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Regulatory assets and regulatory liabilities
Capitalised borrowing costs

Objective

1 The objective of the session is for EFRAG FR TEG to further discuss the IASB's tentative decisions made in November 2022 regarding the accounting for regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs to construct that asset.

2 The IASB's tentative decision was discussed by EFRAG RRAWG in February 2023, and by EFRAG FR TEG-CFSS and ASAF in March 2023. However, this is a complex and important topic as it is related to a core building block of the RRA accounting model-total allowed compensation, and it affects whether regulatory assets and regulatory liabilities will be reported by entities. Mixed views have been expressed with concerns aired by some EFRAG RRAWG members on the associated complexity, materiality and inconsistency with an earlier IASB July 2022 tentative decision on the treatment of regulatory returns for assets not yet in use.

3 Of note, EFRAG FR TEG, EFRAG RRAWG and EFRAG FRB supported the July 2022 IASB tentative decision as it reversed a requirement (paragraph B15) for the deferral of regulatory returns granted for assets not yet in use included in the January 2021 IASB Exposure Draft *Regulatory Assets and Regulatory Liabilities (ED)*. Stakeholders including EFRAG in its final comment letter had opposed this requirement.

4 A further discussion by EFRAG FR TEG is also needed to help establish EFRAG's preliminary position on the issue when providing an update to the EFRAG FRB in May 2023 and to help determine whether EFRAG should undertake outreach on this aspect as part of its preparatory work to provide endorsement advice on the forthcoming final Standard.

5 As noted, the capitalised borrowing costs issue was included in the agenda paper for the March 2023 EFRAG FR TEG-CFSS meeting and the EFRAG Secretariat and IASB Staff further described the issue at the meeting. Consequently, as EFRAG FR TEG members are familiar with the issue, the sections below only focus on

(a) a high-level recap of the issue and possible actions,

(b) November 2022 IASB tentative decisions,

(c) the feedback on the matter received by EFRAG and during the March 2023 ASAF meeting, and

(d) EFRAG Secretariat's analysis.

6 If needed, Agenda paper 06-04 (background paper) used for the RRAWG meeting and the following links to IASB papers provide more details on the issue (i.e., the problem of the accounting mismatch due to the capitalisation of borrowing costs that

necessitated the IASB tentative decision, examples illustrating the problem, feedback to the IASB, IASB discussion with its consultative group, IASB staff analysis)

(a) IASB Staff paper AP9: [Cover note];

(b) IASB Staff paper AP9A: [Capitalised borrowing costs];

(c) IASB Staff paper AP9B: [Consultative Group for Rate Regulation meeting]; and

(d) IASB Staff paper AP9C: [Capitalised borrowing costs (Addendum)].

High-level recap of the accounting mismatch problem and possible actions (The below content is excerpted from the March EFRAG FR TEG-CFSS meeting agenda paper)

7 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.

8 Feedback to the IASB 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 (RCB). The regulatory return rate typically includes both a debt and an equity return. Applying IAS 23 *Borrowing Costs*, an entity capitalises borrowing costs incurred in constructing an asset as part of the cost of that asset when specified conditions are met. The entity then recognises the capitalised borrowing costs in profit or loss as part of the depreciation expense during operation.

9 When an entity capitalises the borrowing costs incurred during the construction of an asset, applying the July IASB's tentative decision on regulatory returns could be viewed as creating an accounting mismatch and, in certain circumstances, result in the front-loading of profit during the construction period (examples of these can be seen in the background paper 06-04 and the IASB staff paper AP 9A).

10 This is because:

(a) the debt return included within the regulatory returns would be reflected in profit or loss during the construction period—either as revenue under IFRS 15 *Revenue for Contracts with Customers* (when regulatory returns are included in regulated rates as the asset is being constructed) or as part of regulatory income related to the recognition of a regulatory asset (when regulatory returns are included in regulated rates only once the asset is operational).

(b) the capitalised borrowing costs would be recognised in profit or loss as part of depreciation expense only once the asset is operational (under IAS 23).

11 The accounting mismatch problem occurs for both of the following situations:

(a) Regulatory returns are included in regulated rates charged during the operation period of an asset.

(b) Regulatory returns are included in regulated rates charged, and therefore in revenue recognised, during the construction of the assets.

