STAFF PAPER

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IASB® meeting

Project	**Rate-regulated Activities**
Paper topic	Total allowed compensation—Regulatory returns on an asset not yet available for use

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Objective

1. This paper:

   (a) analyses feedback from comment letters and outreach events on the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft) proposals in relation to regulatory returns on an asset not yet available for use. This paper also includes recommendations to address that feedback.

   (b) provides a preliminary analysis of how entities' accounting treatment of borrowing costs incurred in the construction of an asset could affect the amount of regulatory returns reflected in profit or loss during the construction period, if the IASB agrees with the staff recommendation in paragraph 2(a). We recommend analysing this matter further at a future meeting.

Summary of staff recommendations

2. We recommend:

   (a) the final Standard specifies that when a regulatory agreement entitles an entity to regulatory returns on an asset not yet available for use, these returns form part of the total allowed compensation for goods or services supplied during the period in which the entity incurs the capital outlay to construct the asset—that is, the construction period.

(b) the final Standard provides guidance on how the provisions of the regulatory agreement may affect the amount of regulatory returns on an asset not yet available for use to which an entity is entitled during the construction period.

(c) the staff analyse further whether an entity's capitalised borrowing costs should affect the recommended treatment of regulatory returns on an asset not yet available for use described in subparagraph (a).

Structure of the paper

3. This paper is structured as follows:

(a) proposals in the Exposure Draft (paragraphs 5–9);

(b) summary of comments received (paragraphs 10–14); and

(c) staff analysis (paragraphs 15–67).

4. The appendix to this paper illustrates the accounting outcome of applying the recommended treatment of regulatory returns on an asset not yet available for use, if an entity capitalises borrowing costs incurred in constructing the asset.

Proposals in the Exposure Draft

5. Paragraph 16 of the Exposure Draft states that the Exposure Draft adopts the principle 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.

6. Paragraph B10 of the Exposure Draft proposes that the target profit that a regulatory agreement entitles an entity to add in determining a regulated rate for goods or services supplied in a period should form part of the total allowed compensation for goods or services supplied in the same period, unless the Exposure Draft specifies a different treatment (that is, paragraphs B12, B15 and B17 of the Exposure Draft).

7. An example of target profit requiring a different treatment is regulatory returns on an asset not yet available for use. Paragraph B15 of the Exposure Draft proposes that:

   (a) such regulatory returns should form part of the 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 applies that basis consistently.

8. The Board concluded that the proposal in paragraph B15 is consistent with the principle underlying the model (paragraph 5) because no goods or services are being supplied using an asset before it is available for use. Furthermore, the proposal would avoid a lack of comparability that would result when applying paragraph B10 to different regulatory approaches, for example:

   (a) regulatory agreements that allow these returns to be included in regulated rates as the asset is being constructed; and

   (b) regulatory agreements that allow those returns to accumulate while the asset is being constructed and to be included in regulated rates only once the asset is in operation.

9. Applying paragraph B15 to regulatory returns on an asset not yet available for use would:

   (a) give rise to a regulatory liability if an entity is entitled to include the returns in regulated rates as the asset is being constructed. This is because, according to the Exposure Draft, the revenue already recognised includes an amount that will provide part of the total allowed compensation for goods or services to be supplied in the future (that is, differences in timing arise).

   (b) not give rise to a regulatory asset if an entity is entitled to accumulate the returns as the asset is being constructed and to include these returns in regulated rates over the period in which the asset is in operation. This is because, according to the Exposure Draft, these returns provide part of the total allowed compensation for goods or services to be supplied using the asset and will be included in revenue in that same period (that is, differences in timing do not arise).

Summary of comments received

10. Some respondents agreed with the proposal for an entity to reflect regulatory 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. Respondents said entities fulfil service requirements in accordance with the regulatory agreements during the construction period (paragraph 11).

    (b) not result in useful information. Most of the users from whom we received feedback said reflecting regulatory returns during the construction period would enhance users' understanding of the effects of the regulatory agreement on an entity's financial performance, future cash flows and credit quality.

    (c) be costly to implement. Respondents said regulatory agreements generally do not attribute regulatory returns to single assets, but rather provide a return on the wider network. According to these respondents, entities applying the proposals would have to separate assets not yet available for use from the rest of the regulatory capital base and attribute regulatory returns to individual assets. For many entities, this would be impracticable given the high volumes of assets that are under construction.

    (d) be inconsistent with US generally accepted accounting principles (GAAP). Some respondents—mainly preparers in North America and Europe—said the proposals would result in a loss of comparability with peer companies applying US GAAP. Some users from whom we received feedback during the comment period said alignment between IFRS Accounting Standards and US GAAP in this area is important.

