IFRS Accounting

Staff paper

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Objective

1. This paper includes staff analysis and recommendations about the interaction between the IASB's tentative decision on regulatory returns on an asset not yet available for use and an entity's capitalisation of borrowing costs to construct that asset.

Staff recommendations

2. The staff recommend that the final Accounting Standard require that, when there is a direct relationship between an entity's regulatory capital base and its property, plant and equipment and the regulatory agreement provides the entity with:

   (a) both a debt and equity return on an asset not yet available for use, the entity shall reflect in the statement of financial performance during the construction period only those returns in excess of the entity's capitalised borrowing costs.

   (b) only a debt return on an asset not yet available for use, the entity shall not reflect the return in the statement of financial performance during the construction period if the entity capitalises its borrowing costs.

Structure of the paper

3. This paper is structured as follows:

   (a) the IASB's tentative decision (paragraphs 5–8); and

   (b) staff analysis (paragraphs 9–46).

4. In this paper, the term 'regulatory returns' refers to regulatory returns on an asset not yet available for use.

The IASB's tentative decision

5. At its July 2022 meeting, the IASB tentatively decided that when an entity has an enforceable present right to regulatory returns, those returns should form part of the total allowed compensation for goods or services supplied during the construction period of an asset.[1]

6. The effects of the IASB's tentative decision depend on whether the regulatory returns are included in regulated rates charged during:

   (a) the construction period (paragraph 7); or

   (b) the operation period of an asset (paragraph 8).

Returns included in regulated rates charged during construction

7. If regulatory returns are included in the regulated rates charged during construction, they are accounted for as part of revenue in the construction period. Applying the IASB's tentative decision, regulatory returns form part of the total allowed compensation for goods or services supplied during the construction period if the entity has an enforceable present right to those returns during the construction period. Because the regulatory returns are included in revenue recognised and form part of the total allowed compensation for goods or services supplied in the same period, no differences in timing arise. Consequently, no regulatory liabilities would arise during the construction period, unless there are amounts of regulatory returns included in revenue that an entity will be required to deduct in regulated rates charged in the future.

Returns included in regulated rates charged during operation

8. If regulatory returns are included in the regulated rates charged during operation, they are accounted for as part of revenue during the operation period. However, applying the IASB's tentative decision, regulatory returns form part of the total allowed compensation for goods or services supplied during the construction period if the entity has an enforceable present right to those returns during the construction period. Because part of the total allowed compensation for goods or services supplied in the construction period is included in regulated rates charged, and hence in revenue recognised, during operation, differences in timing arise during the construction period. In such cases, those differences in timing will give rise to a regulatory asset and regulatory income during the construction period.

Staff analysis

9. The staff analysis is structured as follows:

   (a) identifying the problem (paragraphs 10–24);

[1] Agenda Papers 9B and 9C of the July 2022 IASB meeting.

(b) addressing the problem (paragraphs 25–43); and

(c) conclusion (paragraphs 44–46).

Identifying the problem

10. The Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft) does not propose amendments to IAS 23 *Borrowing Costs*. Applying IAS 23, an entity capitalises borrowing costs incurred in constructing an asset as part of the cost of that asset when specified conditions are met.

11. Feedback on the Exposure Draft indicates that regulatory agreements typically compensate entities for borrowing costs incurred in constructing an asset by providing them with regulatory returns on the regulatory capital base.[2] The regulatory return rate typically includes both a debt and an equity return (paragraph 27).

12. This section analyses the interaction between the IASB's tentative decision on regulatory returns (paragraph 5) and an entity's capitalisation of borrowing costs when there is:

    (a) a direct relationship between an entity's regulatory capital base and its property, plant and equipment (paragraphs 13–19); and

    (b) no direct relationship between an entity's regulatory capital base and its property, plant and equipment (paragraphs 20–24).

A direct relationship between an entity's regulatory capital base and its property, plant and equipment

13. In some regulatory schemes, an entity's regulatory capital base has a direct relationship with its property, plant and equipment (see Agenda Paper 9B of October 2022 IASB meeting). In these schemes, the regulatory requirements are closely aligned with the accounting requirements. The regulator typically requires entities to reconcile their regulatory capital base to their property, plant and equipment and to track any differences. These schemes are common in North America.

