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REGULATORY ASSETS AND REGULATORY LIABILITIES

PRACTICAL IMPLICATIONS OF PROJECT SCOPE

EFRAG SECRETARIAT BRIEFING, MAY 2021



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The publication of Briefings is part of EFRAG's strategy to stimulate debate within Europe and clarify the IASB discussions on *Regulatory Assets and Regulatory Liabilities*. The views expressed in this Briefing are those of the EFRAG Secretariat and have not been approved by either EFRAG TEG or the EFRAG Board. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

Any views expressed in this Briefing are tentative and reflect EFRAG Secretariat's understanding of how the proposals included in the IASB's exposure draft *Regulatory Assets and Regulatory Liabilities* might be applied.

Due to the nature of the Briefing, the EFRAG Secretariat has not included questions to constituents. However, constituents may express their views on the topic when responding to the EFRAG draft comment letter. EFRAG will develop its final views after considering the feedback received from its constituents.

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IASB's ED *Regulatory Assets and Regulatory Liabilities*

- ES1 Rate regulation determines when and how much total allowed compensation can be charged to customers for goods and services supplied in a period. In practice, differences in timing arise when the period in which total allowed compensation for goods or services is included in the regulated rates is different to the period in which those goods or services were supplied.
- ES2 Existing IFRS Standards do not require a company to recognise a right to increase or obligation to decrease the regulated rates in the future for such differences in timing. Rate regulation can significantly affect a company's financial performance and financial position, however, users of financial statements do not get information about the effects of differences in timing on a company's financial statements and their assessment about the company's current and future performance is limited.
- ES3 On 28 January 2021, the IASB published the Exposure Draft *Regulatory Assets and Regulatory Liabilities* ('the ED'). The ED establishes accounting principles for reporting these differences in timing in a company's financial statements in order to provide relevant information which faithfully represents the effects of differences in timing on the company's financial performance and financial position. The ED has a comment period of 180 days and a comment deadline on 30 July 2021.
- ES4 Regulatory assets and regulatory liabilities are created by a regulatory agreement that determines the regulated rate in such a way that the part (some or all) of total allowed compensation for goods or services supplied in one period is charged to customers in a different period. Any other rights or obligations created by the regulatory agreement should be accounted for under other IFRS Standards. Under the ED, a regulatory asset or regulatory liability can exist only if:
- the entity is party to a regulatory agreement;
 - the regulatory agreement determines the regulated rate an entity charges for the goods or services it supplies to customers; and
 - part of the total allowed compensation for goods or services supplied in one period is charged to customers through the regulated rates for goods or services supplied in a different period (past or future).
- ES5 The ED explains that a regulatory asset or a regulatory liability can exist only if the features above are present.
- ES6 The proposed Standard is intended to supplement information an entity already provides by applying IFRS 15 *Revenue from Contracts with Customers* and other IFRS Standards and IFRS Interpretations such as IFRIC 12 *Service Concession Arrangements*. Therefore, an entity should not recognise any assets or liabilities created by a regulatory agreement other than regulatory assets and regulatory liabilities as defined by the ED. Other assets and liabilities, if any, would be recognised under other IFRS Standards.
- ES7 The ED proposes not to restrict the scope of the proposed requirements to apply only to regulatory agreements with a particular legal form or only to those enforced by a regulator with particular attributes. Instead, the ED proposes that an entity recognise all its regulatory assets and all its regulatory liabilities existing at the end of the reporting period.

Objective and structure of this Briefing

- ES8 The objective of this Briefing is to stimulate debate on the outcome of the IASB's proposals on scope of the proposed Standard and how the proposed requirements would affect activities which were not envisaged to be subject to the type of rate regulation described in the ED. It is intended to complement EFRAG's outreach and facilitate dialogue with stakeholders on EFRAG's draft comment letter responses on the scope of the proposed Standard.
- ES9 This Briefing starts by providing background information in Chapter 1: *Background*.
- ES10 In Chapter 2: *Scope of the Project*, the EFRAG Secretariat analyses the scope of the IASB project as defined in the IASB's ED *Regulatory Assets and Regulatory Liabilities*.
- ES11 Finally, in Chapter 3: *Entities that may be Affected by the Proposals*, the EFRAG Secretariat considers the application of the IASB's proposals on scope applied to different activities that are subject to regulated prices. The chapter illustrates how an assessment of eligibility to be within scope can be made to a selection of five fact patterns.
- ES12 The five facts patterns include examples identified by EFRAG TEG during the development of the IASB proposals. Chapter 3 also includes the analysis of a fact pattern related to arrangements/agreements in monopolistic industries and captures some of the sectors where some stakeholders have noted may unexpectedly fall within the scope of the proposed Standard (e.g., banking, insurance entities).
- ES13 These fact patterns are not an exhaustive representation of circumstances where questions of eligibility to be within the scope of the proposed Standard may arise. For example, the analysis of this bulletin does not cover situations where stakeholders may not have clarity of whether an agreement is within either the scope of IFRIC 12 or the proposed Standard. EFRAG is still in process of obtaining fact patterns where there is a lack of clarity on the interaction with IFRIC 12.