11. Many respondents said regulatory returns on an asset not yet available for use compensate entities for fulfilling the following obligations during the construction period:

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

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

12. These respondents argued these obligations are the goods or services supplied to customers during the construction period. Consequently, they suggested that reflecting regulatory returns on an asset not yet available for use in profit or loss during the construction period, regardless of when those returns are included in the regulated rates, would be consistent with the principle underlying the model (paragraph 5). A few respondents suggested that such an approach to regulatory returns could be justified by:

(a) identifying performance obligations arising from their regulatory agreements. According to a few respondents, investing in infrastructure and providing capital could also be identified as performance obligations—that is, regulatory agreements typically impose obligations on entities in addition to supplying goods or services directly to customers.

(b) considering an approach similar to that used in IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*. According to a few respondents, in deciding when to recognise a grant, an entity applying IAS 20 would consider the intent of the grant or its prescribed conditions. When considering regulatory returns on an asset not yet available for use, these respondents thought the final Standard should consider the fact that these returns compensate an entity for carrying out investments and providing corresponding funds during the construction period (paragraph 32) and require entities to recognise those returns in that period.

(c) analysing the service entities provide to their customers. According to a respondent, in addition to operating the assets, entities also plan for, construct and decommission assets. This respondent suggested defining the period over which goods or services are provided more broadly than just when an asset is in operation.

13. However, a few respondents said that regulatory returns on an asset not yet available for use should form part of the total allowed compensation for goods or services

supplied in the period in which those returns are included in the regulated rates. This would reflect the fact that different regulatory agreements may consider regulatory returns on an asset not yet available for use differently. Regulatory agreements allow those returns to be included in the regulated rates charged as the asset is being constructed in some cases and, in other cases, once the asset is in operation. According to these respondents, these different ways in which regulatory agreements may consider regulatory returns on an asset not yet available for use may give rise to different rights and obligations.

14. The staff also gathered input from the Consultative Group for Rate Regulation (Consultative Group) on these proposals at a meeting held on 4 March 2022.[1] The staff shared this feedback with the IASB at its meeting in May 2022. The majority of the members of the Consultative Group supported an accounting treatment that would lead to entities reflecting regulatory returns on an asset not yet available for use in profit or loss during the construction period.

Staff analysis

15. The staff analysis is structured as follows:

    (a) identifying issues related to the term 'goods or services' (paragraphs 16–28);

    (b) clarifying the goods or services supplied in exchange for regulatory returns on an asset not yet available for use (paragraphs 29–55); and

    (c) other issues—capitalised borrowing costs (paragraphs 56–67).

Identifying issues related to the term 'goods or services'

16. Differences in timing give rise to either a regulatory asset or a regulatory liability. Differences in timing arise when part or all of the total allowed compensation for goods or services supplied in one period is included in the regulated rates charged to customers—and hence included in revenue—in a different period.

17. The principle underlying the model, and consequently the assessment of whether differences in timing arise, requires that an entity determines whether amounts

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[1] The material discussed at that meeting can be found here. The meeting notes summarise the discussion.

included in the regulated rates charged to customers in any one period relate to goods or services supplied in the same period or in a different period. In other words, the entity is required to determine *when* goods or services are supplied so that the related compensation is reflected in the entity's reported financial performance in the same period.

18. The Exposure Draft does not define or describe the term 'goods or services'. The Exposure Draft however proposes treatments for various components of total allowed compensation that suggest different notions of goods or services:

    (a) a narrow notion of goods or services for regulatory returns on an asset not yet available for use (paragraph 19); and

    (b) a broader notion of goods or services for amounts that recover allowable expenses (paragraph 20).

19. The notion that goods or services are being supplied using an asset only once the asset is available for use underpins the proposals on regulatory returns on an asset not yet available for use (paragraph B15 of the Exposure Draft).

20. On the other hand, 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**. […]

21. The broader notion of goods or services in paragraph B4 does not restrict goods or services to those supplied directly to customers. For example, paragraph B4 includes amounts that recover expenses not directly linked to goods or services supplied to customers in the current period (for example, environmental clean-up costs (Illustrative Example 7A.9) and a loss on remeasurement of futures contract

(Illustrative Example 7A.13).[2] This broader notion of goods or services also does not restrict goods or services to those supplied using assets that are available for use as implied by paragraph B15 (paragraph 23(a)).

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

23. The national standard-setter said an entity may incur allowable expenses, for example, overheads incurred when constructing an asset that the entity recognises as expenses. According to this respondent, the entity may reach different conclusions depending on whether it applies paragraph B4 or paragraph B15 of the Exposure Draft to those expenses. Similarly, in our outreach conducted during the comment period, stakeholders said it is possible that entities are entitled to recover impairment losses relating to an asset not yet available for use through regulated rates to be charged in the future. In both cases:

    (a) applying paragraph B4—the amounts that recover these expenses (overhead expenses or impairment losses) would provide part of the total allowed compensation for goods or services supplied in the same period in which an entity recognised the expenses applying IFRS Accounting Standards. Therefore, the entity would recognise a regulatory asset relating to the expenses that are recoverable through regulated rates to be charged in the future.

