EFRAG

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EFRAG RRA Comment Letter Unresolved Items

Issues paper

Objective of this paper

1 This paper aims to summarise the discussion on the three different topics (CWIP, discounting and IFRS 3 exception) to which the EFRAG's draft comment letter (DCL) on the IASB Exposure Draft *Regulatory assets and Regulatory Liabilities* (the ED) did not present a conclusive EFRAG position.

2 EFRAG TEG will discuss and agree on the position to be proposed to the EFRAG Board for the final comment letter on the basis of the following: the input received from the outreach (including from members of the EFRAG RRAWG); comment letters on the EFRAG DCL; and results of the EFRAG effects-analysis survey to preparers and users.

3 This paper is intended to solely support a discussion that could help EFRAG TEG to identify the direction to take in developing its position for EFRAG's final comment letter on the ED. The following aspects are addressed across the three topics:

(a) The ED's proposals;

(b) Views expressed in the DCL;

(c) Outreach feedback that includes feedback from events held so far with stakeholders across different jurisdictions and the EFRAG CFSS-TEG meeting held on 16 June 2021;

(d) Main messages from the EFRAG RRAWG-TEG meeting held on 21 June 2021 (hereafter referred to as EFRAG RRAWG-TEG joint meeting); and

(e) The EFRAG Secretariat preliminary recommendations.

4 At the EFRAG RRAWG-TEG joint meeting, the EFRAG Secretariat presented issues papers for the three topics, and these included the genesis of the IASB decisions within the ED as well as a summary of past positions expressed by EFRAG TEG and EFRAG RRAWG members.

Regulatory returns on construction work in progress

IASB ED proposal

5 Total allowed compensation (TAC) is the amount that an entity is entitled to charge customers, in the same or a different period, in exchange for the goods or services supplied in a specified period, in accordance with the regulatory agreement. TAC consists of several components which affect profit or loss including allowable

recoverable expenses less chargeable income, target profit which consists of profit margin, regulatory returns and performance incentives, and regulatory interest income or expenses.

6 Regulatory returns- Regulatory agreements typically determine the regulatory return for a period by specifying a return rate and a base (e.g., regulatory capital base) to which that return rate applies. Common terms for such a base are 'regulatory capital base' or 'regulatory asset base'[1], although other terms are also used.

7 Regulatory returns are included in TAC and recognised in the profit or loss when the regulatory agreement entitles the entity to add it in determining the regulatory rate charged to customers.

8 However, for assets not yet in use or construction work in progress (CWIP), and where the regulatory agreement allows regulatory returns to be charged to customers while an asset is under construction; the ED proposes that these regulatory returns should be included in TAC only when the asset is in use and over the regulatory recovery period of the asset through the regulated rates. Correspondingly, a regulatory liability is recognised during the construction period and thereafter regulatory income recognised when the asset is in use.

9 Paragraphs BC 98, 99 and 100 of the Basis for Conclusions in the ED provide reasons for the IASB decision. Further background of past IASB discussions can be found in March 2020 IASB staff papers AP 9A- Background and Regulatory Capital Base; AP 9B Regulatory returns on construction work in progress base;

Views expressed in the EFRAG DCL

10 The EFRAG DCL did not present a conclusive position on the proposed treatment of regulatory returns when the regulatory agreement allows regulatory returns to be charged to customers while an asset is under construction. The EFRAG DCL expressed two views.

View 1 (Reasons to disagree with the IASB proposal)

11 The proposal departs from the alignment of the accounting treatment with the regulatory treatment of regulatory returns. In certain cases (e.g., under IFRIC 12 *Service Concession Arrangements*), it is not uncommon to recognise revenue during the construction period. The proposal may fail to faithfully reflect performance throughout the duration of the contract.

12 EFRAG notes that the delivery of goods or services often involves a combination of various assets, rather than a single asset. Furthermore, EFRAG considers that:

(a) The driver for recognition of regulatory returns for assets under construction is different to the accounting for performance incentives and penalties, including those related to assets under construction, which was based on performance, rather than the delivery of goods or services, leading to potential inconsistencies.

(b) Preparers of some entities would face operational challenges of keeping track of assets under construction on a stand-alone basis.

