



STAFF PAPER

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IASB® meeting

Project	Rate-regulated Activities	
Paper topic	Total allowed compensation—Overview	
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Objective

- At the December 2021 meeting, the IASB decided to prioritise the redeliberation of topics related to total allowed compensation. This paper provides an overview of the topics within the total allowed compensation workstream that the staff plan to discuss with the IASB.
- We are not asking the IASB to make decisions on this paper. However, we ask the IASB to comment on any additional matters that the staff may need to consider in the redeliberations of the proposals on total allowed compensation.

Structure of the paper

- This paper is structured as follows:
 - summary of proposals on total allowed compensation (paragraphs 4–17);
 - feedback—summary of key messages (paragraphs 18–33); and
 - redeliberations—topics and timing considerations (paragraphs 34–35).

Summary of proposals on total allowed compensation

4. The Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft) defines total allowed compensation as the full amount of compensation for goods or services supplied that a regulatory agreement entitles an entity to charge customers through the regulated rates, in either the period when the entity supplies those goods or services or a different period.
5. Paragraph 16 of the Exposure Draft proposes that an entity reflects 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.
6. Paragraph B2 of the application guidance of the Exposure Draft states that total allowed compensation comprises:
 - (a) amounts that recover allowable expenses minus chargeable income;
 - (b) target profit, of which main components are:
 - (i) profit margins that vary with an allowable expense;
 - (ii) regulatory returns; and
 - (iii) performance incentives; and
 - (c) regulatory interest income and regulatory interest expense.
7. Paragraphs B3–B27 of the application guidance of the Exposure Draft aim to help entities determine whether components of total allowed compensation included in determining the regulated rates charged to customers in a period relate to goods or services supplied in the same period or to goods or services supplied in a different period. In other words, the application guidance aims to help an entity determine whether components of total allowed compensation included in rates charged to customers and recognised in revenue in a period should affect profit or loss in the same period or a different period.
8. The paragraphs that follow summarise the proposed guidance for the components of total allowed compensation mentioned in paragraph 6.

Amounts that recover allowable expenses minus chargeable income

9. Paragraphs B3–B9 of the Exposure Draft propose that the 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 Accounting Standards. For example, if a regulatory agreement allows an entity to recover the cost of an item of property, plant and equipment through the regulated rates charged to customers, the depreciation expense recognised in a period in accordance with IFRS Accounting Standards is an allowable expense. The amount that recovers that depreciation expense forms part of the total allowed compensation for goods or services supplied in the same period, even if the recovery occurs in a different period.
10. The IASB concluded that if allowable expenses are recognised in a period as an expense by applying IFRS Accounting Standards, that fact provides a clear link from those expenses to goods or services supplied in that period, and from those goods or services to the related component of the total allowed compensation for those goods or services.

Target profit—profit margins that vary with an allowable expense

11. Paragraph B12 of the Exposure Draft proposes that profit margins on allowable expenses should form part of total allowed compensation in the period when an entity recognises the expense by applying IFRS Accounting Standards. Because these profit margins vary with the allowable expense, the IASB concluded that they should form part of the total allowed compensation for goods or services supplied in the same period as when the entity recognises the underlying allowable expense.

Target profit—regulatory returns

12. A significant component of an entity's target profit often consists of regulatory returns. Regulatory agreements typically determine the regulatory return for a period by specifying a return rate that is applied to a base, such as the regulatory capital

base.¹ Paragraphs B13–B14 of the Exposure Draft propose that if the regulatory agreement entitles an entity to add regulatory returns in determining a regulated rate for goods or services supplied in a period, those regulatory returns form part of the total allowed compensation for goods or services supplied in the same period. However, for regulatory returns on assets not yet available for use, paragraph B15 of the Exposure Draft proposes that:

- (a) those regulatory returns 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 should use a reasonable and supportable basis in determining how to allocate the return on that asset over those remaining periods and apply that basis consistently.

13. The IASB concluded that these proposals were consistent with the principle underlying the model (paragraph 5) because the regulatory returns would form part of the total allowed compensation for goods or services supplied during the periods when the assets included in the base are being used to supply goods or services. In addition, the proposals for returns on assets not yet available for use would also result in the same outcome regardless of when regulatory returns on an asset not yet available for use are included in determining the regulated rates charged to customers.

