STAFF PAPER

October 2021

IASB® meeting

Project	**Rate-regulated Activities**
Paper topic	Feedback summary—Total allowed compensation

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Objective

1. This paper analyses the feedback from comment letters and outreach events on the proposed concept of total allowed compensation set out in the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Question 3 of the Invitation to Comment).

Key messages

2. Most respondents agreed with the proposed requirement for regulatory returns applied to a base, such as the regulatory capital base, to form part of total allowed compensation for goods or services supplied in the same period that a regulatory agreement entitles an entity to add them in the regulated rates charged to customers.

3. Some respondents agreed with the proposal for an entity to reflect returns on an asset not yet available for use in the period when the asset is being used to supply goods or services to customers. However, most respondents disagreed. According to these respondents, the proposals would:

   (a) not reflect the economic substance of the regulatory agreements;

   (b) not result in useful information;

   (c) be costly to implement; and

(d) be inconsistent with US generally accepted accounting principles (GAAP).

4. In outreach during the comment period, most users said entities should reflect returns on assets not yet available for use in the statement of financial performance during the construction phase.

5. Most respondents agreed that performance incentives should form part of or reduce the total allowed compensation for goods or services supplied in the period in which an entity's performance gives rise to the incentive. A few accounting firms raised concerns about the practical difficulties that entities may face when measuring regulatory assets or regulatory liabilities associated with performance incentives that test entities' performance across multiple reporting periods.

6. Many respondents agreed with the proposed guidance on profit margins on allowable expenses and regulatory interest income and regulatory interest expense.

7. However, views were mixed on the proposed guidance on amounts that recover allowable expenses minus chargeable income. While many agreed with the proposals, many others—mainly preparers in Europe and Asia-Oceania subject to allowance-based regulatory schemes—disagreed. These respondents particularly disagreed with the proposed guidance on depreciation expenses.

8. The proposals aim to link the recognition of compensation arising from the regulatory depreciation to the depreciation expense recognised in accordance with IFRS Standards. The application of the proposals to allowance-based regulatory schemes would lead, according to these respondents, to the recognition of regulatory assets and regulatory liabilities that would:

(a) not reflect an entity's rights and obligations arising from their regulatory agreements;

(b) neither meet the proposed regulatory asset and regulatory liability definitions in the Exposure Draft nor the asset and liability definitions in the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*);

(c) not result in useful information; and

(d) be costly to account for.

9. A few accounting firms said that further guidance is needed to apply the concept of total allowed compensation to allowance-based regulatory schemes.

Structure of the paper

10. The feedback received on the proposed definitions of regulatory assets and regulatory liabilities is structured as follows:
    (a) Question 3(a)(i)—Regulatory returns applied to a base, such as the regulatory capital base (paragraphs 12–15);
    (b) Question 3(a)(ii)—Regulatory returns on assets not yet available for use (paragraphs 16–56);
    (c) Question 3(a)(iii)—Performance incentives (paragraphs 57–63);
    (d) Question 3(b)—Other components of total allowed compensation (paragraphs 64–81); and
    (e) Question 3(c)—Need for additional guidance (paragraphs 82–87).

11. The Appendix to this paper summarises the regulatory approaches commonly used for regulatory returns on assets not yet available for use in different jurisdictions and the corresponding effects of the proposals for entities subject to these regulatory approaches.

Question 3(a)(i)—Regulatory returns applied to a base, such as the regulatory capital base

Proposed requirements

12. Paragraphs B13–B14 of the Exposure Draft propose that regulatory returns applied on a base, such as the regulatory capital base[1], that a regulatory agreement entitles an entity to add in determining a regulated rate for goods or services supplied in a period

[1] Regulatory asset base (RAB) or regulatory asset value (RAV) are also terms commonly used by regulatory agreements to refer to the regulatory capital base (RCB).

should form part of the total allowed compensation for goods or services supplied in the same period.

Summary of comments received

13. The Board asked stakeholders whether they agree with the proposed requirement in paragraphs B13–B14 of the Exposure Draft.

14. Most respondents agreed that regulatory returns applied to a base, such as the regulatory capital base, should form part of total allowed compensation for goods or services supplied in the same period that a regulatory agreement entitles an entity to add them in the regulated rates charged to customers.

15. A few respondents—mainly a few standard-setters in Asia-Oceania and Europe and a few accounting firms—said it was unclear how the proposals dealt with inflation adjustments reflected in either the regulatory returns or the regulatory capital base. Some of these respondents said the final Standard should made clearer that any accrued inflation that an entity is entitled to recover through increased rates in the future should be considered a regulatory asset.

