
Consultative Group for Rate Regulation

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Project **Rate-regulated Activities**

Topic **Capitalised borrowing costs**

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Purpose of the paper

- The purpose of the paper is:
 - to discuss whether and how an entity’s accounting treatment of borrowing costs may affect the amount of regulatory returns on an asset not yet available for use that the entity should reflect in profit or loss during the construction period; and
 - to explore possible courses of action that the IASB should consider.
- In this paper, the term ‘regulatory returns’ refers to regulatory returns on an asset not yet available for use, unless otherwise specified.

Structure of the paper

- The paper is divided into the following sections:
 - proposed requirements (slides 2–3);
 - summary of comments received (slide 3);
 - the IASB’s tentative decision (slide 4); and
 - topics on which we need your feedback (slides 5–20).

Proposed requirements

- Paragraph B10 of the Exposure Draft *Regulatory Assets and Regulatory Liabilities* (Exposure Draft) sets out the general principle for target profit—target profit that a regulatory agreement entitles an entity to add in determining a regulated rate for goods or services supplied in a period forms part of the total allowed compensation for goods or services supplied in the same period.
- As an exception to that general principle, paragraph B15 of the Exposure Draft proposes that:
 - regulatory returns on an asset not yet available for use should form part of total allowed compensation for goods or services supplied once the asset is available for use and over the remaining periods in which the entity recovers the carrying amount of the asset through the regulated rates; and
 - an entity uses a reasonable and supportable basis in determining how to allocate the returns over those remaining periods and applies that basis consistently.

Proposed requirements—*continued*

- Paragraph B15 is consistent with the principle underlying the proposed model that an entity should 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 (paragraph 16 of the Exposure Draft). According to the Exposure Draft, an entity cannot supply goods or services using assets that are not yet available for use and, therefore, is not entitled to regulatory returns on those assets before the assets are available for use.¹
- The effect of these proposals is that an entity would recognise regulatory returns as part of income and previously capitalised borrowing costs as an expense as part of an asset's depreciation expense during the operation of the asset. Hence, the Exposure Draft does not propose amendments to IAS 23 *Borrowing Costs*.

Summary of comments received

- Most respondents disagreed with the proposed treatment of regulatory returns.
- Many respondents said regulatory returns compensate the entity for the following services:
 - continuous investment in the network that includes an asset not yet available for use; and
 - provision of capital to fund that investment during the construction period.
- According to these respondents, reflecting regulatory returns in profit or loss during the construction period, regardless of when those returns are included in regulated rates, would be consistent with the principle underlying the model. This is because an entity supplies the services mentioned above during the construction period.
- At the March 2022 meeting of the Consultative Group for Rate Regulation (Consultative Group), most members supported an accounting treatment that would lead to entities reflecting regulatory returns in profit or loss during the construction period.
- A few respondents suggested alternative approaches to the proposed treatment of regulatory returns in the Exposure Draft that take into consideration the borrowing costs capitalised applying IAS 23 (slide 16).

¹ Paragraph BC99 of the Basis for Conclusions on the Exposure Draft provides the rationale for this proposal.

The IASB’s tentative decision

IASB’s July 2022 tentative decision

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.

- Table 1 illustrates the effects of the IASB’s tentative decision depending on whether the regulatory returns are included in regulated rates charged during the construction or during the operation period of an asset.

Table 1—Effects of the tentative decision		
When regulatory returns are included in regulated rates	Effects of the tentative decision	Assessments
Construction period	Regulatory returns are accounted for as part of revenue in the construction period. Because regulatory returns form part of the total allowed compensation for goods or services supplied during the construction period and they are included in revenue in that same period, no differences in timing arise.	An entity should assess the terms of the regulatory agreement to determine whether there are amounts of regulatory returns reflected in revenue that an entity will be required to deduct in regulated rates charged in the future. If so, the entity would account for the corresponding regulatory liability during the construction period.
Operation period	Regulatory returns form part of the total allowed compensation for goods or services supplied during the construction period, however, they are only included in revenue during the operation period. Consequently, a difference in timing arises. An entity would account for regulatory returns as a regulatory asset and regulatory income if the entity has an enforceable present right to these returns during the construction period.	An entity should assess the terms of the regulatory agreement to determine whether it has an enforceable present right to the regulatory returns during the construction period.

