

# Project Update

Accounting for Regulatory assets and Regulatory liabilities

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*RRA team*



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# PROJECT HISTORY





## IASB TENTATIVE DECISIONS

# ALLOWABLE EXPENSE AND BENCHMARK EXPENSES (1/2)

## Purpose

- To discuss stakeholders' concerns about the proposed definition of allowable expense and the treatment of allowable expenses based on benchmarks

## IASB tentative decisions

IASB tentatively decided that the final Standard:

- retain the proposed definition of allowable expense (i.e., paragraph B4 of the ED)
- clarify that a regulatory agreement may determine the amount that compensates an entity for an allowable expense using a basis different from the basis the entity uses to measure the expense in accordance with IFRS; and
- clarify the treatment of allowable expenses based on benchmarks and include examples to help entities identify differences in timing in those cases.

## ALLOWABLE EXPENSE AND BENCHMARK EXPENSES (2/2)

### EFRAG Comment Letter

- In some situations, the proposals related to allowable expenses will not reflect the economic substance of the regulatory agreement (e.g., recoverable costs are based on regulatory accounting and not IFRS expenses) and may result in regulatory assets and regulatory liabilities that are inconsistent with the IASB definitions of these terms
- EFRAG recommended the IASB to further analyse whether:
  - the proposals in the ED relating to allowable expenses can be applied across diverse regulatory regimes including those where costs are based on sectoral averages and where recoverable costs under the regulatory agreement are based on regulatory accounting and not IFRS expenses. And to thereafter clarify if and when these regulatory agreements are in scope
  - further analyse whether the Ed proposals can be applied across diverse regulatory regimes including those where costs are based on sectoral averages or where recoverable costs are based on regulatory agreement and not IFRS expenses

### Discussions at EFRAG FR TEG

- EFRAG FR TEG members supported the IASB's tentative decision on allowable expense and benchmark expenses
- The IASB tentative decision would address the concerns included in the EFRAG Final Comment letter, without restricting the scope of the final Standard

## DIFFERENCES IN REGULATORY RECOVERY PACE AND ASSETS' USEFUL LIVES (1/3)

### Purpose

- To discuss stakeholders' concerns about the proposed treatment of regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives

### IASB tentative decisions

The IASB tentatively decided that the Standard will:

- provide guidance to help an entity determine whether its regulatory capital base and its property, plant and equipment have a direct relationship;
- require an entity to account for regulatory assets or regulatory liabilities arising from differences between the regulatory recovery period and the assets' useful lives if the entity has concluded that there is a direct relationship between its regulatory capital base and its property, plant and equipment; and
- require an entity that has concluded that its regulatory capital base and its property, plant and equipment have no direct relationship to provide disclosures to enable users of financial statements to understand the reasons for its conclusion



## DIFFERENCES IN REGULATORY RECOVERY PACE AND ASSETS' USEFUL LIVES (2/3)

### EFRAG Comment Letter

- Some of EFRAG's stakeholders disagreed with the recognition of regulatory assets and regulatory liabilities that arise from differences in shorter or longer recovery periods than the estimated useful economic life of the asset. These stakeholders noted that:
  - Such differences do not give rise to regulatory assets and regulatory liabilities as defined in the ED. Rather these regulatory assets and regulatory liabilities are the result of a 'matching concept' and ignore the economic reality of regulatory agreements that allow for the recovery of asset costs over a different period than the useful economic life under IFRS
  - Such regulatory assets and regulatory liabilities would not meet the definitions in the ED

## DIFFERENCES IN REGULATORY RECOVERY PACE AND ASSETS' USEFUL LIVES (2/3)

### Discussions at EFRAG FR TEG

- EFRAG FR TEG members supported the IASB's tentative decision to find a solution to the concerns noted
- One member highlighted that there would be significant judgement involved to identify a direct (no direct) relationship between the regulatory capital base and the IFRS property, plant and equipment (PPE)
- Members asked whether in incentive-based regulatory regimes where there is no direct relationship, there would be any regulatory assets and regulatory liabilities to recognise. Many of the differences in timing that arose from differences between the regulatory capital base and the IFRS PPE would not result in recognition of regulatory assets and regulatory liabilities if there was no direct relationship. For such cases the IASB was considering disclosure requirements
- Members considered that it would be important to test the application of direct (no direct) relationship as this was a new concept (not included in the ED) that would have a significant impact on the outcome of the RRA accounting model.