14. At its October 2022 meeting, the IASB noted that in those schemes there is a direct relationship between the regulatory depreciation (that is, the depreciation of the regulatory capital base) and the accounting depreciation. Consequently, differences between the regulatory recovery period and assets' useful lives would give rise to differences in timing. We think this conclusion could be extended to regulatory returns. When an entity's regulatory capital base has a direct relationship with its property, plant and equipment and the entity is constructing an asset, the regulatory capital base would generally include the amounts the entity invested in the construction of the asset and any regulatory returns

[2] In some regulatory agreements, the regulatory capital base includes assets that are being constructed—that is, assets not yet available for use. In some others, the regulators maintain two regulatory bases, one with assets in operation (rate base) and the other with assets being constructed (construction work-in-progress base). For simplicity, this paper assumes the regulatory capital base includes assets not yet available for use.

accrued on that investment. If the entity capitalises borrowing costs during the construction period, the entity would be recovering these costs through the regulatory returns included in the regulatory capital base. In other words, in these schemes, part of the regulatory returns compensates the entity for the capitalised borrowing costs incurred in constructing the assets.

15. Illustrating the schemes described in paragraph 13, assume that:

    (a) an entity invests CU1,000 in the construction of an asset during year 1. During that period, the entity is entitled to regulatory returns on that asset of CU80, comprising both a return on equity and a return on debt.

    (b) the regulator allows the entity to include in its regulatory capital base CU1,080, which includes the construction cost of the asset of CU1,000 and regulatory returns of CU80. The entity recovers both the construction cost and the regulatory returns only *once the asset is in operation* and over its useful life.

    (c) the entity incurs borrowing costs of CU35 in constructing the asset during year 1 and, applying IAS 23, capitalises those costs.

16. Applying the IASB's tentative decision to the example above, the entity would record the following journal entries:

Year 1	Dr	Cr
Property, plant and equipment	1,035	–
Regulatory asset	80	–
Regulatory income	–	80
Cash / Debt	–	1,035
Total	*1,115*	*1,115*

17. In the example above, the entity's regulatory capital base has a direct relationship with its property, plant and equipment. Consequently, part of the regulatory returns (CU80) compensates the entity for borrowing costs incurred in constructing the asset and capitalised as part of the cost of that asset (CU35). In this case, we think applying the IASB's tentative decision on regulatory returns (paragraph 5), together with the accounting for the asset applying IAS 16 and IAS 23, could imply the entity is entitled to recover CU1,115 in regulated rates charged in the future. However, the regulator entitles the entity to recover only CU1,080—that is construction cost of CU1,000 and regulatory returns of CU80 (paragraphs 28 and 35).

18. We discussed this matter with the members of the Consultative Group on 4 October 2022.[3] Of the few members that commented, those from North America said the accounting outcome described in paragraphs 16–17 would create a problem that the IASB needs to address.

19. We think the problem described in paragraphs 16–17 could also arise if *regulatory returns are included in regulated rates charged*, and therefore in revenue recognised, *during the construction of the assets* (paragraphs 33 and 36). Applying the IASB's tentative decision, no regulatory liability would arise in such cases. An entity would include the part of regulatory returns that compensates for capitalised borrowing costs in revenue during the construction period—and hence, as part of another asset (for example, accounts receivable) arising from the recognition of revenue. The entity would, however, include those borrowing costs as part of the cost of the asset being constructed—and hence, as part of the depreciation expense during the operation period. Based on the evidence gathered so far, we think this second case is less common.

No direct relationship between an entity's regulatory capital base and its property, plant and equipment

20. In some other regulatory schemes, the link between an entity's regulatory capital base and its property, plant and equipment is less direct (see Agenda Paper 9B of October 2022 IASB meeting)—paragraphs 21–22.

21. In some cases, the regulatory capital base is only a regulatory tool for the regulator to derive the allowed revenue to which an entity is entitled for a period—the regulatory capital base is completely disconnected from the entity's property, plant and equipment. Consequently, in these schemes the regulatory returns applied to the regulatory capital base would not have a direct relationship with the borrowing costs capitalised as part of the cost of the individual assets—that is, these schemes would not give rise to the problem described in paragraphs 16–17.