Impact of the IASB proposals when applied to different fact patterns

- ES14 In Chapter 3, EFRAG Secretariat assesses five different fact patterns against the elements of scope as defined in the ED. EFRAG Secretariat observes that there are situations where entities with similar characteristics to those described in the scope of the ED might be affected by the IASB's proposals.
- ES15 EFRAG Secretariat notes that the definition of a regulatory agreement which establishes the prices charged to customers for goods or services supplied and its enforceability has an important role when determining whether an entity may be affected by the IASB proposals.
- ES16 In addition, it is important that there are differences in timing between the period when the total allowed compensation for goods or services is included in the regulated rates and the period in which those goods or services are supplied, and such differences are enforceable.

CHAPTER 1: BACKGROUND

IASB's work on Rate-regulated Activities

- 1.1 In July 2009, the IASB published an Exposure Draft *Rate-regulated Activities* to address concerns about how the impact of rate regulation should be reflected in the primary financial statements of companies. The ED proposed that regulatory assets or regulatory liabilities should be recognised only if an entity's activities are subject to "cost-of-service" rate regulation. The project was suspended in 2010 due to diversity of views from respondents from different jurisdictions, and because it seemed unlikely the fundamental question whether regulatory balances should be recognised could be answered in a reasonable time.
- 1.2 Following an agenda consultation, in 2012, the IASB decided to restart the project on Rate-regulated Activities (RRA) and added a standard-level project to its agenda to understand the need for guidance and challenges related to differences between existing regulatory regimes.
- 1.3 In 2014, the IASB published a Discussion Paper *Reporting the Financial Effects of Rate Regulation*. The DP described the common features of various types of rate regulation and grouped the features that seemed most likely to give rise to rights and obligations that meet the definitions of an asset and a liability in the *Conceptual Framework*. The type of regulation containing those features was termed 'defined rate regulation'.
- 1.4 In January 2021, the IASB published a second exposure draft on the project. The ED *Regulatory Assets and Regulatory Liabilities* proposes an accounting model for regulatory assets and regulatory liabilities to supplement the information already provide by applying existing IFRS Standards. The main principle of the proposed model is that a company should reflect the total allowed compensation for goods or services supplied as part of its reported financial performance for the period in which it supplies those goods or services.

EFRAG's work on Rate-regulated Activities

- 1.5 EFRAG recognised the importance of having guidance on accounting for regulatory account balances and contributed to development of the IASB project on rate-regulated activities by responding to the 2009 ED and 2014 DP. Furthermore, in response to the 2014 DP, EFRAG conducted outreach events.

EFRAG Draft Comment Letter

- 1.6 In April 2021, EFRAG issued its draft comment letter (DCL) where it welcomes the IASB's ED and the IASB's efforts to address the accounting for regulatory assets and regulatory liabilities and provide investors with relevant information about a company's financial position and financial performance. EFRAG's DCL can be found [here](#). Comments on the EFRAG DCL are welcome by 28 July 2021.
- 1.7 To inform its response to the DCL, EFRAG obtained the input of the EFRAG Rate-regulated Activities Working Group (RRAWG) and conducted an early-stage effects analysis outreach to preparers and users of financial statements of rate-regulated entities based on survey questionnaires. The outreach to preparers included questions on the application of the scope of the proposed Standard.
- 1.8 If finalised as a new IFRS Standard, the proposed accounting model in the ED would replace IFRS 14 *Regulatory Deferral Accounts*. IFRS 14 which is an interim Standard and is not endorsed in Europe permits a variety of accounting approaches for reporting the effects of rate regulation.