12 The IASB Staff considered that the accounting mismatch issue could arise in situations when there is either a direct or no direct relationship between an entity's regulatory capital base and its property, plant and equipment. However, **when there is no direct relationship, 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. Consequently, the IASB Staff considered that entities, where there is no direct relationship between RCB and PPE, should only apply the July IASB's tentative

decision (i.e., allow the noted accounting mismatch) and the November 2022 tentative decision to address the accounting mismatch issue should only apply when there is a direct relationship.

13 The IASB Staff explored four approaches with its consultative group at its November 2022 meeting:

(a) Approach 1: No further action (i.e., allow the noted accounting mismatch);

(b) Approach 2: Deferring the entire debt return;

(c) Approach 3: Deferring part of regulatory return equal to capitalised borrowing cost; and

(d) Approach 4: IAS 23 Option- Amend IAS 23 prohibiting capitalisation of borrowing costs.

14 Based on the feedback received at its Consultative Group meeting, the IASB Staff analysed further Approaches 2 to 4 in IASB Staff paper 9A discussed at the IASB meeting in November 2022. The IASB Staff recommended that the final Accounting Standard require that when there is a direct relationship between an entity's RCB 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 (i.e., Approach 3).

(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 (i.e., Approach 2).

15 In effect, the IASB staff recommendations for IASB tentative decisions address cases where an entity receives regulatory returns that consist of both an equity and a debt return and the case when an entity receives regulatory returns that only consists of a debt return. In the first case (returns = equity + debt returns), the IASB's tentative decision would be aligned with approach 3. In the second case (returns = debt return), the IASB's tentative decision would be aligned with approach 2.

16 Reasons provided by the IASB staff for this recommendation include:

(a) This approach would result in more useful information than that provided by applying the July IASB's tentative decision on regulatory returns;

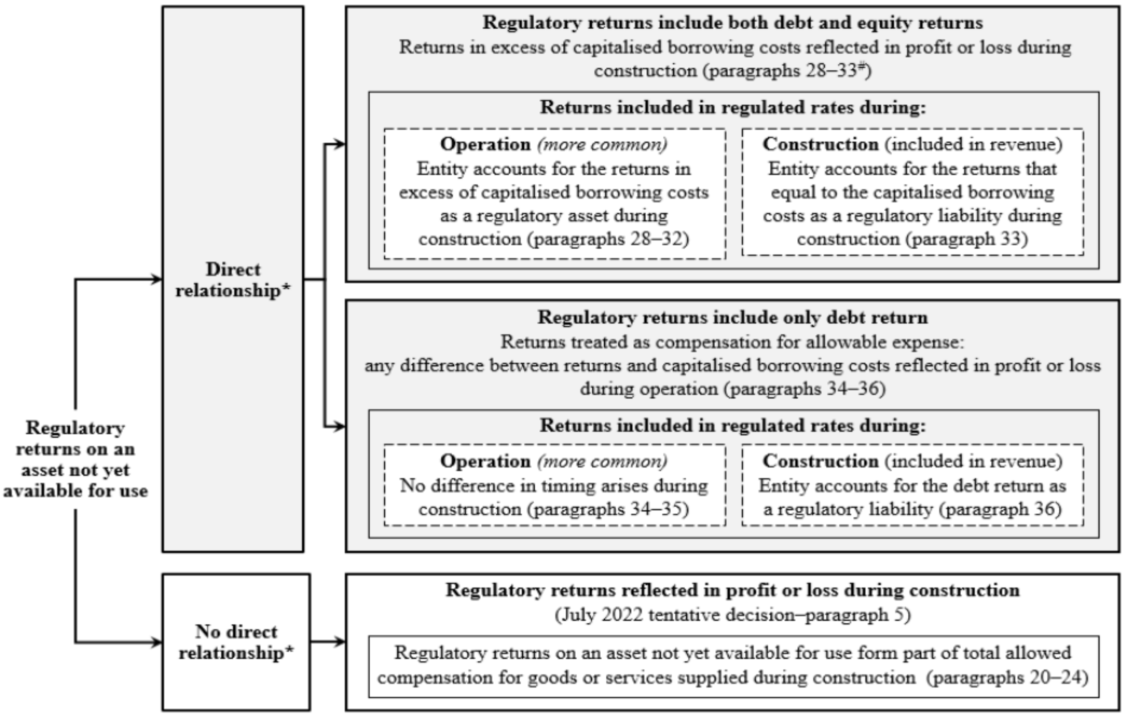
(b) The regulatory schemes that result in entities' regulatory capital base having a direct relationship with their property, plant and equipment are economically different from regulatory schemes that do not;

(c) Would not conflict with that July IASB's tentative decisions; and

(d) May not be costly to implement - either the approach is aligned with the current accounting applied by some entities affected by the approach or the additional tracking the approach may require is unlikely to give rise to significant operational difficulty.