Topics on which we need your feedback

- Topic 1—How regulatory agreements compensate entities for borrowing costs
- Topic 2—How the capitalisation of borrowing costs may affect the amounts of regulatory returns that an entity can reflect in profit or loss during the construction period

Topic 1—How regulatory agreements compensate entities for borrowing costs

- This section describes how regulatory agreements typically compensate entities for borrowing costs incurred either as a regulatory return calculated on the regulatory capital base or as a pass-through cost. We would like to gather input from you on the features of these different approaches and how widespread they are. We would also like to gather input from you on some possible accounting implications.
- Regulatory agreements typically compensate entities for borrowing costs either as a regulatory return calculated on the regulatory capital base or as a pass-through cost:
 - **regulatory returns**—we understand this is the most common manner in which regulatory agreements compensate entities for borrowing costs. The regulatory returns are typically calculated by applying a return rate to the entire regulatory capital base that may include assets not yet available for use. The return rate typically represents the cost of capital that includes both debt and equity returns. When the return rate includes a debt return, regulatory agreements typically exclude capitalised borrowing costs from the regulatory capital base that the entity will recover through the regulated rates.
 - **pass-through costs**—regulatory agreements may, in some cases, determine the amount of compensation to which an entity is entitled for the supply of goods or services in a period—referred to as ‘allowed revenue’ in some schemes—to include an amount that aims to provide the entity compensation for borrowing costs. In such cases, the borrowing costs represent a pass-through cost that is recovered through regulated rates.² The compensation for borrowing costs may not distinguish borrowing costs incurred on assets not yet available for use from borrowing costs incurred on assets in operation.

² Regulatory agreements may use the term ‘pass-through costs’ to refer to those costs that a regulatory agreement allows an entity to recover based on the actual amount incurred by the entity. In this paper, ‘pass-through costs’ also include costs that are included in regulated rates charged based on estimated costs rather than actual costs.

Topic 1—How regulatory agreements compensate entities for borrowing costs—*continued*

- Some regulatory agreements may entitle an entity to recover borrowing costs as pass-through costs by including those borrowing costs in regulated rates—and in revenue—as the entity incurs those costs. The entity may either expense those borrowing costs or capitalise them as part of the cost of assets being constructed. The entity would treat the related compensation charged in regulated rates in a period, and recognised in revenue in that period, as an amount that recovers allowable expenses. Considering the proposals in the Exposure Draft, if the entity capitalises the borrowing costs as part of the cost of an asset, that amount of compensation forms part of total allowed compensation for goods or services supplied in the future as the entity depreciates the asset. Consequently, the entity would account for that amount as a regulatory liability during the construction period of the asset by applying paragraphs B3–B8 of the Exposure Draft. The entity would fulfil that regulatory liability when the borrowing costs are recognised as an expense applying IFRS Accounting Standards, that is when the asset is depreciated. This accounting treatment is aligned to that proposed by the Exposure Draft for the fulfilment of regulatory liabilities related to regulatory returns that are included in regulated rates during construction period.
- Feedback on the Exposure Draft indicated that the proposed treatment of regulatory returns would be costly to implement given the high volumes of assets that are under construction.³ This raises the question of whether stakeholders would have similar concerns about the proposals when regulatory agreements compensate borrowing costs as a pass-through cost and part of these borrowing costs are capitalised during the construction of the assets.