CHAPTER 2: SCOPE OF THE PROJECT

In this chapter, the EFRAG Secretariat focuses its analysis on the scope of the IASB's ED. Specifically, the EFRAG Secretariat assesses whether rate-regulation gives rise to regulatory assets and regulatory liabilities that fall within the scope of the IASB's ED Regulatory Assets and Regulatory Liabilities.

The scope of the project as described by the IASB

- 2.1 The ED proposes that an entity apply the proposed requirements to all its regulatory assets and all its regulatory liabilities.
- 2.2 As noted in ES4, regulatory assets and regulatory liabilities are created by a regulatory agreement that determines the regulated rate in such a way that part (some or all) of the total allowed compensation for goods or services supplied in one period is charged to customers in a different period.
- 2.3 The ED describes a regulatory agreement as a set of enforceable rights and obligations that determine a regulated rate to be applied in contracts with customers. The ED does not specify the form of the regulatory agreement, however, it states that practices for establishing regulatory agreements vary between jurisdictions and between industries and provides examples of forms that a regulatory agreement could take:
 - a) a contractual licensing agreement between an entity and a regulator;
 - b) a service concession arrangement; or
 - c) a set of rights and obligations specified by statute, legislation or regulation.
- 2.4 The ED also does not specify whether a particular type of body, such as a regulator, must exist to enforce compliance with the regulatory agreement, and what the characteristics of that body should be.
- 2.5 In the IASB's view, narrowing the scope of the ED to include only regulatory agreements subject to a regulator with particular characteristics would not lead to more useful information about the effects of regulatory assets and regulatory liabilities.
- 2.6 The ED does not specifically state that it does not apply to self-regulation. Typically, an entity cannot have enforceable rights and enforceable obligations with itself. However, the applicable facts and circumstances need to be assessed against the conditions outlined in the scope (see paragraph 2.3).

EFRAG preliminary comments on scope

- 2.7 EFRAG supports the overall objective of the ED and agrees that it would enable users to understand how the financial performance and the financial position of a reporting entity is affected by the differences in timing created by the rate regulation.
- 2.8 EFRAG acknowledges that there is clarity on the scope of the model within the utilities sector. However, EFRAG is still assessing possible unintended consequences including on the possible impact of the scope outside the utilities sector.

- 2.9 EFRAG understands the merits of a broad and principles-based definition of scope. However, EFRAG considers and seeks constituents' feedback on whether additional scope criteria might be helpful indicators when assessing whether an entity may be affected by the proposed Standard (e.g., limited competition in sector, regulator committed to support entity's financial viability through rate-setting process, and customer having no ability to avoid price increases).
- 2.10 EFRAG notes that enforceable present rights and enforceable present obligations that the ED intends to cover in the scope can also arise from a regulatory framework that is enforceable by law, but where a regulatory agreement per se might not exist. Therefore, there is the question of how to interpret "statute" and whether a company's articles of association should be understood to mean statute. If so, there could be cases when self-regulation could give rise to regulatory assets and regulatory liabilities as described in the ED.
- 2.11 EFRAG considers that more specific guidance and examples on what constitutes a regulatory agreement and a description of the characteristics of a regulator would be helpful to appropriately identify entities that may be affected by the proposed Standard.

EFRAG's view on what constitutes a regulatory agreement

- 2.12 EFRAG considers the description of a regulatory agreement to be important to ensure that the scope would only include activities intended to be within the proposed accounting model.
- 2.13 EFRAG notes that the enforceable present rights and enforceable present obligations that the ED intends to cover in the scope can also arise from a regulatory framework that is enforceable by law, but where a regulatory agreement per se might not exist.
- 2.14 EFRAG suggests that more specific guidance and examples on what constitutes a regulatory agreement would be helpful to appropriately identify activities within the scope of the proposed Standard.

EFRAG's view on description of a regulator

- 2.15 The IASB's ED does not specify whether a particular type of body, such as a regulator, must exist to enforce compliance with the regulatory agreement, and what the characteristics of that body should be.
- 2.16 EFRAG notes that the principles-based definition does not necessitate the definition of a regulator. However, EFRAG considers that clarifying some of the regulator's characteristics would be helpful to determine whether certain entities may be affected by the proposed Standard and would help limit unintended consequences such as broader application than intended.
- 2.17 In EFRAG's view, specifying that the regulator is an independent body would be important to avoid structuring opportunities, such as situations where entities could set up a related party to be the 'regulator' in order to be eligible to apply the proposed accounting model and recognise regulatory assets and/or regulatory liabilities. Similarly, there is the possibility of new contracts being written by entities for purposes of falling within the proposed scope.