17 The IASB Staff considered that the IAS 23 option would be easier for entities to apply as it would not require tracking and would result in information that is easier to understand. However, the IASB Staff considered that conflicts with the IASB's conclusion, when it developed IAS 23, which specified borrowing costs should form part of the cost of an asset.

18 The below flow chart summarises the IASB Staff's recommendations on capitalised borrowing costs. References to paragraphs are to November IASB paper AP9A: Capitalised borrowing costs.



* Between an entity's regulatory capital base and its property, plant and equipment
\# Paragraph reference to Agenda Paper 9A

November 2022 IASB tentative decision on capitalised borrowing costs (This is reproduced from the March EFRAG FR TEG-CFSS meeting agenda paper)

19 In agreement with the IASB staff recommendations, the IASB tentatively decided that when an entity's **regulatory capital base and its property, plant and equipment have a direct relationship** and the **entity capitalises its borrowing costs**:

(a) if the regulatory agreement provides the entity with both a debt and an equity return on an asset not yet available for use—to require the entity to reflect only those returns in excess of the entity's capitalised borrowing costs in the statement of financial performance during the construction period; and

(b) if the regulatory agreement provides the entity with only a debt return on such an asset—to prohibit the entity from reflecting the return in the statement of financial performance during the construction period.

20 All 11 IASB members agreed with these decisions.

Feedback received by EFRAG and during ASAF

EFRAG RRAWG (February 2023) (This is reproduced from the March EFRAG FR TEG-CFSS meeting)

21 EFRAG RRAWG discussed the IASB's tentative decisions regarding the accounting for regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs to construct that asset.

22 Mixed views were expressed on the IASB's tentative decision with a few members preferring no further action while one agreed to address the accounting mismatch. Concerns revolved around the additional complexity, materiality of the issue, and

perceived inconsistency with the regulatory agreement's approach. Detailed comments are as follows:

(a) For those that indicated that they preferred no action to be taken (i.e. make no amendments to address the noted accounting P&L mismatch due to the borrowing costs being recognised as part of regulatory income (P&L) in a period whereas the capitalised borrowing costs are only recognised in P&L afterwards), reasons provided include that the tentative decisions would be costly to make sure that there is no accounting mismatch; the amendment would result in excess complexity and questions on whether the issue was material.

(b) One member preferred to address the accounting mismatch for a direct relationship by deferring part of the regulatory return equal to capitalised borrowing costs (consistent with the IASB's tentative decisions).

23 One member indicated that their company has a non-direct relationship between the RCB and its PPE and they invoice returns on construction work in progress during the construction period. In this situation, there would also be this accounting mismatch because the revenue would include the total amount charged to customers but they apply IAS 23. This member suggested disclosing information if material. This member did not agree with amending IAS 23 because the rate-regulated activities model is a supplementary model and the underlying model should not change.

24 Another member indicated that the Standard should take into consideration what the regulation stipulates on the total allowed compensation. Therefore, for situations whereby the regulated return is included in the regulated rate in the operation phase, this member did not agree with recognising a regulatory asset. The IASB Staff responded that the recognition of a regulatory asset is linked to if goods or services are supplied during construction rather than the period when the regulator includes the returns in the rates charged. The proposed model is consistent with accrual accounting and the treatment of regulatory returns is consistent with the treatment of performance bonuses.

25 This member also indicated that for situations whereby the regulated return is included in the regulated rate in the construction phase, she was not comfortable with recognising a liability as this is contradictory with the July IASB tentative decisions (i.e., regulatory returns that are included in IFRS 15 revenue during construction should not result in timing differences).