Question 3(a)(ii)—Regulatory returns on assets not yet available for use

Proposed requirements

16. Paragraph B15 of the Exposure Draft proposes that:

    (a) regulatory returns on an asset not yet available for use should form part of total allowed compensation for goods or services supplied once the asset is available for use and over the remaining periods in which the entity recovers the carrying amount of the asset through the regulated rates; and

    (b) an entity uses a reasonable and supportable basis in determining how to allocate the return on that asset over those remaining periods and it applies that basis consistently.

17. The Board concluded that the proposal in paragraph B15 is consistent with the principle underlying the model because no goods or services are being supplied using an asset before it is available for use.[2]

Summary of comments received

18. The Board asked stakeholders whether they agree with the proposed requirement in paragraph B15 of the Exposure Draft.

19. Many of the respondents used the term ‘construction work in progress’ to refer to ‘assets not yet available for use’ and the term ‘construction period’ to refer to the period in which the assets are not yet available for use. The remainder of this section also uses this terminology.

20. Some respondents—mainly a few accountancy bodies in Africa, a few securities regulators in Europe, Latin America and Africa and a few national standard-setters in Europe and Latin America—agreed with the proposals. A few of these respondents said:

    (a) reflecting returns on construction work in progress in profit or loss when the asset is used to supply goods or services (and consumed through depreciation) would result in a faithful representation of profit patterns particularly for entities that have material, long-duration construction work in progress; and

    (b) the proposals would result in comparability across entities regardless of the regulatory approach followed by the regulator (see Appendix).

21. However, most respondents disagreed with the proposals because, in their view, the proposals:

    (a) do not reflect the economic substance of the regulatory agreements (paragraphs 23–32);

    (b) would not result in useful information for users of financial statements (paragraphs 33–35);

[2] The underlying principle of the model in the Exposure Draft is that an entity shall reflect the total allowed compensation for goods or services supplied as part of its reported financial performance for the period in which those goods or services are supplied.

(c) would result in high costs to implement (paragraphs 36–39);

(d) are not aligned with the proposed treatment for construction related performance incentives (paragraphs 40–42);

(e) create tension with paragraph B4 of the Exposure Draft (paragraphs 43–47); and

(f) would be inconsistent with US generally accepted accounting principles (GAAP)—(paragraphs 48–53).

22. A few respondents provided some suggestions for the Board's consideration (paragraphs 54–56).

Proposals do not reflect the economic substance of the regulatory agreements

23. Many respondents said that the proposals would not reflect the economic substance of the regulatory agreements because the proposals:

(a) fail to portray the rights to which regulatory agreements entitle entities for regulatory returns on construction work in progress during the construction period (paragraphs 25–28); and

(b) view construction work in progress as stand-alone assets which earn a return for the goods or services they supply while in operation (paragraphs 29–32).

24. These respondents said that the Exposure Draft proposals would:

(a) result in the provision of information that is not relevant and which would not meet the objective of the Exposure Draft.[3]

(b) would be contrary to the underlying principle that an entity reflects total allowed compensation for the goods or services supplied in the period (paragraph 32).

25. Many preparers with regulatory agreements subject to a 'rate base' approach said that in several jurisdictions, entities are entitled by law to obtain a regulatory return for the

[3] The objective of the Exposure Draft is for an entity to provide relevant information that faithfully represents how regulatory income and regulatory expense affect the entity's financial performance, and how regulatory assets and regulatory liabilities affect its financial position.

capital invested during the construction phase of the assets and to charge it to customers during that phase (see Appendix).

26. Some of these respondents—mainly preparers and national standard-setters in Europe—also said the regulatory liability that would arise when regulatory returns on construction work in progress are included in rates charged during the construction period would not meet the definition of a liability. This is because, according to these respondents, entities in receipt of returns on construction work in progress have no legal or economic obligation to reduce future rates either in the form of cash outflows or lower cash inflows. According to these respondents:

    (a) the returns on construction work in progress compensate entities for investing in approved capital projects during the construction period; and

    (b) an obligation to transfer economic resources does not arise even if the construction of the asset is not completed or assets are abandoned—ie entities' entitlement to the regulatory returns on construction work in progress is not dependent on whether goods or services are supplied to customers using the completed assets.

27. Some respondents with regulatory agreements subject to the 'allowance for funds used during construction (AFUDC)' approach said that this allowance represents an amount that the regulators approve to form part of the costs of the assets during the construction period. This amount typically includes a return for debt and a return for equity. Under this approach, an entity would be entitled to recover these returns in the rates charged to customers when the assets are available for use (see Appendix).

