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Regulatory assets and regulatory liabilities

The direct (indirect) relationship concept

Cover note

Objective

- 1 The purpose of this session is to present the results of an IASB staff survey on the direct (no direct) relationship concept, the IASB tentative decisions thereafter, and the EFRAG RRAWG, FR TEG, and TEG-CFSS feedback on the survey results and tentative decisions.

Background

- 2 In March 2023, the IASB staff conducted a survey that asked respondents to determine whether their entities' RCB had a direct (no direct) relationship with their PPE based on the features of their RCB and respective compensation. The results of the survey are presented in [Agenda Paper 9B](#) and discussed at the IASB meeting in September 2023.
- 3 In September 2023, the IASB tentatively decided to:
 - (a) include the direct (no direct) relationship concept to help an entity identify differences in timing arising from the regulatory compensation the entity receives on its regulatory capital base (RCB)
 - (b) specify that an entity's ability to trace differences between the RCB and its property, plant and equipment (PPE) at an asset level is a strong indicator that they have a direct relationship.
- 4 The concept of direct (no direct) concept is central to the IASB's tentative decisions taken since October 2022 on total allowed compensation and more generally the accounting for regulatory assets and regulatory liabilities.
- 5 During 2023, EFRAG FR TEG and FRB discussed the IASB tentative decisions in which the IASB has used the direct (no direct) relationship concept with impacts in respect of the following:
 - (a) the accounting for regulatory assets and regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives;
 - (b) the accounting for regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs to construct that asset; and

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

Key discussion points for the session

- 6 The presentation (Agenda paper 08-02) includes
 - (a) The IASB survey results with a focus on the results from European companies including their assessment of whether they have a direct (no direct) relationship between the RCB and their PPE and the principal factor supporting their assessment.
 - (b) The IASB tentative decisions
 - (c) EFRAG RRAWG, EFRAG FR TEG, and EFRAG TEG-CFSS members' feedback on the survey results and tentative decisions. *The Appendix of this cover note also includes a summary the EFRAG RRAWG and EFRAG FR TEG discussions.*
 - (d) Follow-up outreach conducted so far by the EFRAG secretariat in collaboration with several NSS.

Agenda Papers

- 7 In addition to this cover note, Agenda paper 08-02 – *Survey results on direct (no direct) relationship concept* is provided for this session.

Questions for EFRAG FRB

- 8 Do you have any comments or observations on the direct (no direct) relationship concept introduced by the IASB and its implications on the accounting model?
- 9 Do you foresee any concerns with applying the direct (no direct) concept in hybrid regimes that contain features of both direct and no direct relationships? Please explain.
- 10 Do you foresee any other concerns with applying the direct (no direct) concept? Please explain.
- 11 Do you have any further comments/suggestions on the indicators (slide 7 of agenda paper 08-02) to determine a direct (no direct) relationship concept?
- 12 Do you have any comments or observations on the outreach activities on the direct (no direct) relationship concept?

Appendix

Summary of discussion from EFRAG RRAWG on survey results

- 13 Most members generally continued to support the relief provided by introducing the direct (no direct) relationship concept because the calculations necessary to compute regulatory assets and liabilities would not be practical under some regulatory regimes faced by companies. However, one member noted that the initial objective of the IASB project had been to recognise amounts that were legally enforceable resulting from regulated activities and now the concept of no direct relationship presented an 'exit route' for entities to not recognise regulatory assets and regulatory liabilities.
- 14 The members supporting the model noted the gap between the regulatory treatment of RCB and IFRS accounting for PPE was wide and there was no mandatory reconciliation at the granular level required to be able to determine whether there were timing differences at individual asset level necessary for the recognition of regulatory assets and regulatory liabilities. This view was also supported by one member from the UK on the basis that it was challenging to reconcile the RCB for UK entities against fixed assets.
- 15 One member noted that with hybrid arrangements it could be difficult to conclude whether the relationship was direct or not direct. However, the view of this member was that the indicators proposed by the IASB were helpful. A conclusion on the relationship would have to be made and it was not possible to be both. Another member asked if there could be a different outcome of the same regulation depending on which indicator was used. The view of this member was that the IASB's indicators were useful but questioned whether they would be sufficient.
- 16 The observer from the UKEB also shed light on concerns that are in place in the UK. Some differences in timing would be recognised as regulatory assets and regulatory liabilities by entities with a direct relationship but not by those without a direct relationship. In the UK, regulatory regimes had no direct relationship and UKEB needed to ascertain what that meant for unrecognised regulatory assets and regulatory liabilities and how material these are. There was a concern that not reflecting regulatory assets and regulatory liabilities would fail to reflect the economics and result in a lack of comparability.
- 17 Illustratively, the observer from the UKEB provided an example of a company that had US-based regulatory operations and UK-based regulatory operations. There was a question of whether that would mean that the entity would recognise more regulatory assets and liabilities for the US company but less for the UK and whether that was a fair economic reflection. The observer's view was that just because agreements differed did not mean that one set of agreements ought to have fewer differences in timing being recognised. The differences need to be understood, whether and how they should be recognised rather than simply concluding that there were no adjustments without a direct relationship. This observer considered that the IASB was potentially creating a situation where non-direct entities would recognise fewer regulatory assets or liabilities than entities outside of the UK (like Canada and the US). That would impact comparability.

Summary of discussion from EFRAG FR TEG on survey results

- 1 In response to a question on whether the direct/no direct concept might lead to re-exposure, the IASB representative conveyed that, as per its due process, before the Standard's finalisation, the IASB will consider if a re-exposure is needed. So far there were no indications that this may occur.
- 2 Some members considered that the direct (no direct) concept was a pragmatic approach to solving the concerns raised during stakeholders' feedback to the 2021 IASB ED. A member noted that the concept could be seen as a practical expedient related to minor items. It was also noted that there is a need to ascertain the extent to which there could be challenges in reliably measuring the regulatory assets (liabilities) that were not being recognised.
- 3 However, several members noted that the fact that the assessment of whether an entity is direct (no direct) depends on the entity's ability to reconcile accounting balances with regulatory balances may result in earnings management and put some pressure on auditors. They expressed unease that the determination of whether to recognise some regulatory assets (liabilities) would depend on the ability to reconcile. It also raised questions on the implications/pressures of disclosures.
- 4 Questions were raised on the level at which reconciliations between accounting balances and regulatory balances should be made. If the reconciliation is made on a group of assets level it should be easier than if it is made on an individual asset level. Also, the reconciliation could be made at the consolidated financial statements level, which would take into account business combinations, or at the individual financial statements level.
- 5 A member indicated that if an entity concludes that there is no direct relationship between its PPE and its regulatory capital base, it should revisit its regulatory agreement to ensure that the regulatory assets and the regulatory liabilities are enforceable assets and obligations that will add or deduct an amount in determining the regulated rate.
- 6 A member suggested that EFRAG should further assess to understand why European entities that claim to have no direct regulatory agreements cannot measure regulatory assets and regulatory liabilities (i.e. whether it is a matter of reliability or it is something else) and quantify the impact. He noted that regulation may change in the future to be closer to the Totex regulation prevailing in the US and the forthcoming IFRS Standard should stand the test of time.
- 7 A member questioned whether an entity would be allowed to change from the direct to the no-direct approach or vice versa and the IASB's next steps on hybrid regulatory agreements. On this matter, another member noted that a way forward could be to have part of the regulatory scheme in the scope of the Standard and part outside of the scope.
- 8 A member suggested that an entity that has a 'no direct' relationship between its PPE and its regulatory capital base could provide qualitative disclosures if it cannot provide quantitative disclosures.