26 Another member indicated that there are two types of mismatches: the accounting mismatch as revenue is only recognised in construction and not when assets are in use; and an economic mismatch because of the revenue recognised and the capitalisation of the borrowing costs. This member indicated his company decided not to capitalise their borrowing costs so as not to recognise a regulatory liability.

27 Another member recalled two situations whereby the regulated return is included in the regulated rate in the operation phase: one whereby the construction work in progress is being maintained on an existing network compared to another situation whereby there is a creation of a new asset. For the latter situation, it would be risky to recognise a regulatory asset as the entity may not be sure if it will be successful. Therefore, this member preferred to have criteria to make a distinction between these two situations. A member added that it would also be complicated and complex to measure if the entity earns in the operation period. This member wanted to understand the cash impact of the cash flows being received. The IASB Staff responded that for a new asset being developed, the regulator may set different rules. The entity would need to assess enforceable rights.

EFRAG FR TEG-CFSS meeting (March 2023)

28 One member indicated that the root cause of the issue is IAS 23. On the one hand, they considered that the proposals would be difficult to implement and questioned whether the schemes affected were material. While on the other hand, this member acknowledged that the accounting mismatch would be difficult to explain to users so agreed, at this stage, with the tentative decisions.

29 Another member considered that Approach 3: Deferring part of regulatory return equal to capitalised borrowing cost (as discussed by the IASB's Consultative Group) should apply to all situations and indicated that the IASB's tentative decisions would lead to more complexity.

30 Regarding recognition of a regulatory liability for the capitalised borrowing cost recognised during construction, the IASB Staff indicated that they have seen that for most of the cases, the returns on regulated rates are included in the operation period. They only encountered one case when there is a direct relationship whereby regulated returns are included in the regulated rates during the construction period.

High-level summary of ASAF discussions

31 The below summary is not from the official meeting report (yet to be issued) and is the EFRAG Secretariat's interpretation of the ASAF discussions.

32 There were mixed views at the meeting with some participants agreeing to the IASB tentative decisions while others indicated some concerns as follows.

(a) Some members indicated that where regulated returns are charged during the construction of the assets, their stakeholders were not entirely sure that these cases are not frequent and there is the perception that a regulatory liability is being introduced via the 'back door' with another conceptual approach (compared to the ED). These members asked for further outreach to understand the prevalence.

(b) Another member commented that some stakeholders were concerned that identifying and tracking individual assets and carrying out the relevant treatment would incur significant incremental costs which may make entities provide additional non-gaap indicators to explain the recovery of funds during the construction period. Also, some stakeholders suggested the IASB makes further explanations on the different treatment for (a) the regulatory agreement providing the entity with both a debt and an equity return on an asset not yet available for use compared with (b) the regulatory agreement providing the entity with only a debt return on such an asset.

(c) Another member stated that there were mixed views from the stakeholders. A minority supported amending IAS 23 but there was an acknowledgement that the RRA project supplements current IFRS Accounting Standards. There was also a view that only applying Approach 3: Deferring part of regulatory return equal to capitalised borrowing cost, would have lessened the complexity.

(d) Another member commented that the terms debt return and equity return are not defined so there could be confusion on how it would work in practice.

EFRAG Secretariat analysis

33 As noted above, mixed views have been expressed with concerns aired by some EFRAG RRAWG and CFSS members on the associated complexity, and materiality of the IASB tentative decision on capitalised borrowing costs. The EFRAG Secretariat notes the IASB staff arguments including cost-benefit considerations and the reasons for not amending IAS 23 (i.e., will conflict with earlier IASB conclusions) and as some including RRAWG members have noted, underlying IFRS requirements should not be amended for the Final RRA Standard as it is a

supplemental Standard. We also note the IASB staff's observations that the IASB November 2022 tentative decisions are simply reflecting current reporting practices. However,

(a) The EFRAG Secretariat is not aware of the IASB's specific analysis of the implications of a possible scope exception from IAS 23 for capitalised borrowing costs that are compensated by regulatory returns, and what, if any, would be the consequences of such an amendment.

(b) It is unclear if Option 1 (do nothing and provide disclosures on the capitalised borrowing cost that allows users to be aware of the amount that creates the mismatch) was considered by the IASB, and if not, why not?