Questions for the Consultative Group—Topic 1

1. As mentioned above, this section describes how regulatory agreements typically compensate entities for borrowing costs incurred either as a regulatory return calculated on the regulatory capital base or as a pass-through cost. We are asking for input on:
 - a) regulatory agreements that determine regulatory returns by applying to the regulatory capital base a return rate that includes a debt return—whether and how these agreements establish a link between regulatory returns and the borrowing costs incurred by an entity in constructing an asset.
 - b) regulatory agreements that treat borrowing costs as a pass-through cost that is recovered through regulated rates in the period in which the entity incurs those borrowing costs:
 - i. how widespread are these agreements?
 - ii. in cases when the compensation relating to capitalised borrowing costs is included in regulated rates charged during the construction period, does that compensation represent compensation received in advance for an amount that will be included in the depreciation expense the entity will incur in a future period? If so, would the recognition of regulatory liabilities related to borrowing costs incurred in constructing the assets be operational? How material would those regulatory liabilities be?

³ See [Agenda Paper 9B](#) discussed at the July 2022 IASB meeting.

Topic 2—Capitalisation of borrowing costs and its effect on the amounts of regulatory returns to be reflected in profit or loss during the construction period

- The staff analysis in this section is structured as follows:
 - identifying the problem (slide 7); and
 - exploring approaches to addressing the problem (slides 8–20).

Identifying the problem

- 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. The entity subsequently recognises the capitalised borrowing costs in profit or loss as part of the depreciation expense.
- When an entity capitalises borrowing costs during the construction of an asset, applying the treatment of regulatory returns in the **Exposure Draft** would result in the entity reflecting **both regulatory returns and the capitalised borrowing costs** in profit or loss during **the operation period** (slide 3).
- However, an entity capitalising borrowing costs and applying **the IASB’s tentative decision** could be viewed as creating an **accounting mismatch** and **front-loading profit** during **the construction period** in certain circumstances (that is, **the problem**).⁴ This is because:
 - the debt return included within the regulatory returns would be reflected in profit or loss during the construction period—either as revenue (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).
 - the capitalised borrowing costs would be recognised in profit or loss as part of depreciation expense only once the asset is operational.
- This suggests there may be circumstances when the IASB’s tentative decision would not result in useful information and may need to be modified.
- The staff has developed Examples A and B to illustrate the problem. The staff has identified that the problem could arise when there is a direct relationship between an entity’s regulatory capital base and its property, plant and equipment.⁵ We think in these cases, the regulatory agreement would generally specify that the debt return within the regulatory returns provides compensation for the borrowing costs incurred to construct an asset.
- This is addressed in the next section.

⁴ The appendix of [Agenda Paper 9B](#) of the July 2022 IASB meeting illustrates one situation. The IASB did not discuss this matter at that meeting.

⁵ [Agenda Paper 9A](#) of the May 2022 IASB meeting discussed how the regulatory capital base and an entity’s property, plant and equipment 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 discussed indicators of a direct relationship between the regulatory capital base and an entity’s assets at its [meeting](#) on 28 March 2022.

Exploring approaches to addressing the problem

- This section uses Examples A and B:
 - to provide a numerical illustration of the problem; and
 - to explore possible approaches to addressing the problem.
- This section does so by considering that any approaches to solving the problem:
 - should not affect the conclusion that regulatory returns should form part of the total allowed compensation for goods or services supplied during the construction period.
 - may restrict the amount of regulatory returns reflected in profit or loss during the construction period in certain circumstances.
- Examples A and B illustrate the same fact pattern, except that the regulatory returns are included in regulated rates charged during the operation period of the asset in Example A and during the construction period in Example B.
- In addition, Examples A and B reflect the staff's view that an accounting mismatch and front-loading of profit (that is, the problem) could arise when there is a direct relationship between an entity's regulatory capital base and its property, plant and equipment (slides 9–11). When there is a direct relationship between an entity's regulatory capital base and its property, plant and equipment, there would also generally be a direct relationship between the regulatory returns on the regulatory capital base and the borrowing costs incurred in the construction of the assets. A direct relationship between the regulatory capital base and property, plant and equipment is typically seen in schemes when the regulatory accounting and reporting requirements are aligned with the accounting reporting requirements.
- We observed from feedback on the Exposure Draft that this circumstance—that is, when there is a direct relationship between an entity's regulatory capital base and its property, plant and equipment:
 - is typically present in regulatory schemes in which the regulatory returns are included in regulated rates charged during the operation period (Example A). Feedback indicated that these regulatory schemes are common in North America.
 - may not be common in regulatory schemes in which the regulatory returns are included in regulated rates charged during the construction period (Example B).