[1] Regulatory agreements typically determine the regulatory return for a period by specifying a return rate and a base to which that return rate applies. Some regulatory agreements specify more than one base, each with its own return rate. The items for which amounts are included in such a base are not necessarily recognised as assets or liabilities applying IFRS Standards, and a regulatory agreement does not necessarily measure assets or liabilities on the same basis as IFRS Standards.

View 2 (Reason to support the IASB proposal)

13 The IASB proposal is consistent with the model's underlying principle that an entity should reflect the total allowed compensation for goods or services supplied as part of its reported financial performance for the period in which the entity supplies those goods or services.

14 As a result, the proposed treatment will provide a faithful representation of profit patterns particularly for entities that have material and long-duration CWIP. Profit margins could be considered as misleadingly understated when the asset becomes operational if the regulatory returns were to be recognised as part of the total allowed compensation during construction, also leading to more comparability across entities regardless of the regulatory agreement.

Outreach feedback

15 The feedback from the outreach has been predominantly opposed to the ED`s proposals (i.e., in favour of the DCL View 1) but there has also been some support for View 2 including at the June TEG-CFSS meeting. Below is an elaboration of arguments across the two views expressed in the EFRAG DCL.

Outreach feedback in favour of EFRAG DCL view 1

16 Most of the stakeholders during the outreach have been opposed to the ED`s proposals (i.e., they are in favour of the EFRAG DCL View 1) for the following reasons:

- (a) Operational considerations;
- (b) Conceptual reasons;
- (c) Usefulness of information considerations; and
- (d) Other considerations (e.g., project completion incentives, effects on regulatory agreements).

17 Operational considerations:

- (a) The respective regulatory returns are mostly calculated based on the portfolio of assets and CWIP is included in the regulatory capital base. Is it very difficult to allocate the regulatory return to different assets (finished or unfinished), when assets under construction are not tracked by the entity. Furthermore, one preparer noted that the proportion of regulatory returns as a proportion of revenue can be immaterial and questioned whether the efforts needed to adjust systems to attribute regulatory returns to different assets is worth the effort.

18 Conceptual reasons included the following.

- (a) Some stakeholders have noted that the returns compensate for the provision of capacity and therefore also constitute a kind of good or service. In other words, the model's principle of TAC recognition is predicated on a narrow notion of goods or services being supplied by the entity.
- (b) Some stakeholders have questioned the character of a liability in the absence of any enforceable obligation within the regulatory agreement to reduce future rates charged to customers. One stakeholder noted that this kind of compensation seemed to be a subsidised investment, therefore not allowing regulatory returns on such assets under construction during the construction phase would not be reasonable.
- (c) Several stakeholders have highlighted that in their jurisdiction, there is no obligation to refund or reduce rates charged to customers should the project/asset construction never be completed.

(d) Other stakeholders expressed concern about the deviation between the regulatory and accounting treatment are not aligned.

19 Usefulness of information considerations:

(a) Some stakeholders opined that the accounting requirements may impact the regulatory agreements, which may result in a change in regulation (one regulator was in favour of that).

(b) Some stakeholders noted that the required regulatory liability that for some entities could be held on the balance sheet for long durations (e.g., 40 years) could be misleading to investors.

(c) One preparer expressed concerns about EBITDA distortions that do not correspond to future cash flow prospects that could be confusing for their investors.

(d) One preparer questioned whether comparability of reporting should be a goal in cases where there are differences in entities regulatory agreements. In other words, why should transactions with differing characteristics have the same accounting treatment?

(e) EFRAG observed an outreach to users in a non-EU jurisdiction, where concerns were expressed about the profit and loss distortions that would arise from the proposed IASB treatment. Furthermore, a user respondent[2] to EFRAG's ongoing effects analysis indicated that due to the IASB proposal cash flows would differ from P&L and in this way would underestimate the profitability of the project. The user stated that he would not be able to trust the P&L that much and would have to make an assumption on the cash flow received from assets under construction and reduce some numbers from P&L.

Outreach feedback in favour of the EFRAG DCL view 2

20 A regulator noted that the ED's approach could incentivize timely project completion including through possible shifts to regulatory agreements that only grant regulatory returns when assets are operational.

21 At the June TEG-CFSS meeting, four (of six) NSS representatives that voted in the doodle poll supported the EFRAG DCL View 2 and two supported EFRAG DCL View 1.