(c) The feedback to EFRAG indicates that some stakeholders consider the combination of Options 2 and 3 will result in unnecessary complexity. The reasons for going for a combination of Option 2 and 3 - with different treatment depending on whether fully debt-funded versus being funded through a mix of equity and debt has also not been fully articulated.

34 Another concern on the IASB tentative decision is its perceived inconsistency with the earlier IASB July 2022 tentative decision on the treatment of regulatory returns for assets not yet in use, which as noted was supported by EFRAG FR TEG, FRB and RRAWG. Specifically, the EFRAG Secretariat notes that, in applying the November 2022 tentative decisions and if regulatory returns are included in the **regulated rates charged during the construction of the assets, a regulatory liability would be recognised** (see paragraph 38 below).

35 The EFRAG Secretariat notes that in its comment letter to the ED, EFRAG disagreed with the proposals in paragraph B15[1] of the ED that would require the recognition of a regulatory liability as there is no arising enforceable obligation to reduce rates reflected by this regulatory liability that is recognised when deferring CWIP regulatory returns. Therefore, in EFRAG's view, this recognised regulatory liability did not/does not meet the ED's definition of a regulatory liability.

36 We acknowledge that the IASB Staff have indicated that circumstances of needing to recognise a regulatory liability are rare (i.e., IASB staff has only encountered one situation). However, taking note of this, the EFRAG Secretariat is not sure of the prevalence of this situation in Europe especially as this issue was neither addressed in the EFRAG comment letter and the early-stage analysis nor did it arise in the RRAWG discussions that preceded the drafting of EFRAG's comment letter.

37 For the above reasons, the EFRAG Secretariat considers it appropriate to undertake outreach to EU preparers as part of preparatory work for the endorsement advice. We are cognisant that the IASB is currently undertaking outreach via a survey, but this focuses mainly on the direct (no direct) relationship. Therefore, with a view to better understanding the implications of the November 2022 IASB tentative decision, the EFRAG Secretariat suggests that EFRAG should conduct outreach to:

(a) ascertain the prevalence of situations in the EU where a regulatory liability could occur and if this is consistent with current reporting practices; and

[1] B15 *Sometimes a regulatory return includes an amount determined by applying a specified return rate to a base containing a balance relating to an asset not yet available for use. That balance might be a separate base or part of a larger base. The return on that balance shall not be treated as forming part of the total allowed compensation for goods or services supplied before the asset is available for use. Once the asset is available for use, the return on that balance forms part of total allowed compensation for goods or services supplied over the remaining periods in which the entity recovers the carrying amount of the asset through the regulated rates. An entity shall use a reasonable and supportable basis in determining how to allocate the return on that balance over those remaining periods and shall apply that basis consistently*.

(b) to ascertain the usefulness of the information for users arising from the IASB November 2022 tentative decisions.

EFRAG Secretariat analysis of the implication of the IASB November tentative decisions

38 Below are examples based on applying the November IASB tentative decisions:

(a) Regulatory returns are included in regulated rates charged during the **operation** of the assets

Year 1	Dr	Cr
Property, plant and equipment	1,035	-
Regulatory asset	45[2]	-
Regulatory income	-	45
Cash / Debt	-	1,035
Total	*1,080*	*1,080*

(b) regulatory returns are included in regulated rates charged during the **construction** of the assets

Year 1	Dr	Cr
Property, plant and equipment	1,035	-
Regulatory expense	35	-
Revenue	-	80
Regulatory liability	-	35
Cash / Debt	-	955
Total	*1,070*	*1,070*

Questions for EFRAG FR TEG

39 Does EFRAG FR TEG consider that the issue, relating to the creation of an accounting mismatch and front-loading of profit during the construction period when borrowing costs are capitalised, needs to be addressed? Please explain.

40 Do you agree with the IASB November 2022 tentative decisions or should the two other options be considered?

(a) Approach 1: No further action (i.e., allow the noted accounting mismatch);

(b) Approach 4: Prohibiting capitalisation of borrowing costs (amend IAS 23).

41 For regulated returns being included in the regulated rate during construction, the November IASB tentative decisions will result in the recognition of a regulatory liability (see paragraphs 33 to 38 above). Do EFRAG FR TEG members agree with this? Please explain.

42 Do you agree with the proposed outreach by EFRAG to EU preparers and users on this issue as part of the preparatory work for endorsement advice on the final Standard?

[2] CU80 minus CU35