22. In other cases, it would be impracticable to identify the relationship between the regulatory capital base and an entity's property, plant and equipment *at an asset level* for a variety of reasons. For example, both the componentisation of the items included in the regulatory capital base and their level of aggregation differ from those of an entity's fixed asset register, the regulatory capital base may include forecasted amounts or it may be adjusted by inflation. We think that in these schemes the problem described in paragraphs 16–17 could arise, however, it would be very complex and costly to determine the amount of borrowing costs capitalised as part of the cost of the individual assets for which part of the regulatory returns are providing compensation. These entities would face complexities and costs similar to those of accounting for regulatory assets or regulatory liabilities arising from differences

[3] The feedback from the members of the Consultative Group and the material discussed are included in Agenda Paper 9B.

between the regulatory recovery period and the assets' useful lives (see Agenda Paper 9B of October 2022 IASB meeting).

23. At its October 2022 meeting, the IASB tentatively decided that when an entity concludes its regulatory capital base does not have a direct relationship with its property, plant and equipment, the final Standard should not require or permit the entity to account for regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives.

24. We think in the cases described in paragraphs 21–22, linking the regulatory returns and the capitalised borrowing costs for the purposes of identifying differences in timing would either not result in useful information or result in costs that would outweigh the benefits. Consequently, we think entities in these cases should apply the IASB's tentative decision in paragraph 5.

Addressing the problem

25. As mentioned in paragraph 14, when an entity's regulatory capital base has a direct relationship with its property, plant and equipment, part of the regulatory returns compensates the entity for the capitalised borrowing costs incurred in constructing an asset. This is illustrated by the example in paragraph 15.

26. Entities subject to regulatory schemes described in paragraph 13 generally receive a regulatory return rate that includes either:

    (a) both a debt and an equity return (paragraphs 28–33); or

    (b) a debt return only (paragraphs 34–36).

27. Regulatory returns that include both a debt and an equity return are more common than those that include a debt return only.

Regulatory return includes a debt and an equity return

28. When entities receive a regulatory return that includes both a debt and an equity return, we think the entity's:

    (a) profit or loss should reflect the amount of regulatory returns that is in excess of the capitalised borrowing costs during the construction period. In the example above, we think the entity should reflect regulatory returns of only CU45 (that is, CU80 minus CU35), not CU80, during the construction period. During the operation period, the amount of regulatory returns included in revenue of CU80 will be offset by the borrowing costs included in the depreciation expense (CU35) and the regulatory expense arising from the recovery of the regulatory asset (CU45).

    (b) net assets should include only an amount that arises from regulatory returns that are in excess of the capitalised borrowing costs throughout the construction and operation periods. In the example above, we think the entity should reflect a regulatory asset of only CU45, not CU80, during the construction period.

29. This approach treats:

    (a) the amount of regulatory returns that is equal to the capitalised borrowing costs as an amount that recovers allowable expenses (paragraphs B3–B8 of the Exposure Draft). This amount would be included in profit or loss in the same period as the capitalised borrowing costs are included in the depreciation expense.

    (b) the remaining amount of the regulatory returns that is in excess of the capitalised borrowing costs as regulatory returns. This remaining amount would generally approximate to the equity return and would be included in profit or loss in the construction period.

30. Consequently, this approach is consistent with the IASB's tentative decision on regulatory returns (paragraph 5) and its decisions on allowable expenses.

31. This approach would be aligned to the accounting applied by entities in North America subject to regulatory schemes described in paragraph 13. At present, an entity applying IFRS 14 *Regulatory Deferral Accounts* would generally account for the difference between the regulatory returns and the capitalised borrowing costs (that is, CU45 in the example above) as a regulatory deferral account balance.

32. This approach would require some tracking. For example, when regulatory returns are included in regulated rates charged during the operation of the assets, the recovery of a regulatory asset over the operation period would require entities to track when regulatory returns in excess of the capitalised borrowing costs are included in regulated rates—and hence, included in revenue. However, because there is a direct relationship between entities' regulatory capital base and their property, plant and equipment, the additional tracking may not give rise to significant operational difficulty. Our understanding is that entities are currently required by regulatory agreements to track when regulatory returns are included in regulated rates. Therefore, entities may use existing systems and processes to determine that part of the regulatory returns in excess of the capitalised borrowing costs—for example, entities in North America subject to regulatory schemes described in paragraph 13.