EFRAG RRAWG-TEG joint meeting takeaway

22 At the EFRAG RRAWG-TEG joint meeting on 21 June 2021, RRAWG members echoed concerns similar to those aired against the ED's proposal during the outreach (i.e., in support of EFRAG DCL View 1). They provided the same operationality, conceptual and usefulness of information reasons aired during the EFRAG outreach as summarised in paragraphs 14 to 20 above.

23 Several EFRAG TEG members highlighted the diversity of regulatory agreements across jurisdictions and thereby questioned the appropriateness of the IASB ED's approach of deferral of the recognition of regulatory returns for all types of regulatory agreements. Some TEG members also questioned the appropriateness of the comparability goal expressed in BC 98. A TEG member opined that comparability was important for users but financial statements truly reflecting the underlying business model was even more important (i.e., relevance trumps comparability).

24 There was a discussion on the economic substance of the transaction when a regulatory return is granted and whether the asset under construction is only earning regulatory returns because it is used to supply goods or services. Several EFRAG

[2] This is a single user view. A more representative view of users will only be available after the effects analysis and the EFRAG outreach event to users to be held on 12 July 2021.

TEG members and EFRAG RRAWG members acknowledged that the regulatory returns could be compensation for a service other than the goods or services supplied to customers when the asset is in use (e.g., continuity in transmission of service, constructing the asset was a performance and constructing the asset and managing the portfolio was part of the obligation). An EFRAG TEG member noted that there could be merit in considering whether the end customer was not restricted to customers of goods and services as construction of facilities could be seen as a public good.

25 An EFRAG TEG member who indicated support for View 1 emphasised that reflecting the economic substance ought to be the overarching reason for the appropriate accounting treatment. As such, a deviation of the accounting treatment from the regulatory treatment of returns *per se* is not a problem if the accounting treatment is reflecting the economic substance.

EFRAG Secretariat recommendation

26 Based on the outreach feedback and takeaways from the EFRAG RRAWG-TEG joint meeting, the EFRAG Secretariat recommends that EFRAG TEG adopts a position against the IASB proposal (View 1 of the EFRAG DCL).

27 As discussed at the EFRAG RRAWG-TEG joint meeting, the assessment of appropriate accounting treatment ought to focus on the economic substance over form. Hence, if the TEG position in the EFRAG final comment letter is against the IASB proposal, the main reason ought not to be due to deviation from regulatory treatment but rather it should be because there are situations where recognising regulatory returns for CWIP during construction would be the most faithful representation of the economics of the transaction (e.g. when it is established that the regulatory return is compensating the entity for a service other than for its supply of goods and services; also based on the fact that in some jurisdictions, the regulatory agreement does not oblige the entity to refund the regulatory return received if the investment project is not completed. Therefore, this return could be seen as an investment subsidy). EFRAG could consider recommending that the IASB define a broader notion of goods and services supplied to customers or perhaps to have a broader notion of customers (i.e., entity delivers a public service) so as to keep the underlying model principle intact.

28 In addition, cost-benefit considerations and providing relevant information should be considered as further arguments against the proposal.

Questions for EFRAG-TEG members

29 As noted earlier, EFRAG position in the final comment letter will only be taken after incorporating the feedback from the outreach, constituents' comment letter responses to the EFRAG DCL, and results of the effects-analysis survey to preparers and users.

30 Do EFRAG TEG members tentatively agree with the EFRAG Secretariat recommendation to take a position against the IASB ED proposal that recognition of regulatory returns charged to customers during construction should only occur over the period when the asset is in use?

31 Do EFRAG TEG members have any suggestions that could help the IASB develop requirements that ensure regulatory returns charged to customers are only recognised during construction when it reflects the economic substance of the transaction (i.e., when there is clarity on what regulatory returns during the construction period are compensating)?

32 Do EFRAG TEG members tentatively agree that defining a broader notion of goods or services supplied and/or definition of the customer of the entity is needed? If so, please provide suggestions for these broadened definitions.

Discounting of regulatory assets and regulatory liabilities and sufficiency of the regulatory interest rate

IASB proposal

33 Paragraphs 46-49 of the ED propose that an entity discount regulatory assets and regulatory liabilities using the regulatory interest rate (except when the regulatory interest rate for a regulatory asset is insufficient). Paragraphs BC159–BC166 of the Basis for Conclusions describe the reasoning behind the IASB's proposals.