Exploring approaches to addressing the problem—*continued*

Example A—Based on the example included in [Agenda Paper 9B](#) of the July 2022 IASB meeting^{6,7}

- An entity invests CU1,000 of capital to construct an asset in year 1.
- The regulatory agreement allows the entity to accumulate regulatory returns during the construction period (year 1) and to include those returns in regulated rates during the operation period (years 2–6). 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) in year 1 and recovers regulatory returns of CU16 in each of the years 2–6 (CU80 / 5 years). The entity concludes that it has an enforceable present right to these regulatory returns during the construction period.
- 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. The entity reflects capitalised borrowing costs of CU7 in profit or loss as part of depreciation expense in each of the years 2–6 (CU35 / 5 years).
- The regulatory agreement requires the entity to reconcile its regulatory capital base to its property, plant and equipment. The entity applies the same measurement basis and depreciation pace to the assets within its regulatory capital base and to its property, plant and equipment. The entity determines that there is a direct relationship between its regulatory capital base and its property, plant and equipment.

⁶ Monetary amounts are denominated in ‘currency units’ (CU).

⁷ For simplicity, this example ignores the effect of the time value of money.

Exploring approaches to addressing the problem—*continued*

- Considering the IASB’s tentative decision in slide 4, Table 1A shows the entity’s statement of financial performance and statement of financial position for years 1–6:

Table 1A—Applying the IASB's tentative decision to Example A (Regulatory returns are included in regulated rates during the operation period)							<i>In CU</i>
Statement of financial performance	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	TOTAL
Revenue (*)	—	216	216	216	216	216	1,080
Regulatory income / (regulatory expense)	80	(16)	(16)	(16)	(16)	(16)	—
Depreciation expense	—	(207)	(207)	(207)	(207)	(207)	(1,035)
Profit/(loss)	80	(7)	(7)	(7)	(7)	(7)	45
Statement of financial position	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	
Property, plant and equipment	1,035	828	621	414	207	—	
Regulatory asset	80	64	48	32	16	—	
Cash	(1,035)	(819)	(603)	(387)	(171)	45	
Net assets	80	73	66	59	52	45	

(*): Revenue for years 2–6 only includes the amount that recovers the depreciation expense of the asset excluding the capitalised borrowing costs (CU1,000 or CU200 yearly) and the regulatory returns accumulated during the construction period (CU80 or CU16 yearly).

- This example shows that the regulatory returns that compensate the entity for borrowing costs (CU35) are recognised as part of regulatory income in profit or loss in year 1. However, because the borrowing costs are capitalised, they are only recognised as an expense in profit or loss as the property, plant and equipment is depreciated over years 2–6 (CU7 yearly). This arguably results in an accounting mismatch and front-loading of profit referred to above. It could also be argued that during the construction period the net asset position of the entity is overstated by CU35 and the overstated amount is only reversed over the operation period.

Exploring approaches to addressing the problem—*continued*

- As mentioned above, Example B is the same as Example A, except that the regulatory agreement allows the entity to include the regulatory returns in regulated rates during the construction period. We observed from feedback on the Exposure Draft that this example may not be common. In Example B, no differences in timing would arise from those regulatory returns (see Table 1 in slide 4). Considering the IASB’s tentative decision in slide 4, Table 1B shows the entity’s statement of financial performance and statement of financial position for years 1–6:

Statement of financial performance	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	TOTAL
Revenue (*)	80	200	200	200	200	200	1,080
Regulatory income / (regulatory expense)	—	—	—	—	—	—	—
Depreciation expense	—	(207)	(207)	(207)	(207)	(207)	(1,035)
Profit/(loss)	80	(7)	(7)	(7)	(7)	(7)	45
Statement of financial position	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	
Property, plant and equipment	1,035	828	621	414	207	—	
Regulatory asset / (regulatory liability)	—	—	—	—	—	—	
Cash	(955)	(755)	(555)	(355)	(155)	45	
Net assets	80	73	66	59	52	45	

(*): Revenue for year 1 only includes the regulatory returns (CU80) and revenue for years 2–6 only includes the amount that recovers depreciation expense of the asset excluding the capitalised borrowing costs (CU1,000 or CU200 yearly).