    (b) applying the notion of goods or services in paragraph B15—an entity may conclude that no goods or services are being supplied using an asset before it is available for use. Therefore, the entity would not recognise a regulatory asset relating to the amounts that recover these expenses.

24. The national standard-setter and the accounting firm mentioned in paragraph 22 recommended the approach specified in paragraph B4 of the Exposure Draft should prevail.

25. Another accounting firm, however, questioned the application of paragraph B4 of the Exposure Draft. According to this respondent, the application of paragraph B4 could

[2] The Illustrative Examples accompanying the Exposure Draft can be accessed here.

give rise to regulatory assets that are not directly linked to the supply of goods or services to customers (for example, a regulatory asset arising from allowable environmental clean-up costs). This could result in an approach that matches revenue with costs, bringing the proposed model closer to a cost-deferral approach rather than an approach that seeks to account for rights and obligations that meet the definitions of regulatory assets and regulatory liabilities.

26. A few respondents said the notion of goods or services for regulatory returns on an asset not yet available for use is inconsistent with the proposed treatment of performance incentives relating to performance of construction work in paragraph B18 of the Exposure Draft. That paragraph says (**emphasis added**):

> […] if the **performance criteria test** only an entity's **performance of construction work**, the **performance incentive** forms part of or reduces **the total allowed compensation for goods or services supplied in the period** in which **that performance occurs**. […]

27. An entity applying paragraph B18 of the Exposure Draft would treat the performance for construction work as part of or a reduction of total allowed compensation for goods or services supplied in the period in which that performance occurs (that is, during construction). This treatment would arguably not be aligned with the principle underlying the model (paragraph 5) because the asset is still being constructed and thus is not yet available for use. However, the IASB proposed the requirement in paragraph B18 considering the benefits of aligning the treatment of incentives for performing construction work with the treatment of all other performance incentives (paragraph BC105 of the Basis for Conclusions).

28. The following section (paragraphs 29–40) discusses whether and what changes should be made to the proposed treatment of regulatory returns on an asset not yet available for use. It also considers whether those changes would better align with the proposals in paragraphs B4 and B18 of the Exposure Draft.

Clarifying the goods or services supplied in exchange for regulatory returns on an asset not yet available for use

29. The staff analysis in this section is structured as follows:

   (a) whether goods or services are supplied during the construction period (paragraphs 30–40); and

   (b) factors affecting the amount of returns reflected in profit or loss during the construction period on an asset not yet available for use (paragraphs 41–55).

Whether goods or services are supplied during the construction period

30. The staff learnt from stakeholders, including regulators, that regulatory agreements typically impose obligations on entities in addition to supplying goods or services directly to customers. For example, entities are typically also required to carry out continuous investment in the network and to finance that investment.

31. Some stakeholders said assets not yet available for use form part of the wider network. Regulatory agreements often entitle entities to regulatory returns on the entire regulatory capital base that includes assets not yet available for use, without linking the returns to individual assets. According to these stakeholders, the goods or services are supplied using the wider network on which entities earn a return.

32. Some stakeholders said regulatory agreements entitle entities to recover the capital invested in the network and to a return on the capital invested. The return on the capital invested forms part of the regulatory objective to support entities' financial viability.

33. In many jurisdictions in Europe and Asia-Oceania, regulators would allow entities to include regulatory returns on an asset not yet available for use in regulated rates charged as the asset is being constructed. The regulators in a few jurisdictions said their decision is mainly based on the principle of supporting entities' financial needs and access to financing.

34. In some jurisdictions such as those in North America, however, regulators would typically allow regulatory returns on an asset not yet available for use to be included in regulated rates charged only once the asset is available for use. These regulators mainly base their decision on the principle that only customers enjoying the goods or

services supplied using the new or upgraded asset should be required to pay the higher regulated rates that include the returns accumulated during the construction of the asset.

35. The proposed model is designed to supplement revenue information provided by applying IFRS 15 *Revenue from Contracts with Customers*. Regulatory assets or regulatory liabilities arise because the regulatory agreement determines regulated rates in such a way that the revenue recognised in a period does not reflect the total allowed compensation for goods or services supplied in that same period.

36. For a regulatory agreement to entitle an entity to regulatory returns on an asset not yet available for use, the regulatory agreement must give the entity the right to include these returns in the regulated rates. Regulatory agreements vary greatly. The feedback on the proposals indicates that despite their diverse terms, regulatory agreements that entitle entities to regulatory returns on an asset not yet available for use typically determine the returns by applying a return rate, comprising cost of debt and/or equity, either to the amount of capital invested in the construction of the asset or to the outstanding amount of capital invested in the entire regulatory capital base that includes the asset.