34 In cases when there is an indication that the regulatory interest rate for a regulatory asset is not sufficient to compensate the entity for the time value of money and uncertainty risks, the ED (paragraphs 50–53) proposes that an entity estimates the "minimum interest rate" and to use this rate to discount the estimated future cash flows of the regulatory asset. For a regulatory liability, an entity would use the regulatory interest rate as the discount rate in all circumstances. Paragraphs BC167–BC170 of the Basis for Conclusions describe the reasoning behind the IASB's proposals.

35 Paragraph 54 of the ED proposes that, in cases when a regulatory agreement provides a series of different regulatory interest rates in successive periods, an entity translate those uneven rates into a single discount rate for use throughout the life of the regulatory asset or regulatory liability. The result would be similar to determining an effective interest rate.

36 A history of past IASB discussions on discounting can also be found in the June 2019 IASB meeting (agenda paper 9D) and the EFRAG RRAWG-TEG meeting agenda paper 01-03.

EFRAG's position in the DCL

37 EFRAG supports the proposal to require an entity to discount the estimated future cash flows to their present value in measuring regulatory assets and regulatory liabilities. EFRAG recommends that the IASB consider introducing a practical expedient to exempt entities from discounting if the effects of discounting are not significant.

38 The EFRAG DCL disagreed with the proposal for different discounting approaches for regulatory assets and regulatory liabilities.

39 The EFRAG DCL did not have a conclusive position on the appropriate discount rate and expressed two views.

View 1 - Use the regulatory interest rate for regulatory assets and regulatory liabilities.

40 Under View 1, an entity would always use the regulatory interest rate to discount regulatory assets and regulatory liabilities. The regulatory interest rate is negotiated with the regulator and considered objective by users.

41 Supporters of this view disagree with the proposed application of a minimum interest rate as the discount rate for regulatory assets, when the regulatory interest rate provided for a regulatory asset is insufficient. What matters ought to be the discount rate agreed with the regulator, as this represents the rate the entity is entitled to recover (fulfil) when measuring its regulatory assets and regulatory liabilities. Therefore, the application of a minimum interest rate would not be relevant information for users to understand regulatory assets and regulatory liabilities.

EFRAG concerns about estimating minimum interest rate

42 EFRAG disagrees with the use of a minimum adequate rate as the discount rate for regulatory assets, when the regulatory interest rate provided for a regulatory asset is insufficient.

43 In EFRAG's view, the regulatory agreement does not use the concept of a minimum adequate rate and introducing such a rate in the accounting model might be a subjective and complex exercise for preparers. As a result, EFRAG considers that it would likely be challenging in practice to apply the concepts of minimum interest rate (or insufficient or inadequate rate) and would be subject to a lot of discussion with the auditors given the level of judgement involved to make this assessment.

44 What matters ought to be the discount rate agreed with the regulator, as this represents the rate the entity is entitled to recover (fulfil) when measuring its regulatory assets and regulatory liabilities. Therefore, EFRAG considers that the application of a minimum adequate rate would not be relevant information for users to understand regulatory assets and regulatory liabilities.

45 Moreover, EFRAG is concerned that assessing whether a discount rate is sufficient will involve a high degree of subjective judgement and it will be difficult to come to an agreement with auditors on what constitutes a sufficient discount rate. This will likely result in undue costs that will outweigh the benefits of the proposal.

View 2 – Apply the general discounting principles in IFRS Standards

46 Discounting of regulatory assets and regulatory liabilities should follow the general discounting principles in IFRS Standards because the objective of discounting is to appropriately reflect the effects of the time value of money. The regulatory interest rate might have a different objective.

47 In cases where there is a significant financing component and the regulatory interest rate differs from the market rate, an entity should apply the requirements in IFRS 15 *Revenue from Contracts with Customers* and use the prevailing interest rates in the relevant market.

Outreach feedback

48 The feedback from the outreach has been predominantly opposed to the ED`s proposals of using a minimum interest rate, whereas most stakeholders gave support to using the regulatory rate as a discount rate (i.e., in favour of the DCL View 1).

49 During the June 2021 EFRAG TEG-CFSS meeting, a majority of the CFSS members that voted on this topic (4 out of 6) supported view 2 (to follow general discounting guidelines).

