are currently recognising or disclosing in their financial statements (i.e. the EFRAG Secretariat has identified some entities accounting for regulatory differences akin to regulatory assets and regulatory liabilities in their IFRS financial statements - mainly in Portugal). This review will allow us to better know the state of play in Europe and deepen our understanding of some of the regulatory agreements.

35 The EFRAG Secretariat is aware that the IASB staff is conducting a survey to preparers on the likely effects of the prospective Standard. Hence, **we reviewing the IASB survey** to ascertain if we can leverage the IASB outreach and to ensure complementarity of our respective outreach efforts and scope of coverage. The EFRAG Secretariat will also ask the IASB staff whether we could receive the responses to the IASB staff survey for European entities that do not object sharing the surveys with EFRAG.

36 The EFRAG Secretariat **will also consider if educational material will be available before conducting outreach to users of financial statements** (i.e., both generalist and specialist investors).

Update on EFRAG Secretariat's ongoing targeted outreach on direct (no direct) relationship concept

37 Additionally, in collaboration with a selection of national standard setters (ANC-France; ASCG-Germany; DASB-Netherlands; OIC-Italy; NASB-Norway; CNC-Portugal; ICAC-Spain) and FR TEG Members and in anticipation of future necessary endorsement work, in Q2 2024, the EFRAG Secretariat initiated a targeted outreach to EU companies to assess the applicability and possible implications of the newly introduced direct (no direct) relationship concept across Europe.

38 This outreach is building on the IASB staff outreach conducted from February to July (the findings from the outreach can be found here). The main objectives of the outreach are to:

(a) Identify the main industries in the scope of the rate-regulated activities' future standard across the main EU jurisdictions and liaise with affected companies;

(b) To obtain an understanding of how the regulated tariff is determined under the respective regulatory agreements; (e.g. whether it is based on industry averages or other formulae);

(c) To better understand the reasons for concluding why there is a direct or no direct relationship between an entity's RCB and its PPE;

(d) To gather views from the entities on the merits of the direct (no direct) approach; and

(e) Anticipate work for the future endorsement of the standard.

39 Below is an update and high-level observations from the EFRAG Secretariat's outreach to several national standard-setters and affected entities (a more detailed report will be provided at a later date once the outreach is finalised):

(a) **France.** In collaboration with the ANC, the EFRAG Secretariat liaised with five entities of different industries (airports, electricity, water and waste management and railways). The company in the airport industry is likely to be outside of the scope of the Standard. One of the entities in the electricity industry considered that it had a 'no direct' relationship because of the differences between RCB and PPE. They noted that reconciliation may be possible but complex and costly. However, the other entity in the electricity industry assessed themselves to be having a 'direct' relationship. They noted that differences in measurement between RCB and PPE are insignificant, that the regulatory and accounting depreciation rates are fully aligned, and that they can generally track the differences between RCB and PPE. The remaining entities were still assessing whether they were under either a 'direct' or 'no direct' relationship. One of these entities flagged the difficulties they faced in determining the unit of account at a low level.

(b) **Germany:** EFRAG representatives met with the German Transmission Service Operators (TSOs) and the DRSC to discuss the timing of the publication of the prospective IFRS Standard and the implications of the direct (no direct) concept. TSOs are the main companies affected by the Standard in Germany. They considered themselves to be having a 'no direct' relationship and they supported the IASB's tentative decision to introduce the direct (no direct) concept.

(c) **Italy:** The OIC has provided assessments from entities of the railway and highway industries that are under review.

(d) **Netherlands:** The EFRAG Secretariat met with the DASB where it was highlighted that the main companies affected by the Standard in the Netherlands are national and regional grid operators (electricity and gas) and airport businesses. The characteristics of the regulatory agreements vary across industries. National and regional Transmission System Operators (TSOs) replying to the IASB's survey assessed themselves to be having a 'no direct' relationship.

(e) **Norway:** The EFRAG Secretariat met with the NASB whereby it was highlighted that TSOs are the main companies affected by the Standard in Norway. The schemes have a mixed approach whereby there is a direct relationship for 30% of the RCB, which is almost fully aligned with PPE, and a 'no direct' relationship for 70% of the RCB as the cost base is affected by an efficiency score, which is calculated based on the performance of all TSOs.

(f) **Poland.** The EFRAG Secretariat met with three group of entities in the energy industry. Their gas and electricity distribution businesses are those that are likely to be affected by the Rate-regulated prospective Standard. The regulated rate is based on estimated allowed revenue which is determined based on justified expenses and a return on investment (mark-up). Any difference between the estimated allowed revenue and the actual revenue is included in the tariff two years later. One of the entities initially assessed it had a direct relationship because RCB is closely aligned with PPE while another entity considered to be no direct because of the important differences between IFRS and the value of the asset for regulatory purposes and the lack of reconciliation at an individual asset level. The third entity explained that they were not able to assess whether the entity was direct or no direct but they noted that the reconciliation between the RAB and PPE was not difficult and the regulatory depreciation was aligned with the accounting depreciation. Participants raised some concerns on the complexity of the model.

(g) **Spain.** In collaboration with the ICAC, the EFRAG Secretariat met with a company in the water industry. This company is likely to be outside of the prospective Standard because the regulatory agreement does not include a true-up mechanism.

40 The EFRAG Secretariat is also liaising with the Portuguese NSS to have a call with some entities in these jurisdictions.

Next steps

41 We will present the suggested focus areas and approach (taking into account the feedback received by FR TEG) to the EFRAG FRB in September 2024.

42 We plan to have a meeting with the EFRAG RRAWG in November 2024 to discuss the IASB tentative decisions taken in July 2024 and other areas such as inflation adjustments where the EFRAG Secretariat seeks additional input

Questions for EFRAG FR TEG members

43 Do you agree with the areas identified by the EFRAG Secretariat in paragraphs 6 to 33 above? Should the EFRAG Secretariat consider any other issue?

44 Do you agree with the envisaged approach for the areas identified by the EFRAG Secretariat in paragraphs 34 to 36 above?

45 Do you have any remarks/additional comments on the high-level summary of the direct/no direct outreach included in paragraphs 37 to 40 above?