37. The evidence the staff have obtained supports the view that when regulatory agreements entitle entities to regulatory returns on an asset not yet available for use, that fact establishes that the returns provide compensation for the cost of capital incurred in the construction of the asset. In other words, we think that compensation in the form of regulatory returns on an asset not yet available for use typically relates to the provision of capital to finance the construction of the asset during the construction period. For this purpose, a regulatory agreement may *entitle* an entity to regulatory returns on an asset not yet available for use, even if the regulatory agreement allows the entity to *recover* these returns by including them in regulated rates only once the asset is available for use.

38. Therefore, the staff recommend the final Standard modifies the proposed notion of goods or services for regulatory returns on an asset not yet available for use. When a regulatory agreement entitles an entity to regulatory returns on an asset not yet available for use, the service that the entity is providing is the provision of capital. Consequently, those returns form part of the total allowed compensation for goods or

services supplied during the period in which the entity incurs the capital outlay to construct the asset. This means the staff recommend that regulatory returns on an asset not yet available for use are reflected in profit or loss during the construction period. This recommendation would address the feedback summarised in paragraph 10 by:

(a) reflecting the economic substance of the regulatory agreements better, which would result in more useful information about the effects of the regulatory returns on an entity's financial performance, future cash flows and credit quality; and

(b) avoiding high implementation costs that entities would have to incur if entities were required to apply the Exposure Draft proposals at an individual-asset level.

39. The staff acknowledge that this recommendation results in entities recognising income from regulatory returns on an asset not yet available for use during the construction of assets that they control. However, the staff think this outcome is appropriate for regulated entities. Regulatory agreements typically entitle regulated entities to compensation for the recovery of, and the returns on, capital invested in the network as part of the regulatory objective to ensure entities' financial viability (paragraph 32). In turn, regulators impose restrictions on the control that these entities have of their assets (for example, the entities may not be allowed to dispose of the assets unless they have obtained regulatory approval). These entities' rights to compensation for assets they control, together with the restrictions on the control of their assets, differ from those of:

(a) entities subject to a service concession arrangement within the scope of IFRIC 12 *Service Concession Arrangements.* Entities in the scope of IFRIC 12 have a right to receive consideration for providing services to construct assets that are controlled by the grantor in the arrangement. These entities account for revenue from the construction services applying IFRS 15.

(b) non-regulated entities. Non-regulated entities do not have a right to compensation for the recovery of, and the returns on, capital invested in constructing assets that the entities control. Neither are these entities providing services to construct the assets because these entities control those assets.

40. The staff recommendation would be aligned with the proposals in paragraphs B4 and B18 of the Exposure Draft. Regulatory returns on an asset not yet available for use would form part of the total allowed compensation for goods or services supplied during the period in which an entity incurs the capital outlay to construct the asset. Similarly:

(a) applying paragraph B4, amounts that recover allowable expenses relating to an asset not yet available for use would form part of the total allowed compensation for goods or services supplied in the period in which the expenses are recognised. For example, overheads incurred when constructing an asset that an entity recognises as an expense would form part of the total allowed compensation in the same period the expenses are recognised.

(b) applying paragraph B18, performance incentives for construction work would form part of the total allowed compensation for goods or services supplied in the period in which the performance of construction work occurs.

Factors affecting the amount of returns reflected in profit or loss during the construction period on an asset not yet available for use

41. Paragraph 38 includes the staff recommendation that regulatory returns on an asset not yet available for use should form part of the total allowed compensation for goods or services that an entity supplies during the construction period. We think there are two main factors that may affect the amount of returns that the entity should reflect in profit or loss during the construction period:

(a) provisions of the regulatory agreement that may affect the amount of returns to which an entity is entitled (paragraphs 42–55); and

(b) an entity's accounting treatment of borrowing costs incurred during the construction period—this is included in the section 'Other issues—capitalised borrowing' costs (paragraphs 56–67).

42. Regulatory returns on an asset not yet available for use are typically included in regulated rates either:

(a) as the asset is being constructed (paragraphs 43–47); or

(b) over the period in which the asset is available for use (paragraphs 48–54).

43. In many jurisdictions in Europe and Asia-Oceania, regulatory agreements allow entities to include regulatory returns on an asset not yet available for use in regulated rates charged as the entities construct the asset or incur the capital outlay.

44. Some stakeholders subject to this type of regulatory agreement said that, although regulators will typically monitor an entity's progress when constructing an asset, the entity's entitlement to regulatory returns on an asset not yet available for use is not conditional on individual assets becoming operational. Instead, the entity's obligation is to achieve outcomes relating to quantity and quality of the supply of goods or services to customers, using the wider network that includes the assets not yet available for use.