Feedback in favour of EFRAG DCL view 1

50 Most of the stakeholders during the outreach have been opposed to the ED`s proposals (i.e., they are in favour of the EFRAG DCL View 1) for the following reasons:

(a) Operational considerations;

(b) Conceptual reasons;

51 Operational considerations:

(a) Some entities see discounting of regulatory assets and regulatory liabilities as being highly complex or operationally challenging. Those also see similarities to the treatment of IAS 12 *Income Taxes* items, that are not discounted. Some suggested introducing a practical expedient to exempt entities from discounting if the effects of discounting were not significant.

(b) A further concern noted by some participants was that regulatory assets can take between 6 months and 2 years until they are included in the rates. The company was not entitled to a regulatory return during this period. Effective regulatory rates of return will have to be computed in these recurring situations. This would be a costly and burdensome exercise because some companies had a significant portion of individual regulatory assets and regulatory liabilities are measured by using effective regulatory rates. Consequently, the effective regulatory rates of return will have to be updated, and the individual regulatory assets and regulatory liabilities will have to be regularly re-measured.

52 Conceptual reasons:

(a) Some stakeholders pointed out that the objective of discounting in the ED was not clear (time value of money and potentially risk similar to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* and other standards or reflect what was in the regulatory agreement). The regulatory interest rate could follow various objectives (as some highlighted that regulatory discount rate compensated in some cases for equity and financing component, not just for the time value of money), thus the objective of the proposed requirement was not clear and did not reflect existing regulatory practice.

(b) A stakeholder noted that discounting cash flows by applying a minimum interest rate would lead to a loss because cash flows include only allowable expenses and no regulatory return. This loss would be counter-intuitive under regimes where regulation is based on the ‘cost plus’ model, as long as the incurred expenses were allowable. It would be rare to have situations where the regulator would not grant a fair or sufficient return that would fairly compensate the utility company.

(c) Furthermore, in some jurisdictions (for example the US where some European companies have significant operations) the fair rate of return was significantly higher than the market rate. Applying IFRS principles (using the lower rate) would result in a significant gain when discounting regulatory assets. This would not result in useful information for users of financial statements. It was not always obvious why the regulatory interest rate might be higher than the market interest rate, and in some cases, the regulatory rate was compensating for more than only the time value of money (equity and financing component). However, this split was not necessarily clear-cut.

(d) A stakeholder also noted that paragraphs 50-53 of the ED would lead to applying different discount rates in order to measure regulatory assets and regulatory liabilities.

(e) Some stakeholders highlighted that the regulator by law is required to allow the utility provider to recover all allowable costs including a global fair return. Therefore, the regulatory interest rate should always be used as the discount rate. A loss should be recognised only if an expenditure is not allowed/not recoverable.

(f) Furthermore, in some jurisdictions (for example the US where some European companies have significant operations) the fair rate of return was significantly higher than the market rate. Applying IFRS principles (using the lower rate) would result in a significant gain when discounting regulatory assets. This would not result in useful information for users of financial statements.

Feedback in favour of EFRAG DCL view 2

53 There was some support for discounting regulatory assets and regulatory liabilities using the general discounting principles in IFRS Standards based on the poll results during the TEG-CFSS meeting (EFRAG's View 2). Similar support was not indicated in the other outreach events.

Feedback in favour of applying a minimum interest rate

54 Some stakeholders highlighted that the regulatory rate should be used and that a loss should only be recognised if an expenditure is not allowed or not recoverable. This could be understood as a rebuttable presumption, which could also be seen as close to the ED`s proposal. It was expected that cases where the presumption would be rebutted would be rare as in most cases the regulatory interest rate ought to be sufficient to fairly compensate the utility company.

55 Those stakeholders stated that if the minimum concept would be required, a specific symmetric rate (for assets and liabilities) should be defined and there should be a clear understanding of why the regulator does not allow for a discounting component or grants a rate that is lower than market, which is expected to happen only in limited circumstances.

Other considerations

56 Those that accept discounting, suggest using the regulatory interest rate for both regulatory liabilities and regulatory assets.

EFRAG RRAWG-TEG joint meeting takeaway

57 At the EFRAG RRAWG-TEG joint meeting in June 2021, several TEG members supported the use of the rebuttable presumption of regulatory interest rate as a discount rate.