Target profit—performance incentives

14. Paragraphs B16–B20 of the Exposure Draft propose that amounts relating to a performance incentive 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. The Exposure Draft proposes the same treatment for construction-related performance incentives.

¹ ‘Regulatory asset base’ or ‘regulatory asset value’ are other terms commonly used by regulatory agreements to refer to the ‘regulatory capital base’.

15. In paragraphs BC103–BC105 of the Basis for Conclusions on the Exposure Draft, the IASB acknowledged that the proposed treatment for construction-related performance incentives would arguably not align with the underlying principle of the model (paragraph 5) because the asset is still being constructed and thus is not yet available for use. The IASB however concluded that aligning the treatment of construction-related performance 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.
16. 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.

Regulatory interest income and regulatory interest expense

17. The proposed measurement requirements for regulatory assets and regulatory liabilities involve discounting all estimated future cash flows, including cash flows from regulatory interest, to their present value. Paragraphs B21–B27 of the Exposure Draft propose that regulatory interest income and regulatory interest expense should form part of total allowed compensation as the discount unwinds until recovery of the regulatory asset or fulfilment of the regulatory liability.

Feedback—Summary of key messages

18. The feedback is structured as follows:
- (a) incentive-based schemes (paragraphs 19–20);
 - (b) regulatory assets and regulatory liabilities arising from differences between the regulatory recovery pace and assets' useful lives (paragraphs 21–23);
 - (c) allowable expense definition (paragraphs 24–26);
 - (d) regulatory returns other than returns on assets not yet available for use (paragraphs 27–28);
 - (e) regulatory returns on assets not yet available for use (paragraphs 29–31);
 - (f) performance incentives (paragraph 32); and
 - (g) other items (paragraph 33).

Incentive-based schemes²

19. Respondents subject to incentive-based schemes said that the recognition of revenue for incentive-based schemes should be based on an entity's regulatory agreement and not based on when related costs are recognised in accordance with IFRS Accounting Standards.
20. A few accounting firms said that further guidance is needed to apply the concept of total allowed compensation to incentive-based schemes.

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

21. Many respondents—mainly preparers in Europe and Asia-Oceania subject to incentive-based schemes—disagreed with the proposed guidance on depreciation expense (paragraph 9).

² Agenda Paper 9A of this meeting discusses the main features of different types of regulatory schemes, including incentive-based schemes.

22. The proposals aim to link the recognition of compensation arising from regulatory depreciation to the depreciation expense recognised in accordance with IFRS Accounting Standards. According to these respondents, the application of the proposals to incentive-based schemes would lead 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) meet neither 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.
23. We discussed this topic with the members of the Consultative Group for Rate Regulation at its meeting on 28 March 2022. Most members supported an alternative accounting approach that would not require entities to account for regulatory assets or regulatory liabilities relating to the depreciation expense recognised in accordance with IFRS Accounting Standards when there is no direct relationship between regulatory depreciation and accounting depreciation. See Agenda Paper 9B discussed at this IASB meeting.

Allowable expense definition

24. 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 Accounting Standards, that a regulatory agreement entitles an entity to recover by adding an amount in determining a regulated rate’.
25. These respondents said that regulatory agreements may use a basis different from IFRS Accounting Standards for the measurement of allowable expenses. According to these respondents, determining allowable expenses by reference to the regulatory agreement rather than IFRS Accounting Standards would better reflect the compensation to which entities are entitled. Determining allowable expenses based

on IFRS Accounting Standards would, according to these respondents, cause complexity for preparers and provide information that would be difficult for users of financial statements to understand.

26. These respondents recommended the Standard considers allowable expenses by reference to the regulatory agreement.

Regulatory returns other than returns on assets not yet available for use

27. 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 those returns in the regulated rates charged to customers.
28. 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. Illustrative example 7C.2 accompanying the Exposure Draft proposes that if a regulatory agreement adjusted the regulatory capital base for inflation, giving an entity the right to add an inflation adjustment in determining the regulated rates to be charged in future periods, that right would not meet the definition of a regulatory asset. Some of these respondents said the Standard should make clearer that any accrued inflation that an entity is entitled to recover through increased rates in the future should be considered a regulatory asset.