28. According to these respondents, the proposals would not reflect the entities' right to the regulatory returns on construction work in progress in the construction period. These respondents thought that right would meet the asset definition because:

    (a) entities have an enforceable right in accordance with the regulatory agreement to include the AFUDC amount in the rates charged in the future;

    (b) the right that has the potential to generate economic benefits and results from a past event—ie the construction work and the provision of funds during the construction period (paragraph 31); and

(c) entities control that right because they have the enforceable present right to include those amounts in the future rates and obtain the corresponding economic benefits.

29. Many respondents—primarily preparers in Europe and Asia-Oceania and a few national standard-setters in Europe—noted that the Exposure Draft views construction work in progress as stand-alone assets. However, according to these respondents, regulatory agreements generally treat construction work in progress as part of an entity's wider network. These respondents said:

(a) in some cases, regulatory agreements include construction work in progress in entities' regulatory capital base and entitle them to regulatory returns on their entire regulatory capital base, without linking the returns to individual assets. Consequently, goods or services supplied are often not directly linked to a specific asset. Instead, goods or services are supplied by the wider network on which entities earn a return.

(b) regulatory agreements are primarily concerned with entities achieving outcomes, relating to the provision of services, using the wider network. According to these respondents, entities' entitlement to regulatory returns on construction work in progress is *not* conditional on individual assets becoming operational.

30. These respondents questioned the appropriateness of the proposals which, according to them:

(a) would result in the allocation of returns to individual assets under construction, which would be costly (paragraph 36).

(b) aim to match regulatory returns (ie revenue) with IFRS expenses (ie depreciation expense incurred when the asset is in use).

31. Many respondents—mainly preparers and national standard-setters across different jurisdictions—said regulatory returns on construction work in progress compensate entities for fulfilling the following obligations during the construction period:

(a) the construction of the assets—continuous investment in the network infrastructure to ensure reliable, secure and efficient supply of goods or services to customers.

(b) the provision of capital (debt and equity) to fund investment in the network.

32. These respondents argued the obligations in paragraph 31 are the goods or services supplied to customers during the construction period. Consequently, they suggested that reflecting regulatory returns on construction work in progress in profit or loss during the construction period would be consistent with the underlying principle of the Exposure Draft, which is to reflect in the statement of financial performance the total allowed compensation for goods or services supplied during that period (paragraph 24).

Proposals would not result in useful information for users of financial statements

33. Many respondents—mainly preparers and national standard-setters in Europe and North America—said that the proposals would not result in useful information and could potentially confuse users of financial statements, because:

(a) entities' performance during the construction period would be understated, which could be concerning for businesses with high levels of investment. Conversely, recognising regulatory returns on construction work in progress during the operating period would overstate the returns authorised by the regulators during that period.

(b) during the construction period the proposals would not provide users of financial statements with information to assess future cash flows arising from returns on construction work in progress. Users of financial statements would have to obtain this information from other sources to help them assess credit quality and project future cash flows.

(c) the proposals may result in entities developing new, alternative performance measures.

(d) the proposals may affect decision making of investors and lenders because the timing of cashflows is very important when evaluating an entity's ability to distribute dividends and/or make interest payments.

34. Most of the users from whom we received feedback during the comment period said entities should reflect returns on construction work in progress in the statement of financial performance during the construction phase. To support their views, these users gave similar reasons to those described in paragraph 33.[4]

35. A national standard-setter in North America suggested that entities should be required to disclose information about the returns on construction work in progress that the entity has the right to include in the rates charged once the asset is in operation.

High implementation costs

36. Many respondents—mainly preparers in Europe and Asia-Oceania and national standard-setters in Europe—said the proposals would be costly to implement for entities subject to the rate base regulatory approach because:

(a) it will require entities to separate assets that are under construction from the rest of the regulatory capital base. For many entities, this will impracticable and/or entail complex calculations (paragraphs 73–74);

(b) regulatory agreements generally do not attribute regulatory returns to single assets but rather provide a return on the wider network (paragraph 29). According to these respondents, attributing regulatory returns to individual assets would be costly as it would require an entity to:

(i) allocate returns at a single asset level and record information not currently required by regulators;

(ii) track the release of the regulatory liability over the periods in which the entity recovers the carrying amount of the asset—recovery periods are typically long, which complicates this process; and

(iii) reconcile accounting and regulatory bases.

[4] Feedback from users of financial statements is included in AP9 Feedback summary—Overview.

According to these respondents, this process will be particularly challenging for entities with high volumes of assets under construction.