- This example shows that the regulatory returns that compensate the entity for borrowing costs (CU35) are recognised as part of revenue in profit or loss in year 1. However, because the borrowing costs are capitalised, they are only recognised as an expense in profit or loss as the property, plant and equipment is depreciated over years 2–6 (CU7 yearly). This arguably results in an accounting mismatch and front-loading of profit referred to above. It could also be argued that during the construction period the net asset position of the entity is overstated by CU35 and the overstated amount is only reversed over the operation period.

Exploring approaches to addressing the problem—*continued*

- This section analyses possible approaches for addressing the problem:
 - Approach 1—no further action (slide 12);
 - Approach 2—deferring the entire debt return (slides 13–14);
 - Approach 3—deferring part of regulatory returns equal to the capitalised borrowing costs (slides 15–17); and
 - Approach 4—prohibiting capitalisation of borrowing costs (slides 18–19).

Approach 1—no further action

- The IASB may conclude that no further action is required—that is, an entity’s capitalised borrowing costs should **not** affect the amount of regulatory returns reflected in profit or loss during the construction period. Tables 1A and 1B illustrate this approach when applied to Examples A and B.
- The **key arguments supporting Approach 1** are that this approach:
 - is aligned with the principle underlying the proposed model (slide 3) because the regulatory returns would be fully reflected during the period in which goods or services are being supplied—that is, the construction period.
 - would increase comparability of the information about regulatory returns across entities, regardless of entities’ financing capital structure, efficiency of debt financing (for example, whether the borrowing costs exceed the debt return) and accounting treatment of borrowing costs.
 - would not cause undue burden on entities. This approach would give rise to differences in timing—that is a regulatory asset—only in Example A. The regulatory asset is recovered when those regulatory returns are included in regulated rates charged, and hence included in revenue, during the operation of the asset. According to the fact pattern of Example A, the regulatory agreement already requires the entity to track what amount and when the accumulated regulatory returns are included in regulated rates in the future.
 - the staff has only identified a limited set of circumstances (slide 8) when the IASB’s tentative decision may not lead to useful information. Addressing this matter may add complexity to the final Standard, which may outweigh any benefits.
- The **key argument against Approach 1** is that this approach does not address the problem, that is, it could be viewed as giving rise to an accounting mismatch and front-loading of profit when there is a direct relationship between an entity’s regulatory capital base and its property, plant and equipment.

Approach 2—deferring the entire debt return

- The IASB may conclude that entities subject to the circumstances in Examples A and B should defer the entire debt return to the period over which the capitalised borrowing costs are reflected in profit or loss as part of the depreciation expense—that is, the operation period. Table 2 illustrates the effect of this approach considering Example A.⁸ When applying this approach:
 - during the construction period, an entity would reflect in profit or loss only equity return included in the regulatory returns. In this example, the entity would reflect a profit representing the equity return of CU50 (that is, 5% on CU1,000) in year 1.
 - during the operation period, the entity would reflect in profit or loss the difference between the debt return (3% on CU1,000 or CU6 yearly) and the capitalised borrowing costs expensed as part of the depreciation expense (3.5% on CU1,000 or CU7 yearly). In this example, the entity would reflect a net loss of CU1 in each of years 2–6.