Regulatory returns on assets not yet available for use

29. 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—during the construction period, regulated entities fulfil service requirements in accordance with the regulatory agreement (continuous investment in the network to ensure reliable, secure and efficient supply);

- (b) not result in useful information;
 - (c) be costly to implement; and
 - (d) be inconsistent with US generally accepted accounting principles (GAAP).
30. 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.
31. We discussed this topic with the members of the Consultative Group for Rate Regulation at its meeting on 4 March 2022. Most members stated that regulated entities are providing services during the construction period because regulated entities are required to construct and maintain the infrastructure so that a working infrastructure is always available. See Agenda Paper 9B discussed at this IASB meeting.

Performance incentives

32. 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 recognising and measuring regulatory assets or regulatory liabilities associated with performance incentives that test entities' performance across multiple reporting periods.

Other items

33. Some respondents mentioned further guidance was needed in the following areas:
- (a) interaction between components of total allowed compensation—a preparer and a few standard-setters in Europe said the Standard should provide further clarity when components of total allowed compensation overlap. For example, allowable expenses or performance incentives (for example, bonuses) may be recovered by being added to an entity's regulatory capital base on which the entity is entitled to receive regulatory returns. According to these respondents, it is not clear whether such items should be excluded from the regulatory capital base and be treated as separate and distinct regulatory assets.

- (b) expenses becoming allowable by reference to local GAAP—a few accounting firms and a few standard-setters in Europe said that, in some cases, regulatory agreements treat expenses as allowable when they are recognised in accordance with local GAAP. These respondents thought the Standard should clarify how differences in timing would be determined in these cases.
- (c) allowable expenses based on benchmark figures. A few respondents—a preparer and a few national standard-setters in Europe—wondered:
 - (i) 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.
 - (ii) what part of the regulated revenue should be seen as compensation for allowable expenses and what part should be seen as an incentive.

Redeliberations—Topics and timing considerations

- 34. The table sets out our proposed approach to redeliberating the proposals on total allowed compensation:

Topic	Comments
<i>Incentive-based schemes (paragraphs 19–20)</i>	
<p>a) Develop an understanding of the main differences between cost-based and incentive-based schemes to help us consider whether changes are needed to the proposed application guidance on total allowed compensation (paragraph 20)</p>	<p>The proposed application guidance assumes that there is a direct relationship between regulatory compensation and an entity’s underlying expenses. This approach fits well with cost-based schemes but is difficult to apply to incentive-based schemes.</p> <p>Agenda Paper 9A discussed at this meeting provides information about the main features of both types of schemes (cost-based and incentive-based).</p> <p>The staff will consider the different features of these regulatory schemes when analysing each of the topics below.</p>
<p>b) Consider how the components of total allowed compensation can accommodate incentive-based schemes (paragraph 19)</p>	<p>The staff will consider whether and, if so, how to change the proposed application guidance on the components of total allowed compensation to better reflect regulatory compensation for incentive-based schemes.</p>

Topic	Comments
<i>Allowable expenses and regulatory assets and regulatory liabilities arising from differences between regulatory recovery period and assets' useful lives (paragraphs 21–26)</i>	
c) Regulatory assets and regulatory liabilities arising from differences between regulatory recovery period and assets' useful lives (paragraphs 21–23)	<p>The staff will consider whether and, if so, when it is not appropriate to link regulatory compensation (regulatory depreciation) to an entity's allowable expenses (accounting depreciation expense).</p> <p>The discussion of this topic will be informed by the different features of different regulatory schemes (item (a) in this table) and the discussions of the members of the Consultative Group for Rate Regulation (paragraph 23).</p>
d) Definition of allowable expense (paragraph 24)	<p>The staff will consider whether and, if so, how to change the definition of allowable expense to better reflect the recovery of allowable expenses in accordance with the regulatory agreement.</p> <p>The discussion of this topic will benefit from the discussion of the accounting for regulatory assets and regulatory liabilities arising from differences between the regulatory recovery pace and assets' useful lives (item (c) in this table).</p> <p>As part of the work on this topic, we think it is important to distinguish differences in measurement bases from differences in timing (paragraphs 25–26).</p>