37. A few accounting firms and a national standard-setter in North America said that the costs of implementing the proposals for entities subject to the allowance for funds used during construction regulatory (AFUDC) approach would also be high. According to these respondents, the proposals would require entities to:

(a) track differences between the way assets are treated for regulatory purposes and the way they are treated for accounting purposes. For some entities (for example, entities applying IFRS Standards to their consolidated financial statements who have subsidiaries applying US GAAP), this may require them to maintain three sets of asset records—US GAAP, IFRS and a regulatory set.

(b) implement system changes to track the approved regulatory returns so that they can be allocated using a reasonable and supportable basis over the remaining periods in which the entity recovers the carrying amount of the asset through the regulated rates.

38. Some respondents, mainly preparers in Europe, said that determining the opening balances of regulatory assets and regulatory liabilities on first-time adoption of the proposed requirements in paragraph B15 of the Exposure Draft would be costly. This is because it would require entities to collect data to calculate the opening balances that in some cases is unavailable. According to these respondents, the proposed retrospective transitional requirements would involve a high degree of subjective estimation and costs.[5]

39. A few respondents, mainly preparers in Europe, thought that the costs and efforts to implement the proposals would far outweigh the usefulness of the information that users of financial statements would receive.

5 A paper summarising the feedback received on effective date and transition will be discussed at the November 2021 Board meeting.

Lack of alignment with the proposed treatment for construction related performance incentives

40. Many respondents said that the proposals for returns on construction work in progress seem to be inconsistent with the proposed treatment for construction related performance incentives in paragraph B18 of the Exposure Draft. The Exposure Draft proposed that performance incentives, including incentives for performing construction work, form part of or reduce the total allowed compensation for goods or services supplied in the period in which the entity's performance gives rise to the incentive.

41. These respondents were of the view that the arguments that the Board used for proposing the recognition of construction related performance incentives during the construction period (paragraph 58) are equally valid for returns on construction work in progress. Consequently, these respondents recommended the final Standard aligns the treatment of returns on construction work in progress with that for construction related performance incentives.

42. An accounting firm suggested that the lack of alignment between the proposed treatments for returns on construction work in progress and construction related performance incentives could result in changes to regulatory agreements to increase the prevalence of construction related performance incentives. This is because, according to this respondent, the proposed requirements in paragraphs B15 and B18 of the Exposure Draft result in different accounting outcomes for economically similar situations.

Tension with paragraph B4 of the Exposure Draft

43. A national standard-setter in Europe and an accounting firm said the interaction between paragraphs B4 and B15 of the Exposure Draft was unclear.

44. Paragraph B4 of the Exposure Draft says (**emphasis added**):

> If an expense is allowable under the terms of a regulatory agreement, that fact establishes that the expense relates to the supply of goods or services in some period. In applying this [draft] Standard**, an entity shall treat that allowable expense as relating to the supply of goods or services in the period**

> **when the entity recognises the expense applying IFRS Standards**. Thus, the amount that recovers that allowable expense forms part of total allowed compensation for goods or services supplied in that period. […]

45. The national standard-setter said that an entity may incur expenses that are allowable, for example, overheads that the entity expenses when constructing an asset. According to this respondent, the entity could reach different conclusions depending on whether it applies paragraph B4 or paragraph B15 of the Exposure Draft to those expenses. Applying paragraph B4, the entity recognises a regulatory asset for the overheads as they are an allowable expense. However, applying paragraph B15, the entity may conclude the overheads should not form part of total allowed compensation for the period as they were incurred when the asset was not yet available for use.

46. The national standard-setter and the accounting firm recommended the approach specified in paragraph B4 of the Exposure Draft should prevail.

47. Another accounting firm, however, questioned the application of paragraph B4. According to this respondent, the application of paragraph B4 could give rise to regulatory assets that are not directly linked to the supply of goods or services to customers which, according to their view, may bring the model in the Exposure Draft closer to a cost-deferral approach.

Inconsistency with US GAAP

48. In some jurisdictions such as Canada and the United States (US), the regulatory returns on construction work in progress typically accumulate while the asset is being constructed and are included in the regulated rates charged to customers only once the asset is in operation (AFUDC regulatory approach—see Appendix).

49. In those cases, Accounting Standards Codification (ASC) 980 *Regulated Operations* would require entities to capitalise the regulatory returns—typically debiting property, plant and equipment and crediting income—if its recovery through the regulated rates is probable.

50. Regulatory returns generally include both, a debt and an equity component. During the construction period, entities would incur interest expense. For these entities, the recognition in the statement of financial performance of the regulatory returns on construction work in progress would offset their interest expense. Consequently, the net effect in income of entities capitalising the regulatory returns would mainly consist of the equity component of the regulatory returns capitalised.