## CAPITALISED BORROWING COSTS (1/2)

### Purpose

- To discuss stakeholders' concerns about the accounting for regulatory returns on an asset not yet available for use when an entity capitalises borrowing costs to construct that asset

### IASB tentative decisions (November 2022)

The IASB 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.

## CAPITALISED BORROWING COSTS (2/2)

### EFRAG Comment Letter

- EFRAG disagreed with the proposal under paragraph B15 of the ED to defer the inclusion in total allowed compensation of the regulatory returns related to construction work in progress that have been charged to customers during construction (i.e., deferral of these regulatory returns to when the asset is in use).
- EFRAG indicated that the proposed requirement was not appropriate for the diverse regulatory regimes across jurisdictions and where in some instances, the return could be equivalent to an investment subsidy or compensation for building infrastructure.

### Discussions at EFRAG FR TEG (April 2023)

- EFRAG FR TEG considered the comments from RRAWG members (meeting held on 27 February 2023) whereby mixed views were expressed on the IASB's tentative decision with a few members preferring no action being done while one agreed to address the accounting mismatch. Those who favoured no action provided reasons including 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.
- Subject to the results of the IASB's survey to preparers on the direct/no direct concept, EFRAG FR TEG was supportive of additional outreach to EU preparers by EFRAG to understand the prevalence of situations whereby an entity includes regulatory returns when charging the customer during the construction of the asset whilst capitalising borrowing costs.
- Several EFRAG FR TEG members supported the IASB decision not to amend IAS 23 (allow a scope exception) in order to resolve the accounting mismatch problem.

# INFLATION ADJUSTMENTS TO THE REGULATORY CAPITAL BASE (1/2)

## Purpose

- To discuss stakeholders' concerns about inflation adjustments to an entity's regulatory capital base

## IASB tentative decisions (December 2022)

The IASB tentatively decided that the final Accounting Standard specify that an entity is neither required nor permitted to recognise as a regulatory asset, inflation adjustments to the regulatory capital base.

# INFLATION ADJUSTMENTS TO THE REGULATORY CAPITAL BASE (2/2)

## EFRAG Comment Letter

- EFRAG did not have a comment on this specific aspect.

## Discussions at EFRAG FR TEG (April 2023)

- EFRAG FR TEG considered comments from EFRAG RRAWG members (meeting held on 27 February 2023) whereby members were, in general, in agreement with the IASB's tentative decision not to recognise a regulatory asset for inflation adjustments to the regulatory capital base. One EFRAG RRAWG member did not agree with the IASB's tentative decisions indicating that he was not convinced by the argument that it will be too costly to track inflation adjustments.
- There were no comments from EFRAG FR TEG members.

## QUESTION TO EFRAG FRB

1. Does EFRAG FRB agree with the IASB tentative decisions on:
  - a) allowable expense and benchmark expenses
  - b) differences in regulatory recovery pace and assets' useful lives
  - c) capitalised borrowing costs
  - d) inflation adjustments to the regulatory capital base

Please explain.



## APPENDIX - CAPITALISED BORROWING COSTS



## CAPITALISED BORROWING COSTS (1/2)

### Issue

- When an entity capitalises the borrowing costs incurred during the construction of an asset, there is an accounting mismatch and, in certain circumstances, it results in the front-loading of profit during the construction period when applying the July 2022 IASB tentative decisions\*.

### Illustrative example illustrating the issue

- Assumptions:
  - The example relates to returns included in regulated rates charged during operation;
  - 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.
  - 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.
  - the entity incurs borrowing costs of CU35 in constructing the asset during year 1 and, applying IAS 23, capitalises those costs.

\* 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.

## CAPITALISED BORROWING COSTS (2/2)

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

- 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, applying the July IASB’s tentative decision, 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 (that is, there is “double counting” of the debt component, in PPE under IAS 23 and under the regulatory asset).

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