45. In such cases, the Exposure Draft concluded differences in timing would arise because the entity had included in regulated rates charged during the construction period—and therefore recognised in revenue—an amount relating to the returns that would form part of the total allowed compensation for goods or services to be supplied with the asset while in operation. The Exposure Draft proposed requiring the entity to account for these returns as a regulatory liability that the entity would fulfil during the operation of the asset. However, these stakeholders said the entity does not have a liability as defined in the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*). This is because the entity has no legal or economic obligation to reduce future regulated rates either in the form of cash outflows or lower cash inflows, even if the construction of the assets is not completed or the assets are abandoned.

46. Applying the staff recommendation in paragraph 38, no difference in timing would arise from regulatory returns on an asset not yet available for use because they form part of the total allowed compensation for the goods or services supplied in the same period as the returns are recognised in revenue (that is, during the construction period).

47. However, in some of the cases described in paragraphs 43–44, the amount of returns that an entity may be entitled to include in regulated rates charged during the

construction period is calculated considering an estimated amount of capital outlay or is contingent on the entity achieving specified construction targets. In those cases, differences between the returns included in regulated rates charged to customers during the construction period and the calculations of these returns considering actual capital outlay incurred or actual construction targets achieved may give rise to adjustments to future regulated rates. Therefore, an entity would need to consider whether the provisions of the regulatory agreement would give rise to differences in timing relating to the regulatory returns already included as part of its revenue during the construction period. This would affect the amount of regulatory returns on an asset not yet available for use that an entity should reflect in profit or loss, even if the regulatory agreement entitles the entity to include these returns in regulated rates charged during the construction period.

48. In North America, however, the regulatory returns on an asset not yet available for use are typically approved by the regulator to accumulate as an 'allowance for funds used during construction' (AFUDC) that forms part of the cost of the asset as the asset is being constructed. The entity subsequently recovers AFUDC over the period in which the carrying amount of the asset is recovered through regulated rates.

49. Stakeholders subject to this type of regulatory agreement said the regulator must initially authorise the construction of the asset. The regulator is expected to subsequently approve the returns related to the capital invested in the construction that have been incurred prudently and, when the asset is completed, authorise the returns to be included in future regulated rates.[3] Stakeholders, including regulators, also said that if an entity was required to discontinue the construction of an asset in circumstances that were not within the entity's control, the regulator would typically allow the entity to recover the accumulated returns accrued, and costs incurred, up to the date the entity had to discontinue construction.

50. These stakeholders said the entity's right to regulatory returns on an asset not yet available for use would meet the definition of an asset in the *Conceptual Framework* because:

[3] In some cases, the regulator requires the completed asset to be certified by an independent body.

(a) the entity has an enforceable right, as the asset is being constructed, to include AFUDC in regulated rates in the future. This is the case notwithstanding that the recovery of AFUDC is conditional on the asset becoming operational.

(b) that right has the potential to generate economic benefits and results from a past event—that is, the entity has incurred the capital outlay to construct the asset as authorised by the regulator. In turn, the regulator is expected to authorise AFUDC related to the capital invested in the construction of the asset that has been incurred prudently to be included in future regulated rates.

(c) the entity controls that right because it has the present ability to include AFUDC in future regulated rates and to obtain the corresponding economic benefits.

51. These stakeholders also said the uncertainty arising from the regulator's authorisation to include AFUDC in future regulated rates would not affect the existence of the asset, but rather its measurement.

52. Applying the staff recommendation in paragraph 38 to this case, the returns accumulated on an asset not yet available for use during the construction period would form part of the total allowed compensation for goods or services that an entity supplied during the construction period. A difference in timing would arise because the entity would not include these returns in regulated rates charged—and therefore in revenue—until the asset is in operation. In this case, the entity would account for a regulatory asset because the returns that formed part of the total allowed compensation for goods or services supplied during the construction period would be recognised in revenue in the future. That regulatory asset would be subject to the recognition and measurement proposals in the Exposure Draft (paragraph 54).

53. When an entity has an enforceable present right to include regulatory returns on an asset not yet available for use in the regulated rates charged when the asset is in operation, the entity has a right to the returns as the entity incurs the capital outlay to construct the asset. We think the entity's right is not affected by the fact that the amount of the returns that the entity will include in regulated rates is conditional on the asset being completed and receiving the final regulatory approval. We think this is consistent with:

(a) the *Conceptual Framework* requiring a right to have the potential to produce economic benefits. A right can meet the definition of an economic resource, and hence can be an asset, even if the probability that it will produce economic benefits is low.[4]

(b) the principles underlying an entity's right to payment for performance completed to date as described in paragraph 35(c) of IFRS 15. For example, an entity has that right if the entity has:

(i) an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion for reasons other than the entity's failure to perform as promised. This may be analogous to a regulatory agreement under which an entity has no obligation to reduce future regulated rates as a result of the returns already included in the rates (paragraph 45) or has a right to include the returns already accumulated in future regulated rates, even if the assets are not completed or are abandoned in circumstances that are not within the entity's control (paragraph 49).