51. Applying the proposals, an entity would not capitalise the regulatory returns (as a regulatory asset) while the asset is being constructed. Consequently, the statement of financial performance of these entities would not reflect the equity component of the regulatory returns on construction work in progress.

52. Some respondents—mainly preparers in North America and Europe and a national standard-setter in North America—highlighted this difference with US GAAP. Some of these respondents asked the Board to reconsider the proposals because:

    (a) regulatory returns on construction work in progress are a stream of income that is well-understood by a wide range of stakeholders (eg shareholders, regulators, debtholders, lenders, credit rating agencies and analysts);

    (b) the recognition of regulatory returns during the construction period can have a material impact on entities' profit or loss; and

    (c) the proposals would result in a loss of comparability with peer companies applying US GAAP. This could result in entities providing non-GAAP financial measures to enable users of financial statements to compare entities applying IFRS Standards with those applying US GAAP.

53. Some of the users from whom we received feedback during the comment period said alignment between IFRS Standards and US GAAP in this area is important. These users used similar reasons to those described in paragraph 52.[6]

[6] Feedback from users of financial statements on the proposals is included in AP9 Feedback summary—Overview.

Some suggestions for the Board's consideration

54. A few national standard-setters in Europe and Asia-Oceania said the proposals should first require entities subject to rate regulation to identify performance obligations, similar to IFRS 15, arising from their regulatory agreements. These performance obligations may not just entail the supply of goods or services to customers but, for example, investing in infrastructure and providing capital. According to these respondents, the performance obligations will depend on the regulatory agreements and may be different in different jurisdictions.

55. A few national standard-setters in North America and Asia-Oceania thought that a similar approach to that used in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* may be helpful for determining when an entity should recognise regulatory returns on construction work in progress. According to these respondents, an entity applying IAS 20 would consider the intent of the grant or its prescribed conditions for determining when to recognise it. When considering returns on construction work in progress, these respondents thought the fact that these returns compensate an entity for carrying out investments and providing corresponding funds during the construction period should help in making the determination for when to recognise them.

56. A preparers' representative group in North America said that the proposals could be improved by analysing the service entities provide to their customers. According to this respondent, in addition to operating the assets, entities also plan for, construct and decommission assets. This respondent said that the recognition of returns on construction work in progress during the construction period may be done by:

    (a) defining the period over which goods or services are provided more broadly; or

    (b) amending IAS 23 *Borrowing Costs* so that the capitalised interest on assets under construction could be calculated based on the full amount of authorised regulatory returns.

Question 3(a)(iii)—Performance incentives

Proposed requirements

57. Paragraphs B16–B20 of the Exposure Draft propose that amounts relating to a performance incentive form part of or reduce the total allowed compensation for goods or services supplied in the period in which an entity's performance gives rise to the incentive. The Exposure Draft proposes the same treatment for construction related performance incentives.

58. In paragraphs BC103–BC105 of the Basis for Conclusions on the Exposure Draft, the Board acknowledged that the proposed treatment for construction related performance incentives would arguably not align with the principle underlying the model, because the asset is still being constructed and thus is not yet available for use. The Board however concluded that aligning the treatment of incentives for construction related incentives with the treatment of all other performance incentives would:

    (a) provide more useful and understandable information than applying different approaches for different types of performance incentives; and

    (b) avoid unnecessary costs because an entity would not need to develop and implement different policies and processes for different types of performance incentives nor would it need to determine which incentives relate to performing construction work and which do not.

59. The Exposure Draft proposes that if the performance criteria test an entity's performance over a time frame that is not yet complete, the entity should estimate the amount of the performance incentive and determine the portion of that estimated amount that relates to the reporting period. That portion forms part of or reduces the total allowed compensation for the goods or services supplied in the reporting period. An entity should use a reasonable and supportable basis in determining that portion and apply that basis consistently.

Summary of comments received

60. The Board asked whether stakeholders agreed with the proposed guidance on how an entity should determine total allowed compensation for goods or services supplied in a period if a regulatory agreement provides performance incentives.

61. Most respondents agreed with the proposals for performance incentives, including the treatment for construction related performance incentives. A few European preparers said the proposals were appropriate and aligned to the regulatory agreements.

62. A few respondents raised concerns or qualified their support for the proposals:

    (a) an accounting firm agreed with the proposed treatment for construction related performance incentives only in situations when the construction works are a performance obligation in accordance with IFRS 15. This respondent is of the view that performance incentives should only form part of total allowed compensation in those periods in which goods or services are supplied to customers.

