
IASB[®] meeting

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Project	Rate-regulated Activities
Topic	Proposed definition of allowable expense and benchmark expenses
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Objective

1. This paper sets out staff analysis and recommendations about the proposals for allowable expense in the Exposure Draft [Regulatory Assets and Regulatory Liabilities](#) (Exposure Draft).
2. In particular, this paper focuses on the proposed definition of allowable expense and on benchmark expenses. This paper:
 - (a) summarises feedback received on the proposals;
 - (b) analyses the feedback; and
 - (c) recommends how the final Standard could address stakeholders' concerns about the proposals.

Staff recommendations

3. We recommend the final Accounting Standard:
 - (a) retains the definition of allowable expense proposed in the Exposure Draft;
 - (b) clarifies that a regulatory agreement may determine the amount that compensates for an allowable expense using the same or a different basis from the basis an entity uses for measuring the allowable expense in accordance with IFRS Accounting Standards; and
 - (c) clarifies the treatment of allowable expenses based on benchmarks and includes examples to help entities identify differences in timing in those cases.

Structure of the paper

4. This paper is structured as follows:
 - (a) proposals in the Exposure Draft (paragraphs 5–7);
 - (b) summary of comments received (paragraphs 8–12); and
 - (c) staff analysis (paragraphs 13–29).

Proposals in the Exposure Draft

5. The Exposure Draft defines allowable expense as (**emphasis added**):

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.

6. Paragraph B4 of the Exposure Draft says that that:

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. [...]

7. Many illustrative examples accompanying the Exposure Draft deal with fact patterns in which the regulatory agreements entitle an entity to recover expenses incurred when supplying goods or services (see Illustrative Examples 1, 7A and 7B). These illustrative examples show that regulatory assets or regulatory liabilities arise when part or all of the total allowed compensation for the goods or services supplied in a period is included in regulated rates charged in a different period.

Summary of comments received

8. This section focuses on comments received on:

- (a) the proposed definition of allowable expense (paragraphs 9–11); and
- (b) benchmark expenses (paragraph 12).

Proposed definition of allowable expense

9. Most respondents did not comment on the proposed definition of allowable expense. However, 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’ (paragraph 5).
10. 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.

11. 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.

Benchmark expenses

12. A few respondents—a preparer and a few national standard-setters in Europe—said it is unclear how expenses that are allowable based on benchmark figures from a peer group of companies should be treated. One of these respondents wondered what part of the compensation for expenses that is determined based on benchmark figures should be seen as compensation for allowable expenses and what part should be seen as an incentive.

Staff analysis

13. This section analyses the concerns raised by stakeholders relating to:
 - (a) proposed definition of allowable expense (paragraphs 14–22); and
 - (b) benchmark expenses (paragraphs 23–29).

Proposed definition of allowable expense

14. We have observed that regulatory agreements seek to determine regulated rates that ensure the financial viability of the regulated entity and the quality of the goods or services supplied by that entity. To do so regulated rates are typically determined so that regulated entities earn enough income to cover the costs they incur in supplying goods or services and earn a return.
15. However, we have also learned that regulated rates may not guarantee the recovery of (all) costs incurred when supplying goods or services. In addition, the expenses used to determine regulated rates may be calculated on a different basis to that used for accounting purposes. As a result, stakeholders are concerned that the proposed definition of allowable expense refers to 'an expense, as defined in IFRS Standards' because regulators may not consider the IFRS basis when determining the amount of expenses to be included in the calculation of regulated rates.
16. We think that the qualifier 'allowable' in the term 'allowable expense' together with the expression 'as defined in IFRS Standards' in the proposed definition of this term are potentially confusing. It is the regulatory agreement that determines the type, amount and timing of expenses included in the calculation of regulated rates—that is, it is the regulatory agreement rather than IFRS Standards that determines which expenses are *allowable*. The combination of the qualifier 'allowable' with the

expression ‘as defined in IFRS Standards’ has led some stakeholders to think that only expenses that are determined on the basis of IFRS Accounting Standards would be considered ‘allowable expenses’ by the model.

17. However, paragraph B4 of the Exposure Draft says that (**emphasis added**):

[...] 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.’

18. Paragraph B4 of the Exposure Draft does not require that the amount that provides compensation for an allowable expense be measured on the same basis as that required by IFRS Standards to measure the related expense. The proposals only require that the amount that provides compensation for an allowable expense form part of total allowed compensation for goods or services supplied in the same period the entity incurred the related expense, as defined per IFRS Standards.

19. We think that the final Standard should clarify this point—that is, that the regulatory agreement may determine compensation for an allowable expense using a different measurement basis to that required by IFRS Accounting Standards to measure the related item of expense. This could be achieved either by:

- (a) amending the proposed definition of allowable expense; or
- (b) including the clarification in the application guidance of the final Standard.

20. The IASB could amend the definition of allowable expense to remove the expression ‘as defined in IFRS Standards’ from the proposed definition. Removing this expression could help address the concerns raised by stakeholders (paragraph 15). However, we do not recommend this option. The anchor for entities to assess when the compensation for a related expense needs to be reflected in profit or loss is the period in which an entity has recognised the related expense in profit or loss in accordance with IFRS Accounting Standards. Removing this anchor may give rise to further confusion.