(ii) a right to continue to perform its obligations in accordance with the contract and to require the customer to perform its obligations (which include paying the promised consideration). This may be analogous to a regulatory agreement under which an entity's right to include the returns in regulated rates charged is conditional on the asset becoming operational. In this case, the entity has a right to continue constructing the asset, and therefore, a right to the returns despite their recovery is conditional on the asset becoming operational.

54. Following from paragraphs 52 and 53, the entity should apply the recognition and measurement proposals to assess:

(a) whether it is more likely than not that an enforceable present right to include the returns in future regulated rates exists. This determines whether the entity

[4] The Conceptual Framework defines an asset as a present economic resource controlled by the entity as a result of past events.

would recognise a regulatory asset for the returns as the entity incurs the capital outlay to construct the asset.

(b) whether the fact that the returns are included in regulated rates only once the asset is available for use would give rise to outcome or measurement uncertainties. These uncertainties would be reflected in the measurement of the regulatory asset applying the measurement proposals.

55. Therefore, the staff recommend the final Standard provides guidance on how the provisions of the regulatory agreement may affect the amount of regulatory returns on an asset not yet available for use to which an entity is entitled during the construction of the asset (paragraphs 47 and 53).

Questions for the IASB
1. Does the IASB agree with the staff recommendations that the final Standard: a. specifies that when a regulatory agreement entitles an entity to regulatory returns on an asset not yet available for use, these returns form part of the total allowed compensation for goods or services supplied during the period in which the entity incurs the capital outlay to construct the asset—that is, the construction period (paragraph 38). b. provides guidance on how the provisions of the regulatory agreement may affect the amount of regulatory returns on an asset not yet available for use to which an entity is entitled during the construction period (paragraph 55).

Other issues—capitalised borrowing costs

56. Paragraph 38 summarises the staff recommendation that regulatory returns on an asset not yet available for use form part of the total allowed compensation for goods or services supplied during the construction of the asset. This section provides a preliminary analysis of whether the amounts of these returns that an entity should reflect in profit or loss during the construction period should be affected by the

entity's accounting treatment of borrowing costs incurred during the construction period.

57. IAS 23 *Borrowing Costs* requires that an entity capitalises borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset as part of the cost of that asset.[5] The entity subsequently recognises the capitalised borrowing costs in profit or loss as part of depreciation expense.

58. Based on the feedback on the proposals, regulatory returns on an asset not yet available for use are typically calculated applying the weighted-average cost of capital[6] to the capital invested in the construction of assets not yet available for use or to the regulatory capital base that includes the assets not yet available for use. The cost of capital includes both a return for debt and a return for equity. When regulatory agreements provide for a return for debt, they typically exclude borrowing costs capitalised for accounting purposes from the regulatory capital base that the entity will recover through regulated rates.

59. Therefore, the amount of the return for debt may differ from the amount of capitalised borrowing costs because, for example:

    (a) the debt component of the regulatory return rate (for example, a pre-determined rate or a benchmark rate) may differ from the rate implicit in the actual amount of borrowing costs incurred on specific borrowings, or in the case of general borrowings, the capitalisation rate as determined in accordance with IAS 23; and

    (b) the base to which the debt return rate applies (for example, the regulatory capital base that includes the assets not yet available for use) is different from the amount of borrowings, or in the case of general borrowings, the expenditure on the asset that is used to determine the capitalised borrowing costs.

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[5] IAS 23 defines:
(a) borrowing costs as interest and other costs that an entity incurs in connection with the borrowing of funds.
(b) a qualifying asset as an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.

[6] This refers to the cost of capital as determined under the regulatory agreement.

60. Applying the staff recommendation in paragraph 38, regulatory returns on an asset not yet available for use should form part of the total allowed compensation for the goods or services supplied during the period in which an entity incurs the capital outlay to construct the asset. Consequently, when an entity capitalises the borrowing costs during construction of the asset, the entity's profit or loss would reflect a front-loading of income relating to the return for debt. This is because:

    (a) the return for debt is included in profit or loss during the construction period either:

        (i) as revenue (when the regulatory returns are included in regulated rates charged as the asset is being constructed); or

        (ii) as part of regulatory income related to the recognition of a regulatory asset (when the regulatory returns are included in regulated rates charged only once the asset is available for use).

    (b) the capitalised borrowing costs would be recognised in profit or loss as part of depreciation expense only once the asset is available for use.