58 EFRAG RRAWG continued to support applying the regulatory interest rate (View 1). In previous RRAWG meetings, almost all RRAWG members favoured the use of a regulatory interest rate.

59 At the EFRAG RRAWG-TEG joint meeting, those that were in favour of View 1 had the following observations.

(a) In some cases, the compensation is based on WACC and thus clearly higher than just "time value of money plus uncertainty component".

(b) Another RRAWG member noted that the rate used to compute return on the regulatory capital base had been publicly debated. Also, one RRAWG member stated that he had not seen any cases where the rate set by the regulator would not be sufficient for fair remuneration.

(c) Some TEG members favoured the use of the regulatory rate ***first***, but would like to see adjustments under certain circumstances. Therefore, those were considered in paragraph 61.

60 At the meeting, there was no support expressed for view 2 (use of general IFRS discounting principles).

61 Those that were in favour of the minimum rate or a similar concept (rebuttable presumption) stated:

(a) An EFRAG TEG member expressed that there should be some override to the regulatory discount rate when it was obviously not sufficient. The member noted that with the low-interest-rate environment that has been in place in the EU there could be cases where the regulatory interest rate is insufficient.

(b) An EFRAG TEG member stated that the regulatory rate would be the preferred ***starting point*** as it was part of the public negotiation and therefore a fair return would be granted, and another TEG member agreed that a rebuttable presumption of the regulatory interest rate being the first starting point.

(c) An EFRAG TEG member acknowledged that it may be the case that in some jurisdictions and for some entities, there is transparency and public scrutiny on the regulatory interest rate. However, with the broad scope of the project that could extend outside utilities, it is not always the case that the regulatory interest rate is negotiated and transparent. The EFRAG TEG member stated that he was not sure if all entities in scope would have to negotiate with a regulator, which would make adjustments even more important.

62 There were mixed views expressed by two EFRAG TEG members on whether regulatory liabilities ought to also, in some circumstances, be discounted at a rate other than regulatory interest rate (e.g., minimum rate). One member agreed with the IASB reasons in the Basis for Conclusions and the other member pointed to the conceptual inconsistency of not allowing gains for the liabilities.

EFRAG Secretariat recommendation

63 As noted in the above paragraphs, at the EFRAG RRAWG-TEG joint meeting there was only support for the EFRAG DCL view 1 (apply the regulatory interest rate) and for a third view not expressed in the EFRAG DCL of introducing a rebuttable presumption that the regulatory interest rate is the appropriate discount rate, and no support was expressed for the EFRAG DCL view 2.

64 Hence, based on the feedback so far, the EFRAG Secretariat considers that there is a need for EFRAG TEG to tentatively choose between either of the following two views:

(a) The EFRAG DCL view 1 (regulatory interest rate for both regulatory assets and regulatory liabilities); or

(b) A rebuttable presumption that the regulatory interest rate is the appropriate discount rate. We understand that only in rare circumstances, would the regulatory interest rate not be adequate and that paragraph 52 of the ED provides indicators of insufficiency of the regulatory interest rate. Hence, the EFRAG final comment letter could ask the IASB to clarify that the proposed ED requirements are effectively working as a rebuttable presumption.

65 The EFRAG Secretariat also recommends that the EFRAG final comment letter: a) asks for further guidance on how the minimum rate is determined; and b) takes a position on whether regulatory liabilities ought to also, in some circumstances, be discounted at a rate other than the regulatory interest rate (e.g., higher or lower rate than the regulatory interest rate).

Questions for EFRAG-TEG members

66 Do EFRAG TEG members tentatively agree that EFRAG's position in the final comment letter should be in favour of either regulatory interest rate or a rebuttable presumption that the regulatory interest rate is the discount rate to be applied? If so, which of the two views do EFRAG TEG members support?

67 Do EFRAG TEG members tentatively agree with the proposal that the EFRAG final comment letter should recommend the IASB provides further guidance on how the minimum rate is determined?

68 What is the EFRAG TEG tentative view on whether regulatory liabilities ought to also, in some circumstances, be discounted at a rate other than regulatory interest rate (i.e.., a higher or lower rate than the regulatory interest rate)?

IFRS 3 Exception

IASB proposal

69 The IASB proposes that, as an exception to the recognition and measurement principles in IFRS 3 *Business Combinations*, an entity should recognise and measure regulatory assets acquired and regulatory liabilities assumed in a business combination applying the recognition and measurement principles proposed in the ED (modified historical cost), rather than recognise and measure them at fair value.