CHAPTER 3: ENTITIES THAT MAY BE AFFECTED BY THE PROPOSALS

In this chapter, the EFRAG Secretariat focuses on the application of the IASB's proposals on scope. The EFRAG Secretariat assesses the outcome of the IASB's proposals when applied to different fact patterns which characteristics might meet the scope criteria as defined in the IASB's ED. The purpose of the assessment is to identify any situations where the proposed requirements for scope will affect entities that are not subject to rate regulation.

Assessing the outcome of the IASB proposals when applied to different fact patterns

- 3.1 In this chapter, the EFRAG Secretariat assesses how the IASB's proposals on scope will be applied to different facts patterns that exist within a rate-regulated environment.
- 3.2 Entities that would be affected by the proposals would be subject to rate regulation that determines:
- a) how much total allowed compensation entities are entitled to charge customers for goods or services supplied in a period; and
 - b) when the entities can include the total allowed compensation in the regulated rates charged.

Entities within the utilities sector such as supply of water, gas and electricity may be affected by the proposals.

- 3.3 In other situations, the application of the proposals on scope might be more complex, for example, activities which share similar characteristics to rate regulation and could potentially fall within the scope of the ED.
- 3.4 In the section below, the EFRAG Secretariat assesses a selection of five fact patterns which might unintentionally meet the proposed scope requirements of the IASB's ED. The facts patterns include examples identified by EFRAG TEG during the development of the IASB proposals. It also includes the analysis of a fact pattern related to arrangements/agreements in monopolistic industries and captures some of the sectors where some stakeholders have noted may unexpectedly fall within the scope of the proposed Standard (e.g., banking, insurance). These fact patterns are not an exhaustive representation of circumstances where questions of eligibility to be within the scope of the proposed Standard may arise. For example, the analysis of this bulletin does not cover situations where stakeholders may not have clarity of whether an agreement is within either the scope of IFRIC 12 or the proposed Standard. EFRAG is still in process of obtaining fact patterns where there is a lack of clarity on the interaction with IFRIC 12.
- 3.5 The EFRAG Secretariat has assessed each of the described fact patterns below against the necessary elements included in the scope definition of the ED. Those elements are:
- a) an entity is a **party to a regulatory agreement**;
 - b) the **regulatory agreement determines the regulated rate** the entity charges for goods and services it supplies; and

- c) there are **differences in timing** between the period in which the total allowed compensation for goods and services is charged to customers and the period in which these goods and services are supplied to customers.

Fact patterns that may be affected by the proposals

Fact Pattern 1: Transfer pricing agreement between a parent company and its subsidiary

Fact pattern

- 3.6 Group of subsidiaries sell its products to customers at prices determined by the parent company. The selling prices to the customers are based on a cost-plus formula included in a transfer pricing agreement between the parent company and its subsidiaries.
- 3.7 The Group and its subsidiaries prepare their financial statements in accordance with IFRS Standards.

EFRAG Secretariat's assessment

- 3.8 The EFRAG Secretariat considers that the Group of subsidiaries includes different legal entities operating in various jurisdictions.
- 3.9 In the EFRAG Secretariat view, for the transfer pricing agreement to be operational it must be legally enforceable to establish selling prices to the final customers at a fixed or determinable rate. Therefore, the transfer pricing agreement can be interpreted as a form of regulatory agreement which sets the prices (rates) charged to customers.
- 3.10 Depending on the facts and circumstances, EFRAG Secretariat assesses that if the transfer pricing agreement creates differences in timing between the provision of goods and services and the inclusion of the total allowed compensation for goods and services supplied in the revenue, and if enforceable, it is possible that such arrangements fall within the scope of the ED.

Fact Pattern 2: Pricing mechanism agreement between a water Cooperative and its customers

Fact pattern

- 3.11 A Cooperative provides water to its members who are also its owners. The members of the Cooperative are obliged to purchase water from the Cooperative and are not allowed to purchase water from a different water supplier as long as they are members of the cooperative.
- 3.12 The articles of association of the Cooperative establish a pricing mechanism which determines the price of water supplied to its members.
- 3.13 The pricing mechanism often reflects the overall objective that the cooperative's profit margin on average should be nil or relatively low based on a specific cost formula. When setting the water prices, the cooperative is not under the supervision of a regulator, although the objective is to ensure that it provides water services at a reasonable price to its members.