Statement of financial performance	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	TOTAL
Revenue (*)	—	216	216	216	216	216	1,080
Regulatory income / (regulatory expense)	50	(10)	(10)	(10)	(10)	(10)	—
Depreciation expense	—	(207)	(207)	(207)	(207)	(207)	(1,035)
Profit/(loss)	50	(1)	(1)	(1)	(1)	(1)	45
Statement of financial position							
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	
Property, plant and equipment	1,035	828	621	414	207	—	
Regulatory asset	50	40	30	20	10	—	
Cash	(1,035)	(819)	(603)	(387)	(171)	45	
Net assets	50	49	48	47	46	45	

(*): Revenue for years 2–6 only includes the amount that recovers depreciation expense of the asset excluding the capitalised borrowing costs (CU1,000 or CU200 yearly) and the regulatory returns accumulated during the construction period (CU80 or CU16 yearly).

⁸ Approach 2 would result in the same profit/(loss) if applied to Example B.

Approach 2—deferring the entire debt return—*continued*

- The **key argument supporting Approach 2** is that this approach may achieve a reasonable cost-benefit balance. This approach would be easy for users of financial statements to understand and would be relatively straight forward for entities to implement. If the debt return is designed to provide compensation for the borrowing costs, it is unlikely that any variances between the debt return and an entity's borrowing costs would be so significant that the approach does not provide useful information during the operation of the assets. Therefore, this approach is likely to substantively address the problem (that is, an accounting mismatch and front-loading of profit) without adding significant complexity to the preparation and use of the information.
- The **key arguments against Approach 2** are that this approach:
 - treats the debt return and the equity return differently. Approach 2 treats the debt return as compensation that recovers the borrowing expense related to the construction of the asset—similar to amounts that recover allowable expenses in paragraphs B3–B8 of the Exposure Draft. Consequently, this approach would reflect the debt return as part of the total allowed compensation for goods or services supplied during the period in which the entity incurs the related expense—that is, when the asset is depreciated in the operation period. Approach 2 treats only the equity return as compensation for goods or services supplied during the construction period and, consequently, the approach reflects the equity return in profit or loss during that period. The different accounting treatment between the debt and the equity returns does not reflect an economic difference between these components of regulatory returns or a difference related to when goods or services are supplied in exchange for these components of regulatory returns.
 - does not fully address the problem. The entity would reflect in profit or loss the variance between the debt return and the capitalised borrowing costs that originated in the construction period (that is, total net loss of CU5 in Example A) over the operation period (net loss of CU1 yearly over years 2–6).
- We think Approach 2 would require additional tracking when the debt return is included in regulated rates during the construction period (Example B), however, the additional tracking may not give rise to significant operational difficulty. In such cases, regulatory liabilities would arise because an entity would need to defer the debt return it already recognised as part of revenue to the operation period. The fulfilment of regulatory liabilities over the operation period would require the entity to track the debt return on the regulatory capital base to the capitalised borrowing costs that are expensed to profit or loss as the individual assets are depreciated. If there is a direct relationship between the regulatory capital base and the property, plant and equipment, as it is the case in Example B, we expect that the entity would be able to obtain information to account for the fulfilment of regulatory liabilities in the same periods as the capitalised borrowing costs are reflected in profit or loss as part of the depreciation expense of individual assets.

Approach 3—deferring part of regulatory returns equal to the capitalised borrowing costs

- The IASB may conclude that entities subject to the circumstances in Examples A and B should defer part of the regulatory returns that equal the amount of capitalised borrowing costs to the operation period.
- Table 3 illustrates the effect of this approach considering Example A.⁹ When applying this approach:
 - during the construction period, an entity would reflect in profit or loss any equity return included in the regulatory returns and any difference between the debt return and the capitalised borrowing costs. In this example, the entity would reflect a profit of CU45 (that is, the equity return of CU50 (5% on CU1,000) less the difference of CU5 between the debt return of CU30 (3% on CU1,000) and the capitalised borrowing costs of CU35 (3.5% on CU1,000) in year 1.
 - during the operation period there will be no effect on profit or loss. This is because the entity would reflect CU35 (or CU7 yearly) for both the regulatory returns and the capitalised borrowing costs, which will be expensed as part of the depreciation expense over years 2–6.