    (b) an intergovernmental body in Asia-Oceania expressed the concern that the proposals may result in performance incentives being recognised earlier than if the requirements of other IFRS Standards had been applied. This respondent questioned the benefit of the proposals in those cases when the likelihood of recoverability of the performance incentives amounts is relatively low; and

    (c) a European preparer said that in some cases the terms of the regulatory agreements are vague and the regulator exercises discretion affecting the measurement and determination of performance incentives. In those circumstances, this respondent thought the assessment of whether rights and obligations are enforceable is challenging and recommended the final Standard provides further guidance on this matter.

63. A few respondents raised concerns about the accounting for performance incentives that test entities' performances across multiple reporting periods:

    (a) a few preparers in Asia-Oceania and Europe said that the right to a bonus, or obligation for a penalty, would only arise after the performance criteria have been met, or failed to be met, at the end of the performance period. According to these respondents, the recognition of a performance incentive before the performance period is ended would:

(i) not represent a right, or an obligation, arising from the regulatory agreement; and,

(ii) not meet the definition of a regulatory asset or a regulatory liability in the Exposure Draft.

These respondents also said that the recognition of such regulatory assets and regulatory liabilities may be prejudicial to discussions to be held with the regulators.

(b) a preparer in Europe agreed with the comment in paragraph 63(a) in the case of long-term bonuses. However, in the case of long-term penalties, this respondent was of the view an entity should recognise them in the period the entity concludes the penalty is likely and its value can be estimated reliably.

(c) a few accounting firms said that entities may have practical difficulties in measuring reliably regulatory assets or regulatory liabilities associated with performance incentives that test entities' performance across multiple reporting periods. These respondents recommended the Board provides additional guidance about how an entity estimates the amount of the performance incentive and determines the portion of that estimated amount that relates to the reporting period. These respondents recommended the Board considers introducing:

(i) a constraint for the recognition of regulatory income or regulatory expense similar to the constraint in IFRS 15 *Revenue from Contracts with Customers* for variable consideration.

(ii) methods for measuring an entity's progress as required in IFRS 15, including the safeguards regarding the availability of reliable information to make that estimate.

Question 3(b)—Other components of total allowed compensation

Proposed requirements

64. The Exposure Draft proposes that:

    (a) amounts that recover allowable expenses minus chargeable income should form part of total allowed compensation in the period when an entity recognises the expense or income by applying IFRS Standards (paragraphs B3–B9 of the Exposure Draft).

    (b) profit margins on allowable expenses should form part of total allowed compensation in the period when an entity recognises the expense by applying IFRS Standards (paragraph B12 of the Exposure Draft).

    (c) regulatory interest income and regulatory income expense should form part of total allowed compensation as the discount unwinds until recovery of the regulatory asset or fulfilment of the regulatory liability (paragraphs B21–B27 of the Exposure Draft).

Summary of comments received

65. The Board asked whether stakeholders agreed with the proposed guidance in paragraphs B3–B9, B12 and B21–B27 of the Exposure Draft.

66. Many respondents agreed with the proposed guidance. No significant concerns were raised about the proposed treatment of:

    (a) profit margins on allowable expenses (paragraph B12); and

    (b) regulatory interest income and regulatory income expense (paragraphs B21–B27).

67. However, many respondents disagreed with the proposed guidance on allowable expenses minus chargeable income in paragraphs B3–B9 of the Exposure Draft.

68. The main reasons for disagreement with paragraphs B3–B9 of the Exposure Draft were:

    (a) the definition of allowable expense (paragraphs 69–71);

(b) regulatory assets and regulatory liabilities arising from differences between assets' regulatory recovery pace and their useful lives (paragraphs 72–79); and

(c) other items (paragraphs 80–81).

Definition of allowable expense

69. A few respondents—a few European preparers and a few national standard-setters in Europe and Asia-Oceania—disagreed with the definition of allowable expense proposed in the Exposure Draft. The Exposure Draft defines allowable expense as 'an expense, as defined in IFRS Standards, that a regulatory agreement entitles an entity to recover by adding an amount in determining a regulated rate'.

70. These respondents said that regulatory agreements may use a basis different from IFRS Standards for the measurement of allowable expenses. According to these respondents, determining allowable expenses by reference to the regulatory agreement rather than IFRS Standards would better reflect the compensation to which entities are entitled. Determining allowable expenses based on IFRS Standards would, according to these respondents, cause complexity for preparers and provide information that would be difficult for users of financial statements to understand.