61. The recommended treatment of regulatory returns on an asset not yet available for use in paragraph 38, therefore, brings into question:

    (a) whether and when the recommended treatment would not result in useful information; and

    (b) whether modifications to the recommended treatment would be necessary.

62. The staff think that there may be circumstances in which applying the recommended treatment of regulatory returns on an asset not yet available for use may not result in useful information. The appendix to this paper illustrates one situation when this might be the case.

63. The staff also think any approaches to modifying the recommended treatment of regulatory returns on an asset not yet available for use should not affect the conclusion that those returns should form part of the total allowed compensation for the goods or services supplied during the period in which an entity incurs the capital outlay to construct an asset (that is, the construction period). However, when an entity capitalises borrowing costs, it may be necessary to consider whether it would be

appropriate to restrict the amount of the returns the entity reflects in profit or loss during the construction period.

64. The staff may explore modifying the recommended treatment, for example, by requiring an entity:

(a) to defer reflecting in profit or loss a portion of regulatory returns on an asset not yet available for use to the period over which the asset is available for use; or

(b) to recognise borrowing costs related to the construction of the asset as an expense as the entity incurs these costs.

65. The staff learnt from the feedback on the proposals and the outreach undertaken after the comment period that the regulatory capital base has a direct relationship with an entity's property, plant and equipment in some regulatory schemes, but not in others.[7] We think that this difference between regulatory schemes may inform our work relating to capitalised borrowing costs. For example, we may need to consider whether the regulatory returns on an asset not yet available for use should be linked to the borrowing costs incurred to construct the asset when there is a direct relationship between the regulatory capital base and the entity's property, plant and equipment (see approach 1B in the table in paragraph 66 and the example in the Appendix).

[7] Agenda paper 9A of May 2022 IASB meeting discussed how the regulatory capital base and an entity's assets are aligned when such a direct relationship exists. There is generally alignment, with any differences separately tracked, in terms of the componentisation, measurement and depreciation pace. In addition, the Consultative Group for Rate Regulation discussed indicators of a direct relationship between the regulatory capital base and an entity's assets at its meeting on 28 March 2022.

66. The staff may conclude that the treatment of regulatory returns on an asset not yet available for use should not be affected by how an entity accounts for the borrowing costs incurred in the construction of the asset. This table describes a few possible alternative approaches that the staff may consider:

Approach 1A	**Approach 2**	**Approach 3A**
No change to the staff recommendation that the regulatory returns should form part of the total allowed compensation for goods or services supplied during the period in which the entity incurs the capital outlay to construct the asset (construction period). However, this approach aims to limit a possible front-loading of profits during that period. The approach would: • defer recognition in profit or loss of the return for debt up to the amount of capitalised borrowing costs to the period over which the asset is available for use. • result in any amount of the regulatory returns in excess of the capitalised borrowing costs being reflected in profit or loss during the construction period.	<u>Return for equity</u> No change to the staff recommendation that the regulatory returns should form part of the total allowed compensation for goods or services supplied during the period in which the entity incurs the capital outlay to construct the asset (construction period). <u>Return for debt</u> This approach prioritises matching between the recognition of the return for debt and the recognition of the borrowing expense in profit or loss. The approach would: • defer recognition in profit or loss of the return for debt to the period over which the asset is available for use.	No change to the staff recommendation that the regulatory returns should form part of the total allowed compensation for goods or services supplied during the period in which the entity incurs the capital outlay to construct the asset (construction period). Instead, this approach would amend IAS 23 to recognise the related borrowing costs as an expense in the period in which these costs are incurred.

Approach 1B	• result in the return for equity being the only regulatory return that would be reflected in profit or loss during the construction period.	Approach 3B
Similar to approach 1A, except that this approach also considers the relationship between the regulatory capital base and the entity's property, plant and equipment: • Direct relationship—apply approach 1 (that is, the regulatory returns reflected in profit or loss during the construction period are limited to those returns in excess of the capitalised borrowing costs). See example in the Appendix. • No direct relationship—apply the recommended treatment (that is, the entire regulatory returns are reflected in profit or loss during the construction period). Entities could be required to provide additional disclosures.		Similar to approach 3A, except that this approach also considers the circumstances in which it may be appropriate to amend the requirements in IAS 23. Specifically, the related borrowing costs would be recognised as an expense only if there is a direct relationship between the regulatory capital base and the entity's property, plant and equipment.

67. Therefore, the staff recommend analysing further whether an entity's capitalised borrowing costs should affect the recommended treatment of regulatory returns on an asset not yet available for use (paragraph 38) in certain circumstances and if so, what modifications to the recommended treatment would be necessary. The staff plan to discuss this matter with the Consultative Group for Rate Regulation.