70 Paragraph BC 260-b points to operational constraints and costs associated with the determination of fair value under IFRS 3 requirements. An entity would incur significant costs in:

(a) Determining the market discount rate needed to measure regulatory assets and regulatory liabilities at fair value. The entity might incur significant costs because regulatory assets and regulatory liabilities are not traded in active markets and there are generally few observable inputs that could be used in determining the appropriate discount rate- one that market participants would use when pricing those assets and liabilities.

(b) Tracking separately regulatory assets acquired or regulatory liabilities assumed in a business combination at a discount rate that is not explicit in the regulatory agreement.

(c) Determining the discount rate to use subsequently if the regulatory agreement changes the applicable regulatory interest rate.

71 Another reason in the BC for the IFRS 3 exceptions relates to the measurement exception for items that are reflected in or deducted from rates at or near the period cash is received or paid for these items. These items are measured using the same measurement basis applied for the related asset or related liability. In paragraph BC 261, the IASB concluded that the proposed exception would provide a simple and understandable outcome for these regulatory assets and regulatory liabilities and allow consistent accounting in their subsequent measurement.

72 A history of past IASB discussions on the IFRS 3 exception can also be found in November 2018 (IASB Staff Paper 9B), July 2019 (Staff Paper 9A), the EFRAG June joint meeting Paper 01-04.

EFRAG`s position in the DCL

73 The EFRAG DCL acknowledged the IASB's arguments supporting the IFRS 3 exception:

(a) Measuring regulatory assets and liabilities at fair value at the date of acquisition and subsequent remeasurement could result in the recognition of technical gains or losses. The main difference is expected to be the discount rate, as the market value of a regulatory asset and a regulatory liability ought to be the same as the value for regulatory purposes.

(b) IFRS 3 has a different recognition threshold than that of the proposed Standard.

(c) Significant costs could accompany discounting if applying a market discount rate instead of the regulatory interest rate.

74 On the other hand, given that in general EFRAG does not like exceptions, the EFRAG DCL put forward the following arguments against the proposed IFRS 3 exception:

(a) Fair value measurement for the acquired regulatory assets and liabilities could be seen as conceptually consistent with business combination accounting under IFRS and provide relevant information for users.

(b) Subsequent measurement differences could be avoided by discounting the future cash flows for the acquired regulatory assets and assumed regulatory liabilities at an adjusted regulatory rate, similar to the approach used for measuring a loan banking book acquired at fair value and discounted at an adjusted discount rate similar to the effective yield to arrive at the subsequent amortised cost measurement in accordance with IFRS 9.

(c) The results of the early-stage effects analysis also showed that many preparers considered that exempting acquired regulatory assets and regulatory liabilities from the scope of IFRS 3 will have unintended consequences.

75 Based on the above, the EFRAG DCL seeks stakeholders' views on the proposed IFRS 3 exception and on the idea of discounting using an adjusted discount rate for subsequent measurement similar to the approach for subsequent measurement of loans acquired at fair value.

Outreach feedback

76 EFRAG has not received much feedback from stakeholders on this issue in the outreach up to date. A stakeholder commented that it was not common to acquire the rate-regulated entities by acquisition in their jurisdiction. Others indicated that the IASB proposal was not an issue they had identified so far.

77 The doodle poll at the EFRAG CFSS-TEG meeting showed some NSS representatives (four) were against the exception and two were in favour of the exception. The following observations were made:

(a) One stakeholder commented that the discount rate for the acquirer could be different from the regulatory rate, and can be WACC or another rate.

(b) Another stakeholder in favour of the IFRS 3 exception commented that the day 2 gains or losses should not be considered in isolation and that from a conceptual perspective it is almost impossible to determine the fair value on acquisition in a monopoly situation as the cash flows are entity-specific (less market/fair value-oriented).

EFRAG RRAWG-TEG joint meeting takeaway

78 At the EFRAG RRAWG-TEG joint meeting,

(a) a few EFRAG TEG members and one RRAWG member were in favour of fair value accounting using the IFRS 3 guidance instead of the application of the IFRS 3 exception in a business combination.