Topic	Comments
<i>Regulatory returns other than returns on assets not yet available for use (paragraphs 27–28)</i>	
e) Inflation adjustments (paragraph 28)	Some regulatory schemes adjust the regulatory capital base for inflation and provide entities a real return rate on that base excluding inflation. The Exposure Draft proposed that this regulatory approach did not result in a regulatory asset. Stakeholders raised concerns about this proposal (paragraph 28). The staff will consider whether and, if so, how to change the proposal.
<i>Regulatory returns on assets not yet available for use (paragraphs 29–31)</i>	
f) The notion of ‘goods or services’ (paragraph 31)	<p>The Exposure Draft is based on the assumption that ‘goods or services’ are those an entity supplies to customers with the assets it operates.</p> <p>The staff will consider whether and, if so, how to broaden the notion of ‘goods or services’ to better accommodate services that entities are required to fulfil during the construction period in accordance with the regulatory agreement.</p> <p>The discussion of this topic will be informed by the discussions of the members of the Consultative Group for Rate Regulation (paragraph 31).</p> <p>We will consider broadening the notion of ‘goods or services’ along with:</p>

Topic	Comments
	<ul style="list-style-type: none"> i) the interaction between paragraph B15 (regulatory returns on assets not yet available for use) and paragraphs B4³ (compensation for allowable expenses); and ii) the proposed treatment for construction-related performance incentives (paragraph B18 of the Exposure Draft).
<i>Performance incentives (paragraph 32)</i>	
g) Performance incentives (paragraph 32)	<p>The staff will consider whether and, if so, how to change the proposed application guidance on performance incentives to address:</p> <ul style="list-style-type: none"> i) the practical difficulties of applying the proposals to performance incentives that test entities’ performance across multiple reporting periods. ii) the interactions with the proposals relating to regulatory returns on assets not yet available for use (item (f) in this table). <p>The topic in (i) has interactions with the recognition and measurement proposals, for example, whether the recognition of regulatory assets or</p>

³ This deals with the fact that some expenses that are allowable are not necessarily related to the supply of goods or services (for example, overheads incurred when constructing an asset). If an entity applies paragraph B4, the entity will recognise 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.

Topic	Comments
	<p>regulatory liabilities for those performance incentives should be subject to a higher threshold than the proposed ‘more likely than not’ threshold.</p> <p>Consequently, we will consider performance incentives when discussing these other aspects of the model.</p> <p>This topic is particularly important for entities subject to incentive-based schemes.</p>
<i>Other items (paragraph 33)</i>	
<p>h) Interaction between the components of total allowed compensation (paragraph 33(a))</p>	<p>The staff will identify situations in which a component of total allowed compensation (for example, a bonus) is added to an entity’s regulatory capital base. We will then assess whether such items should be excluded from the regulatory capital base and be accounted for applying the requirements for the relevant components of total allowed compensation (for example, the requirements for performance incentives).</p>
<p>i) Expenses becoming allowable by reference to local GAAP (paragraph 33(b))</p>	<p>Respondents also referred to this topic when providing feedback for the proposals on ‘items affecting regulated rates only when related cash is paid or received’ (paragraphs 59–66 of the Exposure Draft).</p>

Topic	Comments
	<p>The staff will discuss whether and, if so, how to change the proposed application guidance to account for regulatory assets or regulatory liabilities for expenses that become allowable by reference to local GAAP. We will consider these matters when discussing how the proposals in paragraphs 59–66 of the Exposure Draft would apply when items of expense or income are treated as allowable or chargeable using a criterion other than cash basis.</p>
<p>j) Allowable expenses based on benchmark figures (paragraph 33(c))</p>	<p>At its February 2022 meeting, the IASB discussed whether regulatory agreements in which the regulated rate is determined using benchmark costs would be within the scope of the Standard.</p> <p>We will build on the above analyses and on the features of incentive-based schemes to consider whether and, if so, how to change the proposed application guidance to account for regulatory assets or regulatory liabilities for allowable expenses based on benchmark figures.</p> <p>This topic is particularly important for entities subject to incentive-based schemes.</p>

35. The topics for redeliberation, and the sequence in which they are discussed, may change. This depends on, for example, the IASB's tentative decisions at future meetings and whether linkages between topics are identified as the redeliberations progress.

Questions for the IASB

Does the IASB have any questions or comments on the topics for redeliberation?

Are there any additional matters that we need to consider in relation to total allowed compensation?

Are there any interactions with other aspects of the proposals that may affect the sequence in which topics are redeliberated?