33. Similarly, the additional tracking is unlikely to give rise to significant operational difficulty when entities include regulatory returns in regulated rates charged during the construction period. In such cases, entities would account for the part of regulatory returns included in revenue recognised that is equal to the amount of capitalised borrowing costs as a regulatory liability. This is because that part of the regulatory returns included in revenue recognised recovers an allowable expense—that is, the borrowing costs that the entity will recognise as an expense as part of the depreciation expense when the asset is in operation. Consequently, that part of the regulatory returns that recovers an allowable expense forms part of the total allowed compensation for goods or services supplied in the period when the individual assets are in operation. Entities would have obtained such information about the capitalised borrowing costs applying IFRS Accounting Standards to account for the fulfilment of the regulatory liability in that same period.

Regulatory return includes a debt return only

34. When entities subject to schemes similar to that described in paragraph 13 receive regulatory returns that include a debt return only, we think the debt return is the regulatory compensation for an allowable expense—that is, the borrowing costs that the entity will recognise as an expense as part of the depreciation expense when the asset is in operation.

35. Applying the approach in paragraph 34, when the debt return is included in regulated rates charged during the operation period, no differences in timing would arise during the construction period. This is because the debt return will be reflected in revenue during the operation period when the entity recognises depreciation expense that includes the capitalised borrowing costs. In some cases, the regulator:

    (a) determines the debt return to be the amount of the capitalised borrowing costs.[4] In those cases, no profit or loss would arise during the operation period because the debt return included in revenue would be the same as the capitalised borrowing costs included in the depreciation expense for that period.

    (b) determines the debt return to be an amount that approximates to the capitalised borrowing costs. In those cases, any differences between the debt return and the capitalised borrowing costs represent an over or under-recovery of the allowable expense. Therefore, any differences should be reflected in profit or loss when the entity recognises the allowable expense (that is, the capitalised borrowing costs included in the depreciation expense) during the operation period. However, the expectation is that the differences between the debt return and the capitalised borrowing costs will not be material.

36. Following from paragraph 34, if an entity received only a debt return on an asset not yet available for use and was allowed to include that return in regulated rates charged during the construction period, the entity would account for the debt return as a regulatory liability during the construction period. This is because the entity would have recognised an amount in revenue that will provide part of total allowed compensation for goods or services to be supplied in the future—that is, when the entity recognises depreciation expense that includes the capitalised borrowing costs as the entity uses the asset to supply goods or services during the operation period. During the operation period, the entity would reflect in profit or loss any differences between the capitalised borrowing costs that are recognised as an expense through the depreciation expense and the regulatory income that arises from the fulfilment of the regulatory liability.

[4] We received this feedback at the Consultative Group meeting on 4 October 2022. See Agenda Paper 9B.

The IAS 23 option

37. When an entity's regulatory capital base has a direct relationship with its property, plant and equipment, the same or a similar profit or loss profile would result if the entity applied (paragraph 38):

    (a) the approach described in paragraphs 28 and 34; or

    (b) the IASB's tentative decision in July 2022 (paragraph 5) and did not capitalise borrowing costs. This approach would require the IASB to amend IAS 23 to prohibit the capitalisation of borrowing costs in such situations (the IAS 23 option). Applying this option, those entities would reflect both regulatory returns and borrowing costs in profit or loss during the construction period.

38. When an entity receives a *regulatory return that includes both a debt and an equity return*, both the approach described in paragraph 28 and the IAS 23 option would require the entity to reflect in profit or loss the difference between the regulatory return and the borrowing costs during the construction period. When an entity receives a *regulatory return that includes a debt return only*, the approach described in paragraph 34 and the IAS 23 option would lead to the entity reflecting any difference between the debt return and the borrowing costs in different periods. If an entity applied the approach described in paragraph 34, any difference between the debt return and the capitalised borrowing costs would be reflected in profit or loss during the operation of the asset. If the entity applied the IAS 23 option, any difference between the debt return and the borrowing costs would be reflected in profit or loss during the construction of the asset. Because the debt return approximates to the capitalised borrowing costs, any difference is expected to be immaterial, and hence, these options are expected to result in a similar profit or loss profile.