(b) two EFRAG TEG members and an RRAWG member supported the IFRS 3 exception. One TEG member noted that the exception was also granted for other matters (e.g., Deferred taxes in IAS 12, IAS 19 *Employee Benefits*). Another TEG member noted that regulatory assets and liabilities were similar to contract assets and liabilities in IFRS 15, and the proposed exception would avoid the post-acquisition difficulties of IFRS 15. An RRAWG noted that the exception allows there not to be a conflict between the intangible asset model and the proposed model.

79 A comment was made that the interaction between measuring assets like PP&E at fair value as part of IFRS 3 and the recognition of regulatory assets and regulatory liabilities should be further explored. One example was what discount rate should be applied to acquired assets and acquired liabilities in a business combination that would be used to provide regulatory goods or services (such as PPE infrastructure). There was also a question of impairment post-acquisition for assets that were used to provide regulatory goods or services.

EFRAG Secretariat recommendation

80 The EFRAG Secretariat observes that most of the RRAWG members had no concerns with the IFRS 3 exception.

81 The limited feedback received during outreach also highlights that that there are likely to be limited or no concerns with the proposed IFRS 3 exception. Furthermore, the EFRAG DCL noted that some preparers that responded to the early-stage effects analysis expected unintended consequences. However, these were not elaborated on and remain unspecified, although one of the consequences mentioned is the impact on acquired goodwill, depending on whether an entity measures acquired regulatory assets and regulatory liabilities at fair value versus measuring them applying the ''regulatory'' measurement model proposed in the ED.

82 The EFRAG Secretariat considers that as detailed in the issues paper for the June meeting, in the past the IASB considered having no IFRS exception for acquired regulatory assets assumed regulatory liabilities (see November 2018 (IASB Staff Paper 9B). However, the IASB sought further analysis on the interaction and raised two questions for the IASB staff to consider in subsequent meetings:

(a) Would the fair value of regulatory assets or regulatory liabilities generally approximate their pre-acquisition carrying values? If so, would the costs of applying IFRS 3 outweigh the benefits?

(b) If initially measured at fair value under IFRS 3, would subsequent adjustments result when the entity reverts to applying the recognition and measurement principles prescribed by the model?

83 Following the IASB staff analysis and board deliberations as reflected in July 2019 (Staff Paper 9A), the IASB came to the decision to have the IFRS 3 exception for acquired regulatory assets and assumed regulatory liabilities. These reasons are reflected in BC 260 and BC 261.

84 The EFRAG DCL proposal for an adjusted discount rate similar to that applied for loans acquired at fair value under IFRS 9 requirements could solve the subsequent

measurement challenges. However, it does not address the other challenges highlighted in BC 260 and BC 261 including costs of identifying a discount rate during the fair value measurement, implications of differing recognition thresholds, the need to allow consistent treatment of measurement exception items.

85 Furthermore, there is a need for EFRAG TEG to consider similar exceptions applied in other IFRS Standards as noted in paragraph 80-b above (i.e., IAS 12, IAS 19, IFRS 15). Other exceptions from IFRS 3 recognition and measurement principles within IFRS Standards include:

(a) Liabilities and contingent liabilities within the scope of IAS 37 or IFRIC 21 *Levies*, an acquirer applies IAS 37 or IFRIC 21 to identify the liabilities it has assumed in a business combination;

(b) Contingent liabilities and contingent assets;

(c) Income taxes;

(d) Employee benefits, assets and liabilities arising from an acquiree's employment benefits are measured applying IAS 19;

(e) Indemnification assets; an acquirer recognises indemnification assets at the same time and on the same basis as the indemnified item;

(f) Reacquired rights; the measurement of reacquired rights is by reference to the remaining contractual term without renewals;

(g) Share-based payment transactions, these are measured by reference to the method in IFRS 2 *Share-based Payment;*

(h) Assets held for sale, IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* requirements apply for acquired non-current assets and disposal groups.

86 In addition, the EFRAG Secretariat would note that in the DCL, EFRAG supported other exceptions (e.g., regulatory assets and regulatory liabilities are excluded from the scope of measurement of IFRS 5*;* and the measurement exception for items that are reflected in or deducted from rates at or near the period cash is received or paid for these items. These items are measured using the same measurement basis applied for the related asset or related liability).

Questions for EFRAG-TEG members

87 Do EFRAG TEG members tentatively agree to support the IFRS 3 recognition and measurement exception? Please explain