71. Some of these respondents have labelled the differences that would arise between the regulatory and the accounting measurement bases as 'permanent differences'. These respondents did not think these differences should be accounted for as regulatory assets or regulatory liabilities. This is because, according to these respondents, these differences do not represent enforceable present rights or enforceable present obligations to adjust the rates in the future. These respondents recommended the final Standard considers allowable expenses by reference to the regulatory agreement.

Regulatory assets and regulatory liabilities arising from differences between assets' regulatory recovery pace and their useful lives

72. Some respondents—mainly preparers in Europe and Asia-Oceania—disagreed with the guidance in paragraphs B6–B8 of the Exposure Draft and some of the illustrative examples accompanying the Exposure Draft. The guidance and, particularly, the examples show how regulatory assets or regulatory liabilities arise because of

differences between the period that the regulatory agreements permit an entity to recover an asset (the regulatory recovery pace) and assets' useful life.

73. The main reason for their disagreement is that, according to these respondents, the proposals are not aligned with regulatory agreements that set an 'allowed revenue' amount to which entities are entitled during a price determination period.

74. According to these respondents, that 'allowed revenue' amount is made of different components. One of these components is the regulatory depreciation, which is set as a fixed proportion of an entity's regulatory capital base.

75. According to these respondents, an entity's regulatory capital base is not a regulatory asset register that can be linked or reconciled to the fixed asset register used for accounting purposes because:

(a) the asset classes in the regulatory capital base and corresponding recovery periods are different to the asset classes and useful lives in the accounting asset register.

(b) regulatory capital base is adjusted for inflation annually, whereas fixed assets are measured mainly at cost for accounting purposes.[7]

(c) regulatory capital base may include items that would not qualify for capitalisation under IAS 16 *Property, Plant and Equipment* (eg bonuses and penalties and operating expenditures). In addition, costs capitalised for accounting purposes may not have been included in the regulatory capital base (eg contributed assets).

(d) fair value adjustments made to the accounting cost base due to business combinations may not have been included in the regulatory capital base.

76. According to these respondents, and any attempt to analyse the regulatory capital base as if it was a regulatory asset register would be highly subjective, complex and costly.[8] Consequently, according to these respondents, regulatory depreciation cannot be compared to accounting depreciation.

[7] According to some respondents, public sector companies in the water industry in Australia measure property, plant and equipment at fair value.

[8] A few preparers in the water industry in Europe said the initial values of the regulatory capital base had been set at entities' market values at the time these entities were privatised.

77. For these respondents, the recognition of revenue for allowance-based regulatory schemes should be based on an entity's regulatory agreement and not based on when related costs are recognised in accordance with IFRS Standards. Consequently, for these respondents:

(a) total allowed compensation should be limited to the 'allowed revenue' amount plus any pass-through adjustments and performance incentives.

(b) differences between regulatory and accounting depreciation would not give rise to assets or liabilities that would meet the proposed definitions of regulatory assets and regulatory liabilities because an entity does not have enforceable rights or enforceable obligations to adjust the rates in the future. A regulator in Asia-Oceania and a European standard-setter said that such regulatory assets or regulatory liabilities would not meet the definitions of assets and liabilities in the *Conceptual Framework* (Agenda Paper 9B).

(c) the proposals would not result in useful information to users of the financial statements, who would need further information via increased use of alternative performance measures.

78. A few of these respondents said that their users (debt providers, lenders, equity investors, rating agencies and market analysts) do not focus on differences between the regulatory capital base's recovery period and the assets' useful lives because the allowed revenue and, ultimately, future cash flows of the businesses are determined based on entities' regulatory capital base and not based on accounting balances. A respondent representing a group of preparers in the electricity sector in Asia-Oceania suggested requiring disclosures such as a reconciliation of the opening to closing regulatory capital base including average useful lives. According to this respondent, this would result in more useful information to users of the financial statements than recognising the proposed regulatory assets and regulatory liabilities.

79. A few respondents—mainly preparers and a regulator in Asia-Oceania—said that entities in the public sector may carry their assets at fair value. These respondents thought it would be useful if the final Standard provides examples illustrating how the model would work if assets are measured at fair value. A few of these respondents

thought having assets measured the fair value could exacerbate the practical challenges of trying to link accounting depreciation to regulatory depreciation.

Other items

80. A few respondents—a preparer and a few national standard-setters in Europe—said it is not clear how expenses that are allowable based on benchmark figures from a peer group of companies should be treated. These respondents wondered:

(a) whether an entity should recognise any regulatory assets or regulatory liabilities by estimating the actual expenses of its peers or whether it should wait until the regulator approves the benchmarked expenses reported by the peer group for the period.