Questions for the IASB
2. Does the IASB agree with the staff recommendation to analyse further whether an entity's capitalised borrowing costs should affect the recommended treatment of regulatory returns on an asset not yet available for use in paragraph 38?
3. Do IASB members have any initial comments on:
a. the overall approach to modifying the recommended treatment of regulatory returns on an asset not yet available for use as described in paragraph 63? That is, that any approaches to modifying the recommended treatment should not affect the conclusion that those returns should form part of the total allowed compensation for the goods or services supplied during the construction period but could, however, affect the amount of the returns the entity is able to reflect in profit or loss during the construction period.
b. the possible alternative approaches to such modification described in paragraph 66?

Appendix—Applying the recommended treatment of regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs

A1. Consider the following fact pattern:

(a) an entity invests CU1,000 of capital in the construction of an asset.[8]

(b) the regulatory agreement allows the entity to accumulate regulatory returns on an asset not yet available for use during the construction period and to include those returns in regulated rates during the operation period. The regulatory agreement applies a return rate of 8% to the capital invested, comprising a return for equity of 5% and a return for debt of 3%. Therefore, the entity accumulates regulatory returns of CU80 (8% x CU1,000) during the construction period.

(c) the entity incurs borrowing costs in constructing the asset amounting to CU35, with an implicit rate of 3.5% (CU35 / CU1,000). Applying IAS 23, the entity capitalises those borrowing costs as part of the cost of the asset.

(d) the componentisation, measurement and depreciation pace of the assets included in the regulatory capital base are aligned to those of the entity's property, plant and equipment. In addition, the regulatory agreement requires the entity to reconcile the regulatory capital base to its property, plant and equipment. All this provides evidence of a direct relationship between the regulatory capital base and the entity's property, plant and equipment—and therefore between regulatory returns on an asset not yet available for use and the borrowing costs incurred in constructing the asset.

A2. Applying the recommended treatment of regulatory returns on an asset not yet available for use in paragraph 38 of this paper and other IFRS Accounting Standards, the entity would carry out the following accounting entries:

[8] Monetary amounts are denominated in 'currency units' (CU).

	DR	CR
During construction period		
Property, plant and equipment Cash *Being capitalisation of borrowing costs*	CU35	 CU35
Regulatory asset Regulatory income *Being origination of difference in timing related to regulatory returns on an asset not yet available for use*	CU80	 CU80
During operation period		
Depreciation expense Accumulated depreciation *Being depreciation of property, plant and equipment related to capitalised borrowing costs incurred during construction*	CU35	 CU35
Cash Revenue *Being recognition of revenue related to regulatory returns on an asset not yet available for use*	CU80	 CU80
Regulatory expense Regulatory asset *Being reversal of differences in timing related to regulatory returns on an asset not yet available for use*	CU80	 CU80

A3. The entity's statement of financial performance and financial position would be as follows:

Statement of financial performance	**Construction period**	**Operation period**
Revenue[9]	-	80
Regulatory income/(regulatory expense)	80	(80)
Depreciation expense[9]	-	(35)
Profit/(loss)	**80**	**(35)**

Statement of financial position	**Construction period**	**Operation period**
Property, plant and equipment[9]	35	-
Regulatory asset	80	-
Cash[9]	(35)	45
Total assets	**80**	**45**

A4. The recommended treatment of regulatory returns on an asset not yet available for use results in front-loading of profit relating to the capitalised borrowing costs of CU35 during the construction period. This front-loading of profit during the construction period would result in a loss during the operation period. Moreover, the entity's right to recover the capitalised borrowing costs will be reflected in both the property, plant and equipment of CU35 and the regulatory asset of CU80.

A5. An alternative approach would be to limit the regulatory asset and related regulatory income to an amount equal to the excess of the regulatory returns of CU80 over the capitalised borrowing costs of CU35, that is CU45 (see approach 1B in the table in paragraph 66). This approach would give rise to a profit of CU45 during the construction period and a nil profit or loss during the operation period.[10]

9 These amounts only relate to regulatory returns on an asset not yet available for use accumulated during the construction period (CU80) and the capitalised borrowing costs incurred during the construction period (CU35). These amounts exclude the initial capital invested of CU1,000, its recovery in regulated rates charged during the operation period and the related depreciation expense.

10 The outcomes arising from this approach would be aligned to those reported by 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 (Topic 980 *Regulated Operations* in the FASB *Accounting Standards Codification*®) or based on US GAAP.

Statement of financial performance	Construction period	Operation period
Revenue[9]	-	80
Regulatory income/(regulatory expense)	45	(45)
Depreciation expense[9]	-	(35)
Profit/(loss)	**45**	**-**

Statement of financial position	Construction period	Operation period
Property, plant and equipment[9]	35	-
Regulatory asset	45	-
Cash[9]	(35)	45
Total assets	**45**	**45**