Statement of financial performance	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	TOTAL
Revenue (*)	—	216	216	216	216	216	1,080
Regulatory income / (regulatory expense)	45	(9)	(9)	(9)	(9)	(9)	—
Depreciation expense	—	(207)	(207)	(207)	(207)	(207)	(1,035)
Profit/(loss)	45	—	—	—	—	—	45
Statement of financial position	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	
Property, plant and equipment	1,035	828	621	414	207	—	
Regulatory asset	45	36	27	18	9	—	
Cash	(1,035)	(819)	(603)	(387)	(171)	45	
Net assets	45	45	45	45	45	45	

(*): Revenue for years 2–6 only includes the amount that recovers depreciation expense of the asset excluding the capitalised borrowing costs (CU1,000 or CU200 yearly) and the regulatory returns accumulated during the construction period (CU80 or CU16 yearly).

⁹ Approach 3 would result in the same profit/(loss) if applied to Example B.

Approach 3—deferring part of regulatory returns equal to the capitalised borrowing costs—continued

- Approach 3 would be consistent with feedback received from a few stakeholders commenting on the Exposure Draft—mainly preparers in North America subject to schemes that allow regulatory returns to be included in regulated rates charged during the operation of the assets. These stakeholders said that during the construction period an entity should account for a regulatory asset only for the portion of regulatory returns in excess of the capitalised borrowing costs.
- Approach 3 would also result in a profit or loss profile similar to amending IAS 23 to require an entity that is entitled to regulatory returns and is subject to the circumstances in Examples A and B:
 - to capitalise, as part of the cost of an asset, the cost of capital that is calculated based on the full amount of the regulatory returns (that is, 8% on CU1,000 in Example A).¹⁰ In doing so, the entity accounts for the excess of the cost of capital capitalised (CU80) over the borrowing costs incurred (CU35) as a regulatory asset, which is reflected in profit or loss as regulatory income (CU45) during the construction period. During the operation period, the entity reflects in profit or loss the regulatory returns as revenue of CU80 (or CU16 yearly), the reversal of the regulatory asset as regulatory expense of CU45 (or CU9 yearly) and the capitalised cost of capital included in the depreciation expense as an expense of CU35 (or CU7 yearly).
 - not to capitalise but rather to expense borrowing costs incurred in the construction of an asset (Approach 4).
- The **key argument supporting Approach 3** is that this approach would address the problem as it would avoid reflecting regulatory returns during the construction period in a way that would result in an accounting mismatch and front-loading of profit. Hence, when entities are subject to the circumstances in Examples A and B, this approach would provide more useful information about regulatory returns than the IASB’s tentative decision.
- The **key argument against Approach 3** is that this approach results in information about regulatory returns that may be more difficult to understand and less comparable across entities.

¹⁰ A representative group of preparers in North America responding to the Exposure Draft suggested a similar approach.

Approach 3—deferring part of regulatory returns equal to the capitalised borrowing costs—*continued*

- We think Approach 3 may require additional tracking, depending on whether regulatory returns are included in regulated rates during:
 - the operation period of the assets (Example A)—in such cases, entities would account for regulatory assets related to regulatory returns in excess of the capitalised borrowing costs (that is, a regulatory asset of CU45 in Example A). The recovery of regulatory assets over the operation period may require entities to track when those amounts of regulatory returns in excess of the capitalised borrowing costs are included in regulated rates—and hence, included in revenue. Nevertheless, we understand that some entities—for example, entities in North America subject to regulatory approaches similar to Example A—already track the amounts of regulatory returns in excess of the capitalised borrowing costs. Therefore, entities may use existing systems and processes to determine that part of the regulatory returns that exceeds the capitalised borrowing costs.
 - the construction period (Example B)—in such cases, entities would account for regulatory liabilities the amount of capitalised borrowing costs incurred during the construction period. Those regulatory liabilities would be fulfilled in the same periods as the individual assets are depreciated. Similar to our analysis on Approach 2 (slide 14), entities would need to perform some tracking but the additional tracking may not give rise to significant operational difficulty. This is because we think entities may determine the fulfilment of regulatory liabilities related to the deferred regulatory returns using information about the capitalised borrowing costs included in the depreciation expense.