21. Alternatively, the IASB could add the clarification described in paragraph 19 to the proposed definition of ‘allowable expense’. If the IASB decided on this approach it would also need to make a similar change to the proposed definition of ‘chargeable income’.¹ However, we think that adding this clarification to the definition of ‘allowable expenses’ would over complicate the definition. We, therefore, think it would be more appropriate to clarify this matter in the application guidance of the final Standard.

22. Consequently, we recommend the final Standard:

¹ The Exposure Draft proposed to define ‘chargeable income’ as: ‘An item of income, as defined in IFRS Standards, that the regulatory agreement obliges an entity to deduct in determining a regulated rate.’

- (a) retains the definition of allowable expense proposed in the Exposure Draft; and
- (b) clarifies that a regulatory agreement may determine the amount that compensates for an allowable expense using the same or a different basis from the basis an entity uses for measuring the allowable expense in accordance with IFRS Accounting Standards.

Benchmark expenses

- 23. In many cases, the regulated rates charged include amounts that compensate an entity for specific expenses incurred when supplying goods or services in the same period the entity incurred those expenses. In such cases, no differences in timing will arise because the compensation is included in the same period in which the entity recognises the expenses.
- 24. This is true even when the regulatory agreement determines the amounts of compensation using a different measurement basis from that used for measuring the related items of expense in accordance with IFRS Accounting Standards. In these cases, the difference is a difference in measurement bases rather than a difference in timing. As long as the compensation is included in profit or loss in the same period as the related expense, the difference in the measurement bases will be reflected in profit or loss as it arises. Some stakeholders referred to these differences as ‘permanent differences’ (paragraph 11).
- 25. An example of expenses being determined by the regulatory agreement using a different measurement basis from that used in accounting is when the regulatory agreement determines the amount of compensation for an item of expense by considering the expenses of an entity’s peer group (benchmark expenses). The main reason a regulatory agreement will use benchmark expenses to determine the compensation is to incentivise an entity to be more efficient.
- 26. In many cases, the terms of the regulatory agreements would allow an entity to keep the entire difference between the compensation determined on a benchmark basis and the related expenses recognised in accordance with IFRS Accounting Standards. In these cases, the entity would recognise a profit (when the expenses recognised are lower than the benchmark expenses included in the regulated rates charged) or a loss (when the expenses recognised are higher than the benchmark expenses included in the regulated rates charged).
- 27. Paragraph 26 shows there is no need to split the regulatory compensation between the proposed components of total allowed compensation in the Exposure Draft, as suggested by the stakeholder in paragraph 12. That stakeholder was wondering whether an entity should split the compensation for an allowable expense determined on the basis of benchmarks between the amount that recovers the allowable expense and a performance incentive (that is, a performance incentive equal to the difference between the benchmarked amounts included in regulated rates charged and the actual expenses recognised). Such a split would not be necessary because the Exposure Draft proposed that the amounts that compensate an allowable expense form part of the total allowed compensation for goods

or services supplied in the period the entity recognised the related allowable expense. When an entity applies these proposals, it would get the outcomes described in paragraph 26, without the need to split the compensation between the allowable expense and a performance incentive.

28. In other cases, the terms of a regulatory agreement may establish that differences between the benchmarked expenses and an entity's actual expenses would be shared between the entity and its customers. The design of this sharing would depend on the specific regulatory objectives being sought (that is, higher or lower protection for an entity and/or its customers). In these cases, the terms of a regulatory agreement may give rise to differences in timing. For example:
- (a) if an entity's actual expense is lower than the benchmarked expense included in the regulated rates charged, a regulatory agreement may allow the entity to keep 60% of the savings, returning 40% of the savings to customers in two years' time. This means that in the period the entity incurred lower than benchmark expenses, a regulatory liability would arise for the 40% of the savings the entity would need to pass onto its customers in two years' time.
 - (b) if an entity's actual expense is higher than the benchmarked expense included in the regulated rates charged, a regulatory agreement may require the entity to bear 60% of the difference, allowing the entity to recover from customers only 40% of the difference in two years' time. This means that in the period the entity incurred higher than benchmark expenses, a regulatory asset would arise for the 40% of the difference between actual and benchmarked expense that the entity would be entitled to recover from customers in two years' time.
29. We think that, when the regulatory agreement determines the amount that compensates an entity's expenses based on benchmarks, differences in timing would arise from terms in the regulatory agreement that seek a variety of regulatory objectives—that is, the provision of incentives for an entity to achieve efficiency and the provision of financial protection to both customers and the entity. In those circumstances, an entity would need to assess whether the terms of the regulatory agreement would give rise to differences in timing. To help entities make this assessment, we think the final Standard should include examples similar to those in paragraph 25.

Question for the IASB

Does the IASB agree the final Accounting Standard:

- a. retains the definition of allowable expense proposed in the Exposure Draft (paragraph 22);
- b. clarifies that a regulatory agreement may determine the amount that compensates for an allowable expense using the same or a different basis from the basis an entity uses for measuring the allowable expense in accordance with IFRS Accounting Standards (paragraph 22); and
- c. clarifies the treatment of allowable expenses based on benchmarks and includes examples to help entities identify differences in timing in those cases (paragraphs 23–29).