(b) what part of the regulated revenue should be seen as compensation for allowable expenses and what part should be seen as an incentive.

81. A national standard-setter in Asia-Oceania said that regulatory assets and regulatory liabilities arising from quantity variances are likely to be the most easily understood differences in timing and thought they should be explained in the application guidance rather than in the illustrative examples.

Question 3(c)—Need for additional guidance

82. The Board asked stakeholders if it should provide any further guidance on how to apply the concept of total allowed compensation.

83. Some respondents mentioned further guidance was needed in the following areas:

(a) how the proposals apply to allowance-based schemes (paragraph 84);

(b) interaction between components of total allowed compensation (paragraph 85);

(c) expenses becoming allowable by reference to local GAAP (paragraph 86); and

(d) derecognition of regulatory liability (paragraph 87).

Allowance-based schemes

84. A few accounting firms said that further guidance is needed to apply the concept of total allowed compensation to regulatory schemes that are based on an 'allowed revenue' amount or other formula-based models. According to one of these respondents, it is unclear whether differences between the period that the regulatory agreements permit an entity to recover the assets in the regulatory capital base and the assets' useful lives would give rise to regulatory assets and regulatory liabilities for entities subject to allowance-based schemes.

Interaction between components of total allowed compensation

85. A preparer and a few standard-setters in Europe said the final Standard should provide further clarity when components of total allowed compensation overlap. For example, allowable expenses or performance incentives (eg bonuses) may be recovered by being added to an entity's regulatory capital base on which a return is earned as part of target profit. According to these respondents, it is not clear whether such items should be carved out from the regulatory capital base and be treated as separate and distinct regulatory assets.

Expenses becoming allowable by reference to local GAAP

86. A few accounting firms and a few standard-setters in Europe said that, in some cases, regulatory agreements consider that expenses become allowable when they are recognised in accordance with local GAAP. These respondents thought the final Standard should clarify how differences in timing would be determined in these cases (see Agenda Paper 9G).

Derecognition of regulatory liability

87. A European national standard-setter said it is unclear whether a regulatory liability for returns on construction work in progress should be derecognised if the construction of the related asset is discontinued and the asset written off.

Question for the Board
Does the Board have any questions or comments on the feedback discussed in this paper? Specifically: a. Is there any feedback that is unclear? b. Are there any points you think the Board did not consider in developing the Exposure Draft but should consider in the re-deliberations? c. Are there any points you would like staff to research further for the re-deliberations?

Appendix—Regulatory approaches for regulatory returns on construction work in progress[9]

A1. This table summarises the two most commonly used regulatory approaches for regulatory returns on construction work in progress—Rate base approach and 'Allowance for funds used during construction'—and the corresponding effects of the proposals for entities subject to these regulatory approaches.

Regulatory approach	Rate base	Allowance for funds used during construction (AFUDC)
Description	Regulatory returns are included in the regulated rates charged to customers during periods when the asset is being constructed.	Regulatory returns accumulate while the asset is being constructed and are included in the regulated rates charged to customers only once the asset is in operation.
Jurisdictions	Asia-Oceania (Australia, Hong Kong), Europe (Austria, Germany, Italy, The Netherlands, United Kingdom)	North America (Canada and United States)
Current accounting	These returns are recognised in revenue as they are included in the rates charged to customers during the construction period.	Entities applying US GAAP or local GAAP based on US GAAP[10] capitalise the AFUDC amount during the construction period. Because entities incur interest expense, the net effect of this capitalisation in profit or loss would typically be the equity component of AFUDC—see paragraphs 49–50 of this paper.

9 Source: input obtained from outreach carried out during the comment period of the Exposure Draft and feedback included in comment letters received.

10 This would also include entities currently applying IFRS 14 *Regulatory Deferral Accounts* that account for regulatory deferral account balances in accordance with their previous GAAP that is US GAAP or a GAAP based on US GAAP.

Regulatory approach	**Rate base**	**Allowance for funds used during construction (AFUDC)**
Effect of the proposals	The proposals would require entities to account for these regulatory returns as a regulatory liability (debiting regulatory expense) during the construction period. Once the asset is in operation, the entity would fulfil the regulatory liability and recognise regulatory income over the remaining periods the entity recovers the carrying amount of the asset.	Entities would *not* recognise a regulatory asset for approved AFUDC amounts during the construction period. The proposals would require entities to recognise the AFUDC amounts in profit or loss as they are included in the rates charged to customers during the operation of the asset—see paragraph 51 of this paper.