39. We think the IAS 23 option would be easier for entities to apply as it would not require tracking (see paragraphs 32 and 33) and would result in information that is easier to understand. Entities applying the final Standard would reflect regulatory returns in profit or loss as a gross amount in all situations rather than as a net amount between the regulatory returns and the capitalised borrowing costs in most cases (paragraphs 27 and 28).

40. However, the staff agrees with a few members of the Consultative Group that said the IAS 23 option conflicts with the IASB's conclusion, when it developed IAS 23, that specified borrowing costs should form part of the cost of an asset. Because the model is supplementary in nature and the accounting for regulatory returns is a core aspect of the model, we think any issues arising from the interaction between that accounting and the capitalisation of borrowing costs should be dealt with by the model rather than by amending IAS 23.

41. The staff also thinks that the approach described in paragraphs 28 and 34 is more aligned with other IASB's tentative decisions that require an entity to first apply IFRS Accounting Standards and then apply the requirements of the final Standard. For example, in September 2022, the IASB tentatively decided to clarify in the final Standard the intended interaction between the model and IFRIC 12 *Service Concession Arrangements*. That is, an entity would apply IFRIC 12 first and then apply the

requirements of the Standard to any remaining rights and obligations to determine if the entity has regulatory assets or regulatory liabilities.

42. In addition, although the IAS 23 option would result in the same or a similar profit or loss profile as the approach described in paragraphs 28 and 34, we think it may be perceived by stakeholders as a more fundamental change to the Exposure Draft proposals than the approach described in paragraphs 28 and 34. The IASB did not consider amending IAS 23 when developing the Exposure Draft proposals.

43. We also note the members of the Consultative Group did not support amending IAS 23 (see Agenda Paper 9B).

Conclusion

44. The staff recommend that the final Accounting Standard require that, when there is a direct relationship between an entity's regulatory capital base and its property, plant and equipment and the regulatory agreement provides the entity with:

    (a) both a debt and equity return on an asset not yet available for use, the entity shall reflect in the statement of financial performance during the construction period only those returns in excess of the entity's capitalised borrowing costs.

    (b) only a debt return on an asset not yet available for use, the entity shall not reflect the return in the statement of financial performance during the construction period if the entity capitalises its borrowing costs.

45. This approach would result in more useful information than that provided applying the IASB's tentative decision on regulatory returns (paragraphs 28 and 34). In addition, we think regulatory schemes that result in entities' regulatory capital base having a direct relationship with their property, plant and equipment are economically different from regulatory schemes that do not. The approach would provide information about regulatory returns that would help users of financial statements to compare the financial position and financial performance of entities subject to those different regulatory schemes. We also think additional disclosures may be necessary to help users of financial statements to analyse the information about regulatory returns of entities subject to schemes that result in a direct relationship relating to the construction period. For example, users may find useful information that links the total amount of regulatory returns on an asset not yet available for use during the reporting period with both the entity's capitalised borrowing costs and the movement of the regulatory asset for the same period. We plan to discuss disclosures with the IASB at a future meeting.

46. Moreover, this approach:

    (a) would not conflict with that IASB's tentative decisions (paragraphs 5, 30 and 41) and the IASB's conclusion on IAS 23 (paragraph 40).

(b) may not be costly to implement—either the approach is aligned with the current accounting applied by some entities affected by the approach (paragraph 31) or the additional tracking the approach may require is unlikely to give rise to significant operational difficulty (paragraphs 32–33).

Question for the IASB
Does the IASB agree that the final Accounting Standard should require that, when there is a direct relationship between an entity's regulatory capital base and its property, plant and equipment and the regulatory agreement provides the entity with: a) both a debt and equity return on an asset not yet available for use, the entity shall reflect in the statement of financial performance during the construction period only those returns in excess of the entity's capitalised borrowing costs (paragraphs 28–33). b) only a debt return on an asset not yet available for use, the entity shall not reflect the return in the statement of financial performance during the construction period if the entity capitalises its borrowing costs (paragraphs 34–36).