EFRAG Secretariat's assessment

- 3.14 EFRAG Secretariat considers that the articles of association of the Cooperative can be interpreted as a type of a regulatory agreement (paragraph 8(c) of the ED refers to a set of rights and obligations specified by statute) which regulates the selling price for water supplied to members of the Cooperative.
- 3.15 Depending on the articles of this statute, EFRAG Secretariat assesses that it is possible that differences in timing are created between the supply of water to members of the Cooperative and the compensation for the goods provided to members. If these differences in timing are enforceable by law, this type of Cooperatives can be affected by the proposed requirements of the ED.
- 3.16 EFRAG Secretariat notes that for a regulatory asset to exist, it is necessary that an entity already supplied goods or services and for a regulatory liability to exist – the entity already included in revenue amounts for goods or services to be supplied in the future.

Fact Pattern 3: Concession agreement between a municipality and its school cafeteria

Fact pattern

- 3.17 A Municipality owns and runs a school cafeteria. The Municipality outsources the operation of the school cafeteria to a commercial operator. The activities of the operator are based on a service agreement with the Municipality.
- 3.18 Under the service agreement the Operator is reimbursed by the Municipality:
- a) based on targeted per-unit cost to produce and serve the meals plus a pre-determined profit margin less revenue received from the sale of the meals; and
 - b) for the cost and profit margin for free meals delivered to students who are not able to pay the target price.

EFRAG Secretariat's assessment

- 3.19 The EFRAG Secretariat considers that the service agreement can be perceived as a regulatory agreement which sets the rate (cost-per-unit plus profit margin) for customers.
- 3.20 Based on facts and circumstances, if there are differences in timing between the provision of goods by the canteen and when the compensation for these goods is charged to customers, and if these differences are enforceable, then the arrangement would fall within the scope of the ED. EFRAG Secretariat notes that for a regulatory assets to exist, it is necessary that an entity already supplied goods or services and for a regulatory liability – it already included in revenue amounts for goods or services to be supplied in the future.
- 3.21 The EFRAG Secretariat observes that the described fact pattern could also contain elements which are within the scope of existing IFRS Standards such as IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* and IFRIC 12 *Service Concession Arrangements*.

Fact Pattern 4: Arrangements/agreements in a monopolistic environment

Fact pattern

- 3.22 In some jurisdictions, due to geographical remoteness, there is only a single provider of particular services such as insurance, healthcare, banking. The natural monopolistic environment does not allow for more market participants to be active in these locations. Therefore, the prices of such services are controlled to protect the customer of paying excessive price because of lack of competition.

EFRAG Secretariat's assessment

- 3.23 Such type of service arrangements could be within the scope of the ED because the regulation establishes a cost-of-service type of regulatory rate. If this regulatory rate is adjusted to account for differences in timing arising because the period when the services are supplied is different from the period in which the compensation is charged to customers and these differences are enforceable, the EFRAG Secretariat assesses that similar service arrangements could be within the scope of the IASB ED.
- 3.24 The EFRAG Secretariat notes that for a regulatory asset to exist, it is also necessary that an entity already supplied goods or services and for a regulatory liability – it already included in revenue amounts for goods or services to be supplied in the future.

Fact Pattern 5: Settlement by third parties on behalf of the customer

Fact pattern

- 3.25 In some jurisdictions, there are agreements under which if the customer is not able to pay the regulated rate for the supply of goods and services then the obligation will be settled/ recovered by a third party (a regulator, a government agency, a contractor etc.).

EFRAG Secretariat's assessment

- 3.26 Applying the proposed requirements in the ED, such arrangements can be considered to meet the definition of a regulatory agreement which established the regulated rate charged to customers. Furthermore, there need to be differences in timing between the period in which goods and services were supplied and the period when the compensation was charged to customers and these differences to be legally enforceable.
- 3.27 The EFRAG Secretariat notes that for a regulatory asset to exist, it is also necessary that an entity already supplied goods or services and for a regulatory liability – it already included in revenue amounts for goods or services to be supplied in the future.
- 3.28 The EFRAG Secretariat observes that for the arrangement to fall within the scope of the proposed Standard, it is important that the customer is charged for the supplied goods or services through the regulated rate.



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