Approach 4—prohibiting capitalisation of borrowing costs

- The IASB may conclude that IAS 23 should be amended to prohibit entities that are entitled to regulatory returns and subject to the circumstances in Examples A and B from capitalising borrowing costs incurred in constructing an asset. This means that an entity would recognise those borrowing costs in profit or loss as it incurs those costs. Consequently, the entity would reflect both regulatory returns on an asset not yet available for use and the borrowing costs incurred in constructing that asset in profit or loss during the construction period.

Statement of financial performance	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	TOTAL
Revenue (*)	—	216	216	216	216	216	1,080
Regulatory income / (regulatory expense)	80	(16)	(16)	(16)	(16)	(16)	—
Depreciation expense	—	(200)	(200)	(200)	(200)	(200)	(1,000)
Borrowing expense	(35)	—	—	—	—	—	(35)
Profit/(loss)	45	—	—	—	—	—	45
Statement of financial position	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	
Property, plant and equipment	1,000	800	600	400	200	—	
Regulatory asset	80	64	48	32	16	—	
Cash	(1,035)	(819)	(603)	(387)	(171)	45	
Net assets	45	45	45	45	45	45	

(*): Revenue for years 2–6 only includes the amount that recovers depreciation expense of the asset excluding the capitalised borrowing costs (CU1,000 or CU200 yearly) and the regulatory returns accumulated during the construction period (CU80 or CU16 yearly).

Approach 4—prohibiting capitalisation of borrowing costs—*continued*

- The **key arguments supporting Approach 4** are that this approach:
 - does not introduce any modification to the amounts of regulatory returns that an entity should reflect during the construction period of an asset. Therefore, it has benefits similar to those of Approach 1 (slide 12).
 - is simple to apply. It does not create potential operational difficulties similar to those of applying Approach 2 (slide 14) and Approach 3 (slide 17).
- The **key arguments against Approach 4** are that this approach:
 - amends the requirements of another Accounting Standard. When the IASB developed IAS 23 it concluded borrowing costs should form part of the cost of an asset if those borrowing costs met specified conditions. This is the case regardless of whether the entity is regulated and if so, what features the regulatory scheme to which the entity is subject may have. This amendment could to some extent challenge that basis. In addition, amending IAS 23 is arguably at odds with an accounting model that aims to supplement information an entity already provides by applying other Accounting Standards.
 - would result in different accounting treatments of borrowing costs—and hence, the cost of an asset—between regulated entities that are entitled to regulatory returns and are subject to the circumstances in Examples A and B and other entities (including non-regulated entities). As mentioned above, when the IASB developed IAS 23, regardless of whether entities are regulated, the IASB concluded that borrowing costs should form part of the cost of the asset if those borrowing costs met specified conditions. Nevertheless, regulated entities that are subject to the circumstances in Examples A and B have rights and obligations that differ from those of other regulated and non-regulated entities. Therefore, this amendment may give users of financial statements information that would help them to understand better the differences among all these different types of entities.

Questions for the Consultative Group—Topic 2

2. This section discusses that the IASB's tentative decision may lead to an accounting mismatch and front-loading of profit (that is, the problem) when there is a direct relationship between an entity's regulatory capital base and its property, plant and equipment. In this case, we think the regulatory agreement would generally specify that the debt return provides compensation for the borrowing costs incurred in the construction of the asset.

Do you think a problem exists? If yes, should the final Standard address that problem?

3. This section presents four courses of action to address the problem.
- a) For each course of action:
- i. have we correctly analysed the arguments supporting or against that course of action?
 - ii. are there any other implementation issues that we should be aware of?
 - iii. are there any additional disclosures that would supplement the information provided by applying that course of action?
- b) Are there other potential courses of action that we should consider?
4. Are there other situations in which the IASB's tentative decision may lead to an accounting mismatch and front-loading of profit or any other problems that the